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HEALTH CARE ORGANIZATIONS With Conforming Changes as of May 1, 2004

AICPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA Audit and Accounting Guide

HEALTH CARE ORGANIZATIONS

With Conforming Changes
as of May 1, 2004

AICPA

AICPA Audit and Accounting Guide

HEALTH CARE ORGANIZATIONS

With Conforming Changes as of May 1, 2004

This edition of the AICPA Audit and Accounting Guide *Health Care Organizations,* which was originally issued in 1996, has been modified by the AICPA staff to include certain changes necessary because of the issuance of authoritative pronouncements since the Guide was originally issued (see page v). The changes made in the current year are identified in a schedule in Appendix H of the Guide. The changes do *not* include all those that might be considered necessary if the Guide were subjected to a comprehensive review and revision.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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NOTICE TO READERS

This AICPA Audit and Accounting Guide has been prepared by the AICPA Health Care Committee to assist preparers of financial statements in preparing financial statements in conformity with generally accepted accounting principles and to assist auditors in auditing and reporting on such financial statements in accordance with generally accepted auditing standards.

Descriptions of accounting principles and financial reporting practices in Audit and Accounting Guides are approved by the affirmative vote of at least two-thirds of the members of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the AICPA in the areas of financial accounting and reporting. SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Audit and Accounting Guides that have been cleared by the Financial Accounting Standards Board (for financial statements of entities other than governmental entities) or Governmental Accounting Standards Board (for financial statements of Governmental entities) as sources of accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. This Audit and Accounting Guide has been cleared by the Financial Accounting Standards Board and the Governmental Accounting Standards Board. AICPA members should consider the accounting principles described in this Audit and Accounting Guide if the accounting treatment of a transaction or event is not specified by a pronouncement covered by rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatments specified by this Audit and Accounting Guide should be used, or the member should be prepared to justify another treatment, as discussed in paragraph 7 of SAS No. 69.

This AICPA Audit and Accounting Guide, which contains auditing guidance, is an interpretive publication pursuant to SAS No. 95, *Generally Accepted Auditing Standards*. Interpretive publications are recommendations on the application of SASs in specific circumstances, including engagements for entities in specialized industries. Interpretive publications are issued under the authority of the Auditing Standards Board. The members of the Auditing Standards Board have found this Guide to be consistent with existing SASs.

The auditor should be aware of and consider interpretive publications applicable to his or her audit. If the auditor does not apply the auditing guidance included in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance.

Public Accounting Firms Registered With the PCAOB

Subject to the Securities and Exchange Commission (SEC) oversight, Section 103 of the Sarbanes-Oxley Act (Act) authorizes the Public Company Accounting Oversight Board (PCAOB) to establish auditing and related attestation, quality control, ethics, and independence standards to be used by registered public accounting firms in the preparation and issuance of audit reports as required by the Act or the rules of the SEC. Accordingly, public accounting firms registered with the PCAOB are required to adhere to all PCAOB standards in the audits of issuers, as defined by the Act, and other entities when prescribed by the rules of the SEC.

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Donald A. Westermann
Robert A. Wright

Health Care Audit Guide Task Force

William E. Fingland, Jr., *Chair*
Kelly Barnes
Terry Duis
Martha Garner

AICPA Staff

Maryann Kasica
Technical Manager
Accounting and Auditing Publications

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The committee and staff also gratefully acknowledge the contributions made to the development, content, and writing of this Audit and Accounting Guide by Maribess L. Miller, former Committee Chair, Larry G. Grinstead, and Robert D. Beard.

This edition of the Audit and Accounting Guide *Health Care Organizations*, has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative pronouncements since the Guide was originally issued. This Guide reflects relevant guidance contained in authoritative pronouncements through May 1, 2004:

- FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, and Revised FASB Statements issued through May 1, 2004, including FASB Statement No. 132 (revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits*
- FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*
- FASB Technical Bulletin 01-1, *Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets*
- FASB Staff Positions issued through May 1, 2004
- FASB Emerging Issues Task Force (EITF) consensus positions adopted at meetings of the EITF held through March 2004
- GASB Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*
- GASB Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements*
- GASB Technical Bulletin 03-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets*
- SOP 03-5, *Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide* Audits of Investment Companies
- Practice Bulletin No. 15, *Accounting by the Issuer of Surplus Notes*
- SAS No. 101, *Auditing Fair Value Measurements and Disclosures*
- PCAOB Auditing Standards approved by the SEC through Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board* (approved by the SEC May 14, 2004)

Users of this Guide should consider pronouncements issued subsequent to those listed above to determine their effect on entities covered by this Guide.

The changes made for the current year are identified in a schedule in appendix H of the Guide. The changes do not include all those that might be considered necessary if the Guide were subjected to a comprehensive review and revision.

This edition includes Statement of Position 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising* (Appendix C), Statement of Position 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* (Appendix D), and Statement of Position 00-1, *Auditing Health Care Third-Party Revenues and Related Receivables* (Appendix E), and Statement of Position 02-2, *Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator* (Appendix F). In using this Guide, readers should refer to the material in these Statements of Position.

Preface

Purpose

This Guide has been prepared to assist providers of health care services in preparing financial statements in conformity with generally accepted accounting principles (GAAP) and to assist independent auditors[1] in auditing and reporting on those financial statements.

Applicability

This Guide applies to health care organizations that are either (*a*) investor-owned businesses or (*b*) not-for-profit enterprises that have no ownership interest and are essentially self-sustaining from fees charged for goods and services, as defined in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, paragraph 8,[2] or (c) governmental. This Guide applies to organizations whose principal operations consist of providing or agreeing to provide health care services and that derive all or almost all of their revenues from the sale of goods or services; it also applies to organizations whose primary activities are the planning, organization, and oversight of such organizations, such as parent or holding companies of health care providers.

This Guide applies to the following types of health care organizations:

- Clinics, medical group practices, individual practice associations, individual practitioners, emergency care facilities, laboratories, surgery centers, and other ambulatory care organizations
- Continuing care retirement communities (CCRCs)
- Health maintenance organizations (HMOs) and similar prepaid health care plans
- Home health agencies
- Hospitals
- Nursing homes that provide skilled, intermediate, and less intensive levels of health care
- Drug and alcohol rehabilitation centers and other rehabilitation facilities

This Guide also applies to integrated delivery systems that include one or more of the above types of organizations.

This Guide does not apply to voluntary health and welfare organizations, as defined in FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*. These organizations should follow the American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide *Not-for-Profit Organizations*. Related fund-raising foundations that meet the definition of a *not-for-profit organization* given in FASB Statement No. 117 also should follow the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.

When separate financial statements are issued for a state or local governmental health care organization that uses enterprise fund accounting and reporting,

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[1] A member performing an attest engagement must be independent pursuant to Rule 101 of the AICPA *Code of Professional Conduct*. Other applicable independence rules/regulations may also apply to members and accountants while performing attest engagements (e.g. Securities and Exchange Commission (SEC), Public Company Accounting Oversight Board (PCAOB), Government Accountability Office (GAO), state licensing boards, etc.).

[2] See paragraph 1.03 of this Guide.

the accounting, reporting, and disclosure requirements set forth in this Guide and by pronouncements of the Governmental Accounting Standards Board (GASB) apply. (See chapter 1 for a discussion of the application of GAAP.) GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, replaces the previous definition with a new definition of enterprise funds. Based on paragraph 67 of GASB Statement No. 34, as amended, any activity that charges a fee to external users for goods or services *may be* reported as an enterprise fund. In addition, paragraph 67 *requires* governments to report activities in enterprise funds if any one of the following three criteria, as summarized below, is met:

(*a*) The activity is financed with debt that is secured solely by a pledge of the net revenues from fees and charges of the activity.

(*b*) Laws or regulations require the activity's costs of providing services, including capital costs, to be recovered with fees and charges rather than with taxes or similar revenues.

(*c*) The pricing policies of the activity establish fees and charges that are designed to recover the activity's costs of providing services, including capital costs.

The primary focus of these criteria is on fees charged to external users. Also, paragraph 67 of GASB Statement No. 34 requires that these criteria should be applied in the context of the activity's principal revenue sources.

This Guide is not the only industry-specific AICPA Audit and Accounting Guide that auditors should consider when performing an audit of a governmental health care entity. The Audit and Accounting Guide *State and Local Governments,* includes governmental health care entities in its scope and was cleared by the GASB. Therefore, certain accounting and financial reporting guidance in that Guide constitutes category (*b*) guidance for governmental health care entities, and the auditing guidance in that Guide should also be considered during an audit of a governmental health care entity that is included in the scope of this Guide. In practice, auditors of governmental health care entities that issue separate financial statements using enterprise fund accounting and reporting may use this Guide as the primary source of guidance because this Guide addresses transactions that are unique to or prevalent in the health care industry. The Audit and Accounting Guide *State and Local Governments*, however, contains information about governmental accounting and financial reporting standards and other matters that are unique to or prevalent in government and not included in this Guide.[3]

Many governmental health care entities are considered to be special-purpose governments as defined in GASB Statement No. 34, paragraph 134.[4] Special-purpose governments are legally separate entities, as that term is described in paragraph 15 of GASB Statement No. 14, *The Financial Reporting Entity*. They

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[3] See paragraphs 1.21 and 12.11 through 12.13 in the Audit and Accounting Guide *State and Local Governments.*

[4] GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, does not provide guidance on separate reporting by individual enterprise funds of a government. Although this discussion of the guidance in GASB Statement No. 34 is written in terms of special-purpose business-type activities that are governmental health care entities, the accounting, financial reporting, and auditing considerations are usually equally applicable when the health care activity is conducted as a function or program of a general-purpose government and reported in an enterprise fund. See footnote 7 to the section heading "Specific Guidance for Special-Purpose Governments" in Chapter 12 of the Audit and Accounting Guide *State and Local Governments*. Reporting guidance on separate reporting by individual enterprise funds of a government is provided in the Audit and Accounting Guide *State and Local Governments.*

may be component units of another governmental entity or they may be other stand-alone governments. (Both terms *component units* and *other stand-alone governments* are also defined by GASB Statement No. 14) Because GASB Statement No. 34 is written from the perspective of general-purpose governments, paragraph 138 of GASB Statement No. 34 discusses how those requirements apply to special-purpose governments engaged only in business-type activities, such as certain governmental health care entities. Governmental health care entities that are special-purpose governments engaged only in business-type activities should present only the financial statements required for enterprise funds. These financial statements are discussed further in paragraph 1.13 of this Guide.

Limitations

This Guide does not discuss the application of all GAAP and all generally accepted auditing standards (GAAS) that are relevant to the preparation and audit of financial statements of health care organizations. The Guide is directed primarily to those aspects of the preparation and audit of health care organizations' financial statements that may be unique to those organizations or areas considered particularly significant to them.

Other Literature

This Guide incorporates certain provisions of FASB Statements No. 116, *Accounting for Contributions Received and Contributions Made*, No. 117, No. 124, *Accounting for Certain Investments Held by a Not-for-Profit Organizations*, No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, as amended, and GASB Statement No. 34 and related pronouncements. Not all guidance included in those Statements, however, is incorporated, repeated, or summarized in this Guide. Accordingly, those Statements, and all authoritative guidance,[5] should be read in conjunction with this Guide.

This Guide supersedes the AICPA Audit and Accounting Guide *Audits of Providers of Health Care Services*. This Guide also incorporates and supersedes AICPA Statements of Position (SOP) 89-5, *Financial Accounting and Reporting by Providers of Prepaid Health Care Services*, 90-8, *Financial Accounting and Reporting by Continuing Care Retirement Communities*, and 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations.*

Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, sets forth audit requirements for health care organizations expending federal awards. Institutions covered by OMB Circular A-133 include not-for-profit hospitals, public hospitals and institutions of higher education, and their affiliated hospitals, voluntary

[5] Other professional literature and authoritative guidance includes statements issued by the AICPA Accounting Standards Executive Committee (AcSEC) and the FASB—including its Emerging Issues Task Force (EITF). Authoritative literature for governmental health care entities includes GASB pronouncements, FASB and AICPA pronouncements specifically made applicable to state and local governmental entities by the GASB, and AICPA Audit and Accounting Guides, Industry Audit Guides, Statements of Position, and Practice Bulletins made applicable to governmental entities and cleared by the GASB.

health and welfare organizations and other community-based organizations.[6] Auditors of health care organizations that are subject to the audit requirements of OMB Circular A-133 should refer to the Audit Guide Government Auditing Standards *and Circular A-133 Audits.*

Effective Date and Transition

The provisions of this Guide, other than those included in paragraphs 1.40 through 1.51, which are discussed below, are effective for financial statements for periods beginning after June 15, 1996.[7] Earlier application is permitted.

The provisions included in paragraphs 1.40 through 1.51 are effective for financial statements issued for fiscal years beginning after December 15, 1994, except for organizations with less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date is fiscal years beginning after December 15, 1995. Earlier application is permitted.

Unless the provisions of this Guide, other than those included in paragraphs 1.40 through 1.51, are applied retroactively under the provisions of the following paragraph, the effect of initially applying this Guide shall be reported as the effect of a change in accounting principle, in a manner similar to the cumulative effect of a change in accounting principle (Accounting Principles Board [APB] Opinion No. 20, *Accounting Changes*, paragraph 19). The amount of the cumulative effect should be based on a retroactive computation. A not-for-profit organization should report the cumulative effect of a change in accounting on each class of net assets in the statement of activities between the captions *extraordinary items*, if any, and *change in unrestricted net assets, change in temporarily restricted net assets*, and *change in permanently restricted net assets*. The cumulative effect on temporary and permanently restricted net assets should be reflected in the statement of changes in net assets. An investor-owned business should report the amount of the cumulative effect in the income statement between the captions *extraordinary items* and *net income* (APB Opinion No. 20, paragraph 20).

This Guide, other than the guidance in paragraphs 1.40 through 1.51, may be applied retroactively by restating the opening net assets for the earliest year presented or for the year this Guide is first applied if no prior years are presented. In the period in which this Guide is first applied, that organization should disclose the nature of any restatement and its effect on the change in net assets for each period presented. An investor-owned business should account for any restatement as a change in accounting principle applied retroactively (APB Opinion No. 20, paragraphs 27 and 28).

In implementing the guidance in paragraphs 1.40 through 1.51, which incorporates the provisions of SOP 94-2 into this Guide, the transition rules of the APB Opinions and FASB Statements adopted, other than their effective dates, should be followed. However, if there is more than one change in accounting principle as a result of applying the guidance in paragraphs 1.40 through 1.51, organizations have the option of including the cumulative effect of adopting

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[6] The Codification of Office of Management and Budget (OMB) Circular A-133 by the U.S. Department of Health and Human Services (HHS) also includes audit requirements for commercial organizations (including for-profit hospitals) that receive federal awards under HHS programs. Generally, the organization has two options regarding audits: (1) a financial-related audit of a particular award in accordance with *Government Auditing Standards*, or (2) an audit that meets the requirements of OMB Circular A-133. See title 45 of the Code of Federal Regulations section 74.26(*d*) for further information.

[7] This Guide does not defer the effective date of any pronouncements that cover not-for-profit organizations.

those accounting principles in the statement of activity or similar statement in the year this Guide is adopted, regardless of the transition rules of the APB Opinions and FASB Statements adopted,[8] and the financial statements should disclose the nature of the cumulative adjustment. (Paragraphs 19 and 20 of APB Opinion No. 20 discuss reporting the cumulative effects of changes in accounting principles.) In circumstances in which there is more than one change in accounting principle resulting from applying this Guide and the cumulative effect of adopting those accounting principles is included in the statement of activity or similar statement in the year the guidance in paragraphs 1.40 through 1.51 is adopted, this Guide does not require the pro forma disclosures required by paragraphs 19(d) and 21 of APB Opinion No. 20.

Substantial Changes to Audit Process Proposed

(Note: This discussion is not applicable to public accounting firms registered with the Public Company Accounting Oversight Board and their associated persons in connection with their audits of issuers as defined by the Sarbanes-Oxley Act, and other entities when prescribed by the rules of the Securities and Exchange Commission.)

In December 2002, the AICPA's Auditing Standards Board (ASB) issued an exposure draft proposing seven new Statements on Auditing Standards (SASs) relating to the auditor's risk assessment process. The ASB believes that the requirements and guidance provided in the proposed SASs, if adopted, would result in a substantial change in audit practice and in more effective audits. The primary objective of the proposed SASs is to enhance auditors' application of the audit risk model in practice by requiring:

- More in-depth understanding of the entity and its environment, including its internal control, to identify the risks of material misstatement in the financial statements and what the entity is doing to mitigate them.
- More rigorous assessment of the risks of material misstatement of the financial statements based on that understanding.
- Improved linkage between the assessed risks and the nature, timing and extent of audit procedures performed in response to those risks.

The exposure draft consists of the following proposed SASs:

- *Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards
- *Audit Evidence*
- *Audit Risk and Materiality in Conducting an Audit*
- *Planning and Supervision*
- *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- *Amendment to Statement on Auditing Standards No. 39,* Audit Sampling

[8] Organizations that adopt the guidance in paragraphs 1.40 through 1.51 of this Guide in the same year in which they adopt FASB Statement No. 116 are permitted to apply the provisions of paragraph 17 of that Statement, concerning recognition of expirations of restrictions, prospectively, as specified in that Statement, regardless of whether they report the cumulative effect of adopting other accounting principles as a result of applying the guidance in paragraphs 1.40 through 1.51 of this Guide.

The proposed SASs establish standards and provide guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. Additionally, the proposed SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial statements under audit.

Readers can access the proposed standards at AICPA Online (www.aicpa.org) and should be alert to future progress on this project.

Applicability of Requirements of the Sarbanes-Oxley Act of 2002, Related Securities and Exchange Commission Regulations, and Standards of the Public Company Accounting Oversight Board

Publicly-held companies and other "issuers" (see definition below) are subject to the provisions of the Sarbanes-Oxley Act of 2002 (Act) and related Securities and Exchange Commission (SEC) regulations implementing the Act. Their outside auditors are also subject to the provisions of the Act and to the rules and standards issued by the Public Company Accounting Oversight Board (PCAOB).

Presented below is a summary of certain key areas addressed by the Act, the SEC, and the PCAOB that are particularly relevant to the preparation and issuance of an issuer's financial statements and the preparation and issuance of an audit report on those financial statements. However, the provisions of the Act, the regulations of the SEC, and the rules and standards of the PCAOB are numerous and are not all addressed in this section or in this Guide. Issuers and their auditors should understand the provisions of the Act, the SEC regulations implementing the Act, and the rules and standards of the PCAOB, as applicable to their circumstances.

Definition of an Issuer

The Act states that the term "issuer" means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)), the securities of which are registered under section 12 of that Act (15 U.S.C. 78l), or that is required to file reports under section 15(d) (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn.

Issuers, as defined by the Act, and other entities when prescribed by the rules of the SEC (collectively referred to in this Guide as "issuers" or "issuer") and their public accounting firms (who must be registered with the PCAOB) are subject to the provisions of the Act, implementing SEC regulations, and the rules and standards of the PCAOB, as appropriate.

Non-issuers are those entities not subject to the Act or the rules of the SEC.

Guidance for Issuers

Management Assessment of Internal Control

As directed by Section 404 of the Act, the SEC adopted final rules requiring companies subject to the reporting requirements of the Securities Exchange Act of 1934, other than registered investment companies and certain other

entities (e.g., 11-K filers), to include in their annual reports a report of management on the company's internal control over financial reporting. See the SEC Web site at www.sec.gov/rules/final/33-8238.htm for the full text of the regulation.

The SEC rules clarify that management's assessment and report is limited to *internal control over financial reporting*. The SEC's definition of internal control encompasses the Committee of Sponsoring Organizations of the Treadway Commission (COSO) definition but the SEC does not mandate that the entity use COSO as its criteria for judging effectiveness.

Under the SEC rules, the company's annual 10-K must include:

1. Management's Annual Report on Internal Control Over Financial Reporting
2. Attestation Report of the Registered Public Accounting Firm
3. Changes in Internal Control Over Financial Reporting

The SEC rules also require management to evaluate any change in the entity's internal control that occurred during a fiscal quarter and that has materially affected, or is reasonably likely to materially affect, the entity's internal control over financial reporting.

Audit Committees and Corporate Governance

Section 301 of the Act establishes requirements related to the makeup and the responsibilities of an issuer's audit committee. Among those requirements—

- Each member of the audit committee must be a member of the board of directors of the issuer, and otherwise be independent.
- The audit committee of an issuer is directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer.
- The audit committee shall establish procedures for the "receipt, retention, and treatment of complaints" received by the issuer regarding accounting, internal controls, and auditing.

In April 2003, the SEC adopted a rule to direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements mandated by the Act.

Disclosure of Audit Committee Financial Expert and Code of Ethics

In January 2003, the SEC adopted amendments requiring issuers, other than registered investment companies, to include two new types of disclosures in their annual reports filed pursuant to the Securities Exchange Act of 1934. These amendments conform to Sections 406 and 407 of the Act and relate to disclosures concerning the audit committee's financial expert and code of ethics relating to the companies' officers. An amendment specifies that these disclosures are only required for annual reports.

Certification of Disclosure in an Issuer's Quarterly and Annual Reports

Section 302 of the Act requires the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) of each issuer to prepare a statement to accompany the audit report to certify the "appropriateness of the financial statements and

disclosures contained in the periodic report, and that those financial statements and disclosures fairly present, in all material respects, the operations and financial condition of the issuer."

In August 2002, the SEC adopted final rules for Certification of Disclosure in Companies' Quarterly and Annual Reports in response to Section 302 of the Act. CEOs and CFOs are now required to certify the financial and other information contained in quarterly and annual reports.

Improper Influence on Conduct of Audits

Section 303 of the Act makes it unlawful for any officer or director of an issuer to take any action to fraudulently influence, coerce, manipulate, or mislead any auditor engaged in the performance of an audit for the purpose of rendering the financial statements materially misleading. In April 2003, the SEC adopted rules implementing these provisions of the Act.

Disclosures in Periodic Reports

Section 401(a) of the Act requires that each financial report of an issuer that is required to be prepared in accordance with generally accepted accounting principles (GAAP) shall "reflect all material correcting adjustments . . . that have been identified by a registered accounting firm . . . ." In addition, "each annual and quarterly financial report . . . shall disclose all material off-balance sheet transactions" and "other relationships" with "unconsolidated entities" that may have a material current or future effect on the financial condition of the issuer.

In January 2003, the SEC adopted rules that require disclosure of material off-balance sheet transactions, arrangements, obligations, and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses. The rules require an issuer to provide an explanation of its off-balance sheet arrangements in a separately captioned subsection of the Management's Discussion and Analysis section of an issuer's disclosure documents.

Guidance for Auditors

The Act mandates a number of requirements concerning auditors of issuers, including mandatory registration with the PCAOB, the setting of auditing standards, inspections, investigations, disciplinary proceedings, prohibited activities, partner rotation, and reports to audit committees, among others. Auditors of issuers should familiarize themselves with applicable provisions of the Act and the standards of the PCAOB. The PCAOB continues to establish rules and standards implementing provisions of the Act concerning the auditors of issuers.

Applicability and Integration of Generally Accepted Auditing Standards and Public Company Accounting Oversight Board Standards

AICPA members who perform auditing and other related professional services have been required to comply with Statements on Auditing Standards (SASs) promulgated by the AICPA Auditing Standards Board (ASB). These standards constitute what is known as "generally accepted auditing standards"

(GAAS). In the past, the ASB's auditing standards have applied to audits of *all* entities. However, as a result of the passage of the Act, auditing and related professional practice standards to be used in the performance of and reporting on audits of the financial statements of issuers are now established by the PCAOB.

Specifically, the Act authorizes the PCAOB to establish auditing and related attestation, quality control, ethics, and independence standards to be used by registered public accounting firms in the preparation and issuance of audit reports for entities subject to the Act or the rules of the SEC. Accordingly, public accounting firms registered with the PCAOB are required to adhere to all PCAOB standards in the audits of "issuers," as defined by the Act, and other entities when prescribed by the rules of the SEC.

For those entities not subject to the Act or the rules of the SEC, the preparation and issuance of audit reports remain governed by GAAS as issued by the ASB.

Extensive Guidance Available in AICPA *Professional Standards*

The AICPA *Professional Standards* and *Codification of Auditing Standards* contains a thorough section that provides important information and guidance about:

- The applicability and integration of GAAS and PCAOB standards;
- Standards applicable to the audits of non-issuers;
- Standards applicable to the audits of issuers;
- The PCAOB's adoption of interim standards;
- Standards applicable if a non-issuer's financial statements are audited in accordance with PCAOB standards; and,
- Applicability of GAAS to audits of issuers

GAAS and PCAOB Standards Included in This Guide

As the ASB and the PCAOB move forward in establishing auditing standards for entities within their respective jurisdictions, this Guide will present both GAAS and PCAOB standards, as applicable depending on the auditing guidance presented in this Guide. Moreover, if differences between GAAS and PCAOB standards emerge, the auditing guidance in this Guide will integrate both sets of standards, as applicable, in order to offer practitioners a seamless source of auditing standards applicable to non-issuers and those applicable to issuers.

Major Existing Differences Between GAAS and PCAOB Standards

At the time of development of this Guide, the major differences between GAAS and final PCAOB Standards approved by the SEC are as follows:

- *Audit of Internal Control.* In connection with the requirement of Section 404(b) of the Sarbanes-Oxley Act that an issuer's independent auditor attest to and report on management's assessment of the effectiveness of internal control, PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*, establishes requirements and provides direction that apply when an auditor is engaged

to audit the internal control over financial reporting and to perform that audit in conjunction with the audit of an issuer's financial statements.

- *References in Auditor's Reports.* PCAOB Auditing Standard No. 1 requires registered public accounting firms to include in their reports on engagements performed pursuant to the PCAOB's auditing and related professional practice standards, including audits and reviews of financial statements, a reference to the standards of the Public Company Accounting Oversight Board (United States).
- *Concurring Partner*—PCAOB Rule 3400T requires the establishment of policies and procedures for a concurring review (generally the SECPS membership rule)[9]
- *Communication of Firm Policy*—PCAOB Rule 3400T requires registered firms to communicate through a written statement to all professional firm personnel the broad principles that influence the firm's quality control and operating policies and procedures on, at a minimum, matters that relate to the recommendation and approval of accounting principles, present and potential client relationships, and the types of services provided, and inform professional firm personnel periodically that compliance with those principles is mandatory (generally the SECPS membership rule).
- *Affiliated Firms*—PCAOB Rule 3400T requires registered firms that are part of an international association to seek adoption of policies and procedures by the international organization or individual foreign associated firms consistent with PCAOB Standards.
- *Partner Rotation*—PCAOB Rule 3600T requires compliance with the SEC's independence rules which include partner rotation.
- *Continuing Professional Education (CPE) Requirements*—PCAOB Rule 3400T requires registered accounting firms to ensure that all of their professionals participate in at least 20 hours of qualifying CPE every year (generally the SECPS membership rule).
- *Independence Matters*—PCAOB Rule 3600T requires compliance with the SEC's independence rules and Standards No. 1, 2 and 3, and Interpretations 99-1, 00-1, and 00-2 of the Independence Standards Board.

Proposed PCAOB Auditing Standards and Proposed Changes to the PCAOB Interim Auditing Standards

As of the publication of this Guide, certain PCAOB Standards and rules have been issued as final pronouncements, but are awaiting SEC approval. As such, these Standards and rules are not yet effective. In addition, the PCAOB has issued exposure drafts of proposed standards and rules. Presented below is a table presenting certain key PCAOB proposed standards and rules that are particularly relevant to the audit of financial statements and how they may significantly affect the audits of issuers.

Auditors of issuers should be alert to the final resolution of these matters. If these Standards are approved by the SEC, auditors of issuers will be required to comply with additional responsibilities and procedures. Furthermore, sections of the existing PCAOB interim auditing standards will be amended and superseded.

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[9] Firms that were not members of the AICPA's SECPS as of April 16, 2003 do not have to comply with this requirement.

PCAOB Standard or Exposure Draft	Status	Explanation and Affect on Existing PCAOB Standards	PCAOB Website Link
Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*	Issued as a final standard by the PCAOB; approved by the SEC	This standard establishes requirements and provides directions that apply when an auditor is engaged to audit both an issuer's financial statements and management's assessment of the effectiveness of internal control over financial reporting. This standard is the standard on attestation engagements referred to in Section 404(b) of the Act. Amendments to the PCAOB's Interim Standards as a result of the issuance of this standard are handled in the proposed auditing standard below.	www.pcaobus.org/rules/Release-20040308-1a.pdf
Proposed Auditing Standard, *Conforming Amendments to PCAOB Interim Standards Resulting From the Adoption of PCAOB Auditing Standard No. 2*	Issued as an exposure draft by the PCAOB	This standard proposes conforming amendments to the PCAOB interim auditing standards as a result of the issuance of PCAOB Auditing Standard No. 2. Sections of the PCAOB Interim Auditing Standards that would be affected include: AU sec. 310, *Appointment of the Independent Auditor*; AU sec. 311, *Planning and Supervision*; AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*; AU sec. 313, *Substantive Tests Prior to the Balance-Sheet Date*; AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*; AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*; AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*; AU sec. 324, *Service Organiztions*; AU sec. 325, *Communication of Internal Control Related Matters Noted in an Audit*; AU sec. 326, *Evidential Matter*; AU sec. 329, *Analytical Procedures*; AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*; AU sec. 333, *Management Representations*; AU sec. 339, *Audit Documentation*; AU sec. 342, *Auditing Accounting Estimates*; AU sec. 508, *Reports on Audited Financial Statements*; AU sec. 530, *Dating of the Independent Auditor's Report*; AU sec. 543, *Part of Audit Performed by Other Independent Auditors*; AU sec. 560, *Subsequent Events*; AU sec.	www.pcaobus.org/rules/Release-20040308-2.pdf

(continued)

PCAOB Standard or Exposure Draft	Status	Explanation and Affect on Existing PCAOB Standards	PCAOB Website Link
		561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*; AU sec. 711, *Filings Under Federal Securities Statutes*; AU sec. 722, *Interim Financial Information*; AT sec. 501, *Reporting on an Entity's Internal Control Over Financial Reporting*; ET sec. 101, *Independence*	
Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board*	Issued as a final standard by the PCAOB; approved by the SEC, May 14, 2004	This standard requires registered public accounting firms to include in their reports on engagements performed pursuant to the PCAOB's auditing and related professional practice standards, a reference to the standards of the PCAOB (United States).	www.pcaobus.org/rules/Release2003-025.pdf
Auditing Standard No. 3, *Audit Documentation*	Issued as a final standard by the PCAOB; approved by the SEC, August 25, 2004	This standard establishes general requirements for documentation the auditor should prepare and retain in connection with any engagement conducted in accordance with auditing and related professional practice standards of the PCAOB. This standard does not supplant specific documentation requirements of other PCAOB auditing and related professional practice standards. This standard would supersede AU sec. 339, *Audit Documentation*, and amend AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, of the PCAOB Interim Auditing Standards.	www.pcaobus.org/rules/Release2003-023.pdf

Auditor Reports to Audit Committees

Section 204 of the Act requires the accounting firm to report to the issuer's audit committee all "critical accounting policies and practices to be used . . . all alternative treatments of financial information within [GAAP] that have been discussed with management . . . ramifications of the use of such alternative disclosures and treatments, and the treatment preferred" by the firm.

Audit Documentation

Section 103 of the Act instructs the PCAOB to require registered public accounting firms to "prepare, and maintain for a period of not less than 7 years, audit work papers, and other information related to any audit report, in sufficient detail to support the conclusions reached in such report." The PCAOB has issued a proposed auditing standard (see the table above) that responds to this directive. Also, in January 2003, the SEC adopted rules to require accounting firms to retain for seven years certain records relevant to their audits and reviews of issuers' financial statements.

Other Requirements

The Act contains requirements in a number of other important areas, and the SEC has issued implementing regulations in certain of those areas as well. For example,

- The Act prohibits auditors from performing certain non-audit or non-attest services. The SEC adopted amendments to its existing requirements regarding auditor independence to enhance the independence of accountants that audit and review financial statements and prepare attestation reports filed with the SEC. This rule conforms the SEC's regulations to Section 208(a) of the Act and, importantly, addresses the performance of non-audit services.
- The Act requires the lead audit or coordinating partner and the reviewing partner to rotate off of the audit every 5 years. (See SEC Releases 33-8183 and 33-8183A for SEC implementing rules.)
- The Act directs the PCAOB to require a second partner review and approval of audit reports (concurring review).
- The Act states that an accounting firm will not be able to provide audit services to an issuer if one of that issuer's top officials (CEO, Controller, CFO, Chief Accounting Officer, etc.) was employed by the firm and worked on the issuer's audit during the previous year.

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Chapter 1

Unique Considerations of Health Care Organizations

Overview

1.01 Financial statements of health care organizations should be prepared in conformity with generally accepted accounting principles (GAAP). AICPA Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1, AU sec. 411), provides the GAAP hierarchy summary for both nongovernmental and governmental organizations.[1]

Classification of Health Care Organizations

1.02 Health care enterprises usually can be classified into the following categories on the basis of their operating characteristics:

a. *Investor-Owned Health Care Enterprises.* These are owned by investors or others with a private equity interest and provide goods or services with the objective of making a profit.

b. *Not-for-Profit, Business-Oriented Organizations.* These are characterized by no ownership interests and essentially are self-sustaining from fees charged for goods and services. The fees charged by such organizations generally are intended to help the organization maintain its self-sustaining status rather than to maximize profits for the owner's benefit. Such organizations often are exempt from federal income taxes and may receive contributions of relatively small amounts from resource providers that do not expect commensurate or proportionate pecuniary return.

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[1] GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, paragraphs 93 through 95, indefinitely extend the provisions of GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*. GASB Statement No. 20, paragraph 6, as amended, requires that proprietary funds should apply all applicable GASB pronouncements as well as any Financial Accounting Standards Board (FASB) Statements and Interpretations, Accounting Principles Board (APB) Opinions, and Accounting Research Bulletins (ARBs) issued on or before November 30, 1989, that do not conflict with or contradict GASB pronouncements. Furthermore, paragraph 7, as amended, of GASB Statement No. 20 provides that governmental enterprise funds and activities reported using enterprise fund accounting and financial reporting *may* apply all FASB Statements and Interpretations issued after November 30, 1989, that do not conflict with or contradict GASB pronouncements. Entities that choose to apply these "new" FASB pronouncements must apply them on an "all or none" basis (that is, they may not select which pronouncements to apply). In addition, GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, provides that governmental enterprise funds and activities reported using enterprise fund accounting and financial reporting that apply the provisions of paragraph 7, as amended, of GASB Statement No. 20 should apply only those FASB Statements and Interpretations issued after November 30, 1989 that are developed for business enterprises (see paragraph 1.53 in this Guide). They should not apply FASB Statements and Interpretations whose provisions are limited to not-for-profit organizations, such as FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, or address issues concerning primarily such organizations, such as FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*. The requirements set forth in this Guide for governmental health care enterprises generally apply to such enterprises that apply paragraph 7, as amended, of GASB Statement No. 20.

c. *Governmental Health Care Organizations.* These are public corporations[2] and bodies corporate and politic. Other organizations are governmental organizations if they have one or more of the following characteristics:
   - Popular election of officers or appointment (or approval) of a controlling majority of the members of the organization's governing body by officials of one or more state or local governments;
   - The potential for unilateral dissolution by a government with the net assets reverting to a government; or
   - The power to enact *and* enforce a tax levy.

   Furthermore, organizations are presumed to be governmental if they have the ability to issue directly (rather than through a state or municipal authority) debt that pays interest exempt from federal taxation. However, organizations possessing only that ability (to issue tax-exempt debt) and none of the other governmental characteristics may rebut the presumption that they are governmental if their determination is supported by compelling, relevant evidence.

d. *Not-for-Profit, Nonbusiness-Oriented Organizations.* These are voluntary health and welfare organizations (see the Glossary) as defined in FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations.* Such organizations are within the scope of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* rather than this Guide.

Financial Reporting of Nongovernmental Health Care Organizations

1.03 The nature of the organization and its operating structure have a significant effect on the needs of financial statement users. According to FASB Statement of Financial Accounting Concepts (Concepts Statement) No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, paragraph 8:

> Some organizations have no ownership interests but are essentially self-sustaining from fees they charge for goods and services. Examples are those private nonprofit hospitals . . . that may receive relatively small amounts of contributions and grants but finance their capital needs largely from the proceeds of debt issues and their operating needs largely from service charges rather than from private philanthropy or governmental grants. As a result, assessment of amounts, timing, and uncertainty of cash flows becomes the dominant interest of their creditors and other resource providers and profitability becomes an important indicator of performance. Consequently, the objectives of FASB Concepts Statement No. 1 [*Objectives of Financial Reporting by Business Enterprises*] may be more appropriate for those organizations. [*Footnote reference omitted.*]

1.04 The financial reporting for not-for-profit, business-oriented organizations and investor-owned health care enterprises generally is consistent

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[2] Black's Law Dictionary defines a public corporation as: An artificial person (e.g., [a] municipality or a governmental corporation) created for the administration of public affairs. Unlike a private corporation it has no protection against legislative acts altering or even repealing its charter. Instrumentalities created by [the] state, formed and owned by it in [the] public interest, supported in whole or part by public funds, and governed by managers deriving their authority from [the] state. Sharon Realty Co. v. Westlake, Ohio Com.Pl., 188 N.E.2d 318, 323, 25, O.O.2d 322. A public corporation is an instrumentality of the state, founded and owned in the public interest, supported by public funds and governed by those deriving their authority from the state. York County Fair Ass'n v. South Carolina Tax Commission, 249 S.C. 337, 154 S.E.2d 361, 362.

except for transactions that clearly are not applicable. For example, not-for-profit, business organizations would have nothing to report for shareholders' equity. On the other hand, investor-owned health care enterprises typically would not have anything to report for contributions.

1.05 The basic financial statements of health care organizations generally consist of a balance sheet, a statement of operations, a statement of changes in equity (or net assets), a statement of cash flows, and notes to the financial statements.[3] The statement of operations for not-for-profit organizations should report a performance indicator (see paragraph 10.19) as well as all other changes in unrestricted net assets for the period. The statement of operations may be combined with the statement of changes in equity (net assets). Illustrative financial statements are included in the Appendix A of this Guide.

1.06 FASB Statement No. 117 requires not-for-profit organizations to provide information about the liquidity of assets and liabilities in the balance sheet. Health care organizations should classify assets and liabilities as current and noncurrent. However, rather than presenting a classified balance sheet, a continuing care retirement community (CCRC) instead may sequence assets according to their nearness of conversion to cash and may sequence liabilities according to the nearness of the maturity and resulting use of cash.

1.07 FASB Statement No. 95, *Statement of Cash Flows*, established standards for cash flow reporting for investor-owned organizations. FASB Statement No. 95 was amended by FASB Statement No. 117 to include not-for-profit organizations. The statement of cash flows may be prepared using the direct or indirect method of reporting cash flows.

1.08 A health care organization may be a part of another organization, such as a medical school or a university, or a subsidiary of a corporation. The recommendations in this Guide apply to the separate financial statements of these organizations as defined above.

Financial Reporting of Governmental Health Care Organizations

1.09 This section of the Guide discusses the financial reporting requirements applicable to governmental health care entities within the scope of this Guide, including the financial reporting requirements of GASB Statement No. 34, as amended, and GASB Statement No. 38, *Certain Financial Statement Note Disclosures.*

1.10 A health care organization may be a part of another organization, such as a general-purpose-government or medical school or a university. The recommendations in this Guide apply to the separate financial statements of these organizations. Therefore, when separate financial statements are prepared for a governmental health care organization that uses enterprise fund accounting and reporting, the accounting and disclosure requirements set forth by GASB pronouncements and this Guide apply. The requirements in this Guide presume that governmental health care organizations apply paragraph 7 of GASB Statement No. 20 (see footnote 1 to this chapter).

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[3] The terms *balance sheet* and *statement of operations* indicate the content and purpose of the respective statements and serve as possible titles for those statements. Other appropriately descriptive titles may also be used. For example, a statement reporting financial position could be called a *statement of financial position* as well as a *balance sheet.* Current practice and purpose suggest, however, that a statement of cash flows only be titled "Statement of Cash Flows."

1.11 This Guide makes various references to implementation guides published by the GASB staff. Those implementation guides are category (*d*) guidance in the hierarchy of GAAP applicable to state and local governments, as discussed in SAS No. 69 and in paragraph 1.61 in this chapter. References to the guidance in GASB staff implementation guides in this Guide do not elevate that guidance to category (*b*) guidance. Similarly, references in this Guide to discussions or examples in the nonauthoritative appendixes of GASB pronouncements or its staff's implementation guides do not elevate that guidance from "other accounting literature."

GASB Statement No. 34 and Related Pronouncements

1.12 Briefly, GASB Statement No. 34 and related pronouncements require that the separately issued financial reports of governmental health care entities that are special-purpose governments engaged only in business-type activities:

- Present a management's discussion and analysis (MD&A) before the basic financial statements as required supplementary information (RSI).
- Present a classified statement of net assets/balance sheet.
- Report three categories of net assets—(*a*) net assets invested in capital assets net of related debt, (*b*) restricted net assets, and (*c*) unrestricted net assets.
- Apply the definition of *restricted* provided in GASB Statement No. 34 in determining restricted assets and restricted net assets.
- Present a statement of revenues, expenses, and changes in net assets/equity that reports on changes in net assets, including permanent endowments. The focus of this statement is to present all changes in net assets.
- Report transfers as *interfund transfers* after *nonoperating revenues and expenses*. Under GASB Statement No. 34, there is no distinction as to the type of transfer.
- Report revenues by major source and separately identify revenue used as security for revenue bonds.
- Distinguish between operating and nonoperating revenues and expenses and provide an intermediate total for operating income or loss.
- Separately report capital contributions and contributions to term and permanent endowments as components of the all-inclusive statement of revenues, expenses, and changes in net assets/equity.
- Separately report special items and extraordinary items at the bottom of the statement of revenues, expenses, and changes in net assets/equity.
- Report operating cash flows using the direct method in the statement of cash flows.
- Present certain note disclosures, including the entity's policy for defining operating revenues and expenses, policy regarding the use of restricted resources, schedules of changes in capital assets and long-term liabilities, disaggregated information about accounts receivable and payable, and short-term debt activity during the year. (Disclosure of disaggregated information about accounts receivable and payable is required by GASB Statement No. 38.)
- If the entity has segments, present segment information based on the definition of a segment in GASB Statement No. 34.

The requirements in this paragraph do not apply to health care units that are not legally separate entities.

1.13 GASB Statement No. 34 requires governmental health care entities that are special-purpose governments engaged only in business-type activities to present three basic financial statements, notes to the financial statements, and RSI:[4]

a. MD&A as RSI.

b. A statement of net assets or balance sheet.

c. A statement of revenues, expenses, and changes in net assets/equity.

d. A statement of cash flows.

e. Notes to financial statements.

f. RSI other than MD&A, as established by GAAP, such as GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers.*

Management's Discussion and Analysis

1.14 GASB Statement No. 34, paragraphs 8 through 11, as amended, establish eight required elements of MD&A for general-purpose governments. However, certain of those elements are not applicable to governmental health care entities that are special-purpose governments engaged only in business-type activities. These governmental health care entities should limit their discussion in MD&A to the elements that are applicable to their entity. Because it is RSI, no additional information should be presented within MD&A.

1.15 Many health care entities that are special-purpose governments engaged only in business-type activities present comparative financial statements. When comparative financial statements are presented, MD&A should present an analysis of both current- and prior-year net assets and changes in them, as discussed in the GASB staff document, *Comprehensive Implementation Guide—2003* (GASB Q&A 2003 Edition), item 7.14. (See paragraph 1.11 in this chapter regarding references in this Guide to discussions in GASB staff implementation guides.) Two completely separate MD&As are not required. When comparative financial statements are presented, the MD&A should present the current year, prior year, and preceding year financial information summarized in the MD&A, and discuss the fluctuations. If comparative financial data is presented, as distinguished from a complete set of comparative statements, notes, and RSI, the requirements for MD&A in paragraph 11 of GASB Statement No. 34 should be met for the current year with comparisons to the prior year, as discussed in the GASB Q&A—2003 Edition, item 7.15.

Measurement Focus and Basis of Accounting

1.16 GASB Statement No. 34, paragraph 92, requires activities reported using enterprise fund accounting and reporting to use the accrual basis of accounting and the economic resources measurement focus. GASB Statement No. 34,

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[4] GASB Statement No. 34 does not provide guidance on separate reporting by individual enterprise funds of a government. Although this discussion of the guidance in GASB Statement No. 34 is written in terms of special-purpose business-type activities that are governmental health care entities, the accounting, financial reporting, and auditing considerations are usually equally applicable when the health care activity is conducted as a function or program of a general-purpose government and reported in an enterprise fund. See footnote 7 to the section heading "Specific Guidance for Special-Purpose Governments" in Chapter 12 of the Audit and Accounting Guide *State and Local Governments*. Reporting guidance on separate reporting by individual enterprise funds of a government is provided in the Audit and Accounting Guide *State and Local Governments.*

paragraphs 93 through 95, indefinitely extend the provisions of GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting* (see footnote 1 to paragraph 1.01 in this chapter). GASB Statement No. 20, as amended, requires governmental health care entities that use enterprise fund accounting and reporting to apply all GASB pronouncements as well as FASB pronouncements issued on or before November 30, 1989 that do not conflict with or contradict GASB pronouncements. In addition, those entities may also apply all FASB Statements and Interpretations issued after November 30, 1989, except for those that conflict with or contradict GASB pronouncements. Only those FASB Statements and Interpretations issued after November 30, 1989 that are developed for business enterprises should be applied, as discussed in GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, paragraph 7, as amended. GASB Statement No. 34, paragraph 115, requires disclosure in the summary of significant accounting policies of the policy for applying FASB pronouncements issued after November 30, 1989, to business-type activities and to enterprise funds. The requirements in this Guide presume that governmental health care entities apply paragraph 7 of GASB Statement No. 20.

Statement of Net Assets or Balance Sheet

1.17 GASB Statement No. 34, paragraphs 97 through 99, provide guidance on the statement of net assets or balance sheet. Governmental health care entities that are special-purpose governments engaged only in business-type activities may use either a balance sheet format—assets equal liabilities plus net assets/equity—or a net assets format—assets less liabilities equal net assets/equity. Assets and liabilities are required to be presented in a classified format.[5]

1.18 Either term *net assets* or *equity* may be used to refer to the difference between assets and liabilities. Regardless of the label, net assets/equity is required to be reported in three broad components: (*a*) invested in capital assets, net of related debt; (*b*) restricted, and (*c*) unrestricted. When permanent endowments are reported in restricted net assets, two additional components—expendable and nonexpendable are required, as discussed in paragraph 35 of GASB Statement No. 34.

1.19 The term *restricted* is defined by GASB Statement No. 34, paragraphs 34 and 99. A restriction is a constraint placed on the use of assets or net assets that is either externally imposed (such as by creditors through debt covenants) or imposed by law through constitutional provisions or enabling legislation. Internally designated net assets should be reported as unrestricted net assets and should not be displayed separately in the net assets section of the statement of net assets/balance sheet, as discussed in paragraph 37 of GASB Statement No. 34. (Designated *assets*, however, may be reported in the statement of net assets/balance sheet, as discussed in paragraph 3.01 in this Guide.)

Statement of Revenues, Expenses, and Changes in Net Assets/Equity

1.20 The operating statement of governmental health care entities that are special-purpose governments engaged only in business-type activities is the

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[5] Guidance regarding the classification of certain specific assets or liabilities can be found in the chapters of the Guide. For example, see paragraph 4.16 in this Guide regarding the reporting of securities as current and noncurrent.

statement of revenues, expenses, and changes in net assets/equity. Changes in both restricted and unrestricted net assets should be reported in this statement using an all inclusive format, illustrated in GASB Statement No. 34, paragraph 101:

Operating revenues (detailed)

Total operating revenues

Operating expenses (detailed)

Total operating expenses

Operating income (loss)

Nonoperating revenues and expenses (detailed)

Income before other revenues, expenses, gains, losses, and transfers

Capital contributions (grant, developer, and other), additions to permanent and term endowments, special and extraordinary items (detailed) and transfers

Increase (decrease) in net assets

Net assets—beginning of period

Net assets—end of period

In a change in net assets approach, the increase or decrease in net assets for the period and net income are not necessarily the same amount (for example, because of capital contributions), as noted in GASB Statement No. 34, paragraph 433. However, GASB Statement No. 34, paragraph 434, indicates that this required format does not preclude governments from presenting different subtotals before the comprehensive performance measure—increase (decrease) in net assets. (See paragraph 1.11 in this chapter regarding references in this Guide to discussions in the nonauthoritative appendixes in GASB pronouncements.) The subtotals required by GASB Statement No. 34 must be presented.

1.21 As discussed in paragraph 100 and footnote 41 in GASB Statement No. 34, governmental health care entities are required to report revenues (net of discounts and allowances) by major source and separately identify revenues that provide security for revenue bonds. (See further discussion in Chapter 10 of this Guide.) As illustrated in paragraph 1.20 of this Guide, separate subtotals are required for operating revenues, operating expenses and operating income (loss). Governmental health care entities are required by GASB Statement No. 34, paragraph 102, to establish a policy that defines operating revenues and expenses that is appropriate to the nature of the activity being reported and to disclose that policy in the notes to the financial statements. Factors that may be considered in establishing that policy are discussed in Chapter 10 of this Guide.

1.22 Revenues from capital contributions as well as contributions to the principal of permanent and term endowments should be reported after nonoperating revenues and expenses, as discussed in GASB Statement No. 34, paragraph 100. Income from permanent or term endowments should be recorded as nonoperating revenue, as discussed in the GASB Q&A 2003 Edition, item 7.334. (See paragraph 1.11 in this chapter regarding references in this Guide to discussions in GASB staff implementation guides.)

1.23 Governmental health care entities that apply paragraph 7 of GASB Statement No. 20 should be aware that FASB Statement No. 130, *Reporting Comprehensive Income*, conflicts with the all-inclusive format required by GASB

Statement No. 34, as discussed in the GASB Q&A 2003 Edition, item 7.315. (See paragraph 1.11 in this chapter regarding references in this Guide to discussions in GASB staff implementation guides.)

Statement of Cash Flows

1.24 GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities*, established standards for cash flow reporting for governmental entities. GASB Statement No. 34, paragraph 105, requires governmental health care entities that are special-purpose governments engaged only in business-type activities to present a statement of cash flows using the direct method, discussed in GASB Statement No. 9, paragraph 31, as amended. A reconciliation of operating income (loss) to operating cash flows also should be presented.

Revenue From Health Care Services

1.25 In general, gross service revenue is recorded in the accounting records on an accrual basis at the provider's established rates, regardless of whether the health care organization expects to collect that amount. Provisions recognizing contractual adjustments and other adjustments (see examples in paragraph 5.02) are recorded on an accrual basis and deducted from gross service revenue to determine net service revenue. For financial reporting purposes, gross revenue does not include charity care (see discussion in paragraph 10.03) and service revenue is reported net of contractual and other adjustments in the statement of operations. Accounting and auditing issues related to receivables and revenue from health care services are discussed in Chapters 5 and 10.

1.26 In many cases, revenues are generated as a result of an agreement to provide health care rather than from the actual provision of services. For example, an integrated delivery system may agree to provide all health-related services for a specified group residing within its primary service area for an agreed-upon amount per member per month (PMPM). These revenues are premium revenues, not patient service revenues, since they are earned by agreeing to provide care, regardless of whether services actually are rendered.

Third-Party Payor Considerations

1.27 Some third-party payors retrospectively determine final amounts reimbursable for services rendered to their beneficiaries based on allowable costs. These payors reimburse the health care organization on the basis of interim payment rates until the retrospective determination of allowable costs can be made. In most instances, the accumulation and allocation of allowable costs and other factors result in final settlements different from the interim payment rates. Final settlements are determined after the close of the fiscal periods to which they apply and may affect materially the health care organization's financial position and results of operations. Consequently, a reasonable estimate of the amount receivable from or payable to these payors should be made in the same period that the related services are rendered. Accounting and auditing issues related to receivables from third parties are discussed in Chapter 5.

Classification and Reporting of Net Assets

1.28 Currently, many not-for-profit health care organizations use fund accounting for purposes of internal recordkeeping and managerial control. Many

individual funds may be established by an organization to help in monitoring compliance with donor or grantor restrictions due to the fiduciary accountability associated with these resources. Each fund consists of a self-balancing group of accounts composed of assets, liabilities, and net assets. Consistent with FASB Concepts Statement No. 6, *Elements of Financial Statements*, FASB Statement No. 117 concluded that although some not-for-profit organizations may choose to classify assets and liabilities into fund groups, information about those groupings is not a necessary part of general-purpose external financial reporting. Although FASB Statement No. 117 does not preclude not-for-profit organizations from using fund accounting for internal record-keeping and reporting, for purposes of external financial reporting each of the individual internal funds must be classified into one or more of the three broad classes of net assets: unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets. These classifications are related to the existence or absence of donor-imposed restrictions and are discussed in more detail in paragraphs 1.29 through 1.33 and also Chapter 9.

1.29 *Unrestricted Net Assets.* These represent the part of net assets that have not been externally restricted for identified purposes by donors and grantors. Unrestricted net assets also include assets whose use is contractually limited, such as—

- Proceeds of debt issues and funds of the health care organization deposited with a trustee and limited to use in accordance with the requirements of an indenture or a similar agreement. (See paragraph 7.18.)
- Other assets limited to use for identified purposes through an agreement between the health care organization and an outside party other than a donor or grantor. Examples include assets set aside under debt agreements, assets set aside under self-insurance (risk-retention) funding arrangements, and assets set aside to meet statutory reserve requirements (such as those required under state law for many health maintenance organizations [HMOs]). (See paragraph 8.20.)

1.30 Information about significant contractual limits (for example, debt covenants and self-insurance trusts) generally is disclosed in the notes to the financial statements. Similarly, internally designated funds should be reported separately from externally designated funds either on the face of the balance sheet or in the notes to the financial statements.

1.31 *Temporarily Restricted and Permanently Restricted Net Assets.* FASB Statement No. 117 defines two classes of donor-restricted net assets: temporarily restricted and permanently restricted. The distinction between these two types of restricted net assets is based on the nature of the donor's restriction. Temporarily restricted net assets are those donor-restricted net assets that can be used by the not-for-profit organization for their specified purpose once the donor's restriction is met. Generally, these restrictions are met either by the passage of time or by actions taken by the entity, such as use of the funds for the purpose intended. Permanently restricted net assets (for example, endowment funds) are those with donor restrictions that do not expire with the passage of time and cannot be removed by any actions taken by the entity. All donor-restricted net assets must be classified into one of these two broad categories for external reporting. Not-for-profit organizations may want to further classify temporarily and permanently restricted net assets into distinct groups that distinguish the nature or purpose of the donor's restriction. Accounting and reporting considerations pertaining to gifts and grants that are externally restricted for identified purposes by donors and grantors are discussed in paragraphs 9.04 through 9.06 and 10.08 through 10.14.

1.32 It should be noted that donor restrictions generally relate to limitations on the use of net assets rather than the use of specific assets. According to FASB Concepts Statement No. 6, paragraphs 101 and 102:

> Restrictions impose responsibilities on management to ensure that the organization uses donated resources in the manner stipulated by resource providers. Sometimes donor-imposed restrictions limit an organization's ability to sell or exchange the particular asset received. For example, a donor may give a painting to a museum stipulating that it must be publicly displayed, properly maintained, and never sold.
>
> More commonly, donors' stipulations permit the organization to pool the donated assets with other assets and to sell or exchange the donated assets for other suitable assets as long as the economic benefits of the donated assets are not consumed or used for a purpose that does not comply with the stipulation. For example, a donor may contribute 100 shares of Security A to an organization's endowment, thereby requiring that the amount of the gift be retained permanently but not requiring that the specified shares be held indefinitely. Thus, permanently restricted net assets and temporarily restricted net assets generally refer to amounts of net assets that are restricted by donor-imposed limits, not to specific assets.

1.33 A not-for-profit organization can report separate line items within any of the three classes of net assets either on the face of the balance sheet or in the notes to the financial statements to further distinguish the nature of donor restrictions within that category of net assets. For example, a health care organization may want to disclose the amount of temporarily restricted net assets restricted for a specific purpose such as indigent care. Further examples are provided in paragraph 15 of FASB Statement No. 117. An organization's internal fund accounting can be used to account for these different types of resources within a specific class of net assets.

Health Care Contracting

1.34 Contracts between a health care provider and a payor based on anything other than full charges requires the provider to accept some financial risk. The nature and degree of risk for the provider varies depending on the contract terms (for example, the definition of the unit of service or the basis for payment). In planning the audit of the health care provider, the auditor considers the audit risk associated with the entity's health care contracts. For example, contracts with payments for services based on a discount from the provider's established rates may have different risks than contracts with payments for services based on a capitated arrangement.

1.35 Generally, capitation payments are made at the beginning of each month and obligate the provider to render covered services during the month. Revenue is earned as a result of agreeing to provide services to qualified beneficiaries and not as a result of actually providing the care. If the provider's accounting system records patient charges and establishes patient receivables as services are rendered, appropriate valuation allowances or adjustments should be recorded so only the amount of contract revenue is recorded.

1.36 A capitation contract may obligate the provider to assume the risk of physician referrals and other outside services. In this case, a liability for unpaid claims, including incurred but not reported claims, should be established. A lag analysis may be helpful in estimating the liability.

1.37 In addition to the capitation payments, the amount of contract revenue may be affected by factors such as reinsurance recoveries, deductibles,

coinsurance, and risk pool adjustments. Risk pool adjustments may be based on factors such as utilization or cost targets.

1.38 Sometimes health care providers enter preferred provider arrangements with self-insured employers whereby the provider guarantees that the employer's health care cost will not increase over a specified amount or percentage. In substance, these providers may have provided aggregate stop-loss insurance to the self-insured employer, and a material liability to the provider may exist. FASB Statement No. 5, *Accounting for Contingencies*, provides guidance on accounting for these contingencies. GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, provides guidance on accounting for contingencies by governmental enterprises.

GAAP Hierarchy for Not-for-Profit Organizations

1.39 SAS No. 69 states that the guidance provided by FASB Statements and Interpretations, Opinions of the APB, and ARBs shall be considered established accounting principles pursuant to Rule 203 of the AICPA Code of Professional Conduct. (Appendix G [paragraph 1.61] of this chapter discusses SAS No. 69 and the hierarchy of sources of GAAP.)

1.40 Not-for-profit organizations should follow the guidance in effective provisions of ARBs, APB Opinions, and FASB Statements and Interpretations unless the specific pronouncement explicitly exempts not-for-profit organizations or their subject matter precludes such applicability. (As noted in paragraphs 1.45 and 1.46, not-for-profit organizations should follow the guidance in FASB Statements No. 116, *Accounting for Contributions Received and Contributions Made*, No. 117, No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, and No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, and this Guide in applying the guidance in pronouncements listed in Appendixes C and D [paragraphs 1.57 and 1.58] of this chapter.)

1.41 The appendixes [paragraphs 1.55 through 1.61] of this chapter are aids to the implementation of the guidance in this chapter.

1.42 Pronouncements issued by the FASB subsequent to this Guide's effective date apply to not-for-profit organizations unless those pronouncements explicitly exempt not-for-profit organizations or their subject matter precludes such applicability.[6]

1.43 Not-for-profit organizations may follow and are not prohibited from following the guidance in effective provisions of the APB Opinions and the FASB Statements and Interpretations listed in Appendix A [paragraph 1.55] of this chapter, which specifically exempt not-for-profit organizations from their application, unless FASB Statements No. 116 or No. 117 or this Guide provide different guidance. (However, the guidance included in the effective provisions of pronouncements listed in Appendix A [paragraph 1.55] applies to all for-profit entities owned, whether owned all or in part, by not-for-profit entities.) The discussion in paragraphs 1.45 through 1.51 should be considered

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[6] The guidance in paragraphs 1.39 through 1.51 addresses only the pronouncements listed in paragraph 1.40. However, not-for-profit organizations are also subject to other pronouncements included in categories (b)–(d) of paragraph 5 of SAS No. 69 and should apply AICPA Audit and Accounting Guides, Statements of Position (SOPs), and Practice Bulletins and FASB Technical Bulletins and the consensus positions of the FASB Emerging Issues Task Force (EITF) that apply to them. (Appendix G [paragraph 1.61] of this chapter discusses SAS No. 69 and the GAAP hierarchy.)

in determining the hierarchy of such guidance and of guidance issued by the AICPA.

1.44 Certain financial reporting guidance listed in Appendix B [paragraph 1.56] of this chapter, such as that concerning common stock and convertible debt, generally does not apply to the kinds of not-for-profit entities covered by this Guide, because such entities do not enter into the kinds of transactions covered by that guidance. (However, the guidance included in the effective provisions of pronouncements included in Appendix B [paragraph 1.56] applies to all for-profit entities owned, whether owned all or in part, by not-for-profit entities. Also, not-for-profit organizations should follow the effective provisions of pronouncements in Appendix B [paragraph 1.56] if they enter into the kinds of transactions covered by that guidance.)

1.45 Other pronouncements, which are listed in Appendix C [paragraph 1.57] of this chapter (ARB No. 51, *Consolidated Financial Statements*, and APB Opinion No. 29, *Accounting for Nonmonetary Transactions*), do not exempt not-for-profit organizations from their scope, but the transactions they contemplate also are covered by FASB Statement No. 116 and this Guide. FASB Statements No. 116, No. 117, No. 124, and No. 136 and this Guide provide guidance for applying the pronouncements to circumstances unique to not-for-profit organizations and not contemplated by the pronouncements and therefore should be followed to apply the guidance in those pronouncements to not-for-profit organizations. (However, the guidance included in the effective provisions of pronouncements included in Appendix C [paragraph 1.57] should be followed by all for-profit entities owned, whether owned all or in part, by not-for-profit entities.)

1.46 Some pronouncements (listed in Appendix D [paragraph 1.58] of this chapter), which may include guidance concerning the recognition and measurement of assets, liabilities, revenues, expenses, gains and losses, and financial statement display, state that their provisions apply only to entities operating in certain industries. Such entities generally are business enterprises. An example of such guidance is FASB Statement No. 63, *Financial Reporting by Broadcasters*. However, some not-for-profit organizations conduct activities[7] in some of those industries and should apply the guidance in the pronouncements concerning the recognition and measurement of assets, liabilities, revenues, expenses, and gains and losses to the transactions unique to those industries. However, such not-for-profit organizations should follow the financial statement display guidance in FASB Statement No. 117 and this Guide, even though it may conflict with display that would result from applying the guidance in the pronouncements listed in Appendix D [paragraph 1.58].

1.47 Financial reporting pronouncements that have not been superseded and are not included in Appendixes A through D [paragraphs 1.55 through 1.58] of this chapter are listed in Appendix E [paragraph 1.59] of this chapter. Not-for-profit organizations should follow the effective provisions of the pronouncements listed in Appendix E [paragraph 1.59].[8]

1.48 Certain other pronouncements, although they do not exempt not-for-profit organizations and do cover transactions conducted by not-for-profit organizations, include some provisions whose application by not-for-profit organizations may be unclear. Nevertheless, not-for-profit organizations are required to follow the effective provisions of those pronouncements. These provisions and their applicability are discussed below.

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[7] Such activities may be conducted by (*a*) for-profit entities owned and consolidated by not-for-profit organizations, (*b*) divisions of not-for-profit organizations, or (*c*) entire not-for-profit organizations.

[8] See footnote 6.

APB Opinion No. 16, *Business Combinations**

1.49 Because the conditions for applying the pooling of interests method of accounting for a business combination generally include an exchange of common stock of the combining entities, not-for-profit organizations generally would not meet the conditions for applying that method. The AICPA Accounting Standards Executive Committee (AcSEC) believes that circumstances exist under which reporting on the combination of two or more not-for-profit organizations (or that of a not-for-profit organization with a formerly for-profit entity) by the pooling of interests method better reflects the substance of the transaction than reporting by the purchase method. Therefore, not-for-profit organizations are, under certain circumstances, permitted to report by the pooling of interests method, even though they generally do not issue common stock. Such circumstances include the combination of two or more entities to form a new entity without the exchange of consideration. See paragraph 11.38 for further guidance.

1.50 An example of acceptable practice, in some circumstances, for reporting business combinations by not-for-profit organizations if there has been no exchange of consideration is to report the (*a*) assets, (*b*) liabilities, and (*c*) net asset balances of the combined entities as of the beginning of the year and disclose the information that would be required to be disclosed for a pooling of interests under APB Opinion No. 16.

Provisions of Certain Pronouncements Concerning Financial Statement Display

1.51 The following pronouncements include provisions specifying the financial statement display of certain financial statement elements or items such as gains and losses, extraordinary items, translation adjustments, income tax expense, and prepaid or deferred income taxes:

- APB Opinion No. 9, *Reporting the Results of Operations*
- APB Opinion No. 26, *Early Extinguishment of Debt*, as amended by 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*; FASB

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* In June 2001, the FASB issued FASB Statement No. 141, *Business Combinations*, which supersedes several pronouncements including APB Opinion No. 16, *Business Combinations*. However, FASB Statement No. 141 does not apply to certain combinations, including a combination involving two or more not-for-profit organizations or the acquisition of a for-profit business entity by a not-for-profit organization. For those combinations, the guidance in APB Opinion No. 16 still applies. Thus, GAAP does not change for those types of combinations. Not-for-profit health care organizations should continue to follow the guidance in this Guide and in APB Opinion No. 16, as amended by pronouncements prior to the issuance of FASB Statement No. 141. Pronouncements that were amended by FASB Statement No. 141 should be applied by those entities as though that Statement had not amended them. In addition, in applying the guidance included in APB Opinion No. 16, not-for-profit health care organizations should continue to apply the amendments to that Opinion that were included in FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, even though FASB Statement No. 121 was superseded by FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. (FASB Statement No. 144 did not carry forward those amendments to APB Opinion No. 16 because APB Opinion No. 16 had been superseded.) The FASB has on its agenda a project on accounting for combinations of not-for-profit organizations, the scope of which also will include the acquisition of a for-profit business entity by a not-for-profit organization. Readers should be alert to the issuance of a final standard. Also, FASB Statement No. 142, *Goodwill and Other Intangible Assets*, is not applicable to goodwill and other intangible assets arising from combinations between not-for-profit organizations or arising from the acquisition of a for-profit business entity by a not-for-profit organization until the FASB completes its deliberation with respect to application of the purchase method by those entities.

Statement No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*); and FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

- APB Opinion No. 30, as amended by FASB Statement No. 128, *Earnings per Share*, FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, and FASB Statement No. 145
- FASB Statement No. 52, *Foreign Currency Translation*
- FASB Statement No. 109, *Accounting for Income Taxes*

None of the preceding pronouncements considers the net asset reporting model included in FASB Statement No. 117 and this Guide. Therefore, preparers of financial statements of not-for-profit organizations should consider the reporting objectives of these APB Opinions and FASB Statements when exercising judgment about how to best display elements, such as in which net asset class.

GAAP Hierarchy for Governmental Organizations

1.52 SAS No. 69 provides that, for state or local governmental entities, officially established accounting principles consist of GASB Statements and Interpretations as well as AICPA and FASB pronouncements specifically made applicable to state and local governmental entities by GASB Statements or Interpretations. (Appendix G [paragraph 1.61] of this chapter discusses SAS No. 69 and the hierarchy of sources of GAAP for governmental entities.) GASB Statements No. 20 and No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, provide guidance on the applicability of FASB and AICPA pronouncements to governmental health care enterprises that use enterprise fund accounting and financial reporting. Footnote 1 and paragraph 1.16 of this chapter discusses the guidance in GASB Statement No. 20.

1.53 GASB Statement No. 29 provides that governmental enterprise funds and activities reported using enterprise fund accounting and financial reporting that apply the provisions of paragraph 7, as amended, of GASB Statement No. 20 should apply only those "new" (issued after November 30, 1989) FASB Statements and Interpretations that are developed for business enterprises, rather than those whose provisions are limited to not-for-profit organizations or address issues primarily concerning such organizations (such as FASB Statements No. 116, No. 117, No. 124, and No. 136). (See paragraph 1.16 of this chapter.)

1.54 Paragraph 33 in the "Basis for Conclusions" of GASB Statement No. 20 also provides that AICPA pronouncements issued after November 30, 1989 and not specifically made applicable to governmental entities should be applied using the same logic used in the application of FASB standards. That is, AICPA pronouncements that do not conflict with or contradict GASB pronouncements should be applied on an "all or none" basis and constitute level "b" in the GAAP hierarchy. (See Appendix G [paragraph 1.61] of this chapter.) Many of the AICPA pronouncements issued after November 30, 1989 provide guidance on specialized industries, including this Guide. However, users of this Guide should note the provisions of SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, discussed in paragraph 8.30 of this Guide.

1.55

Appendix A—Financial Reporting Pronouncements That Specifically Exempt Not-for-Profit Organizations From Their Application

Note regarding effective dates of recently issued pronouncements that are listed in this appendix, or that amend pronouncements listed in this appendix; the applicability of FASB Statement No. 141, *Business Combinations*, FASB Statement No. 142, *Goodwill and Other Intangible Assets*, and FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*; and outstanding FASB exposure drafts of proposed statements of financial accounting standards:

- FASB Statement No. 132 (revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits*, amends APB Opinion No. 28. FASB Statement No. 132 (revised 2003) is effective for fiscal years ending after December 15, 2003, with certain exceptions. Interim-period disclosures are effective for interim periods beginning after December 15, 2003. The provisions of FASB Statement No. 132 remain in effect until the provisions of FASB Statement No. 132 (revised 2003) are adopted.

- FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, amends FASB Statement No. 128. FASB Statement No. 150 is effective for financial instruments entered into or modified after May 31, 2003 and otherwise at the beginning of the first interim period beginning after June 15, 2003, except for mandatorily redeemable financial instruments of a nonpublic entity. See FASB Staff Position (FSP) No. 150-3, *Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150*, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, issued November 7, 2003, for additional effective date information.

- FASB Interpretation No. 46 (revised December 2003). In 2003, the FASB issued FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, and FASB Interpretation No. 46 (revised December 2003), which replaced FASB Interpretation No. 46, to address consolidation by business enterprises of variable interest entities. Special effective date provisions apply to enterprises that have fully or partially applied FASB Interpretation No. 46 prior to the issuance of the revised Interpretation. Otherwise, application of FASB Interpretation No. 46 (revised December 2003) or FASB Interpretation No. 46 is required in financial statements of public entities that have interests in variable interest entities or potential variable interest entities commonly referred to as special-purpose entities for periods ending after December 15, 2003. Application by public entities, other than small business issuers, for all other types of entities is required in financial statements for periods ending after March 15, 2004. Application by small business issuers to entities other

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than special-purpose entities and by nonpublic entities to all types of entities is required at various dates in 2004 and 2005. In some instances, enterprises have the option of applying or continuing to apply FASB Interpretation No. 46 for a short period of time before applying the revised Interpretation. Not-for-profit organizations are not subject to FASB Interpretation No. 46 (revised December 2003), except that they may be related parties for purposes of applying paragraphs 16 and 17 of that Interpretation. Also, if a not-for-profit entity is used by business enterprises in a manner similar to a variable interest entity in an effort to circumvent the provisions of FASB Interpretation No. 46 (revised December 2003), that not-for-profit entity is subject to that Interpretation.

- FASB Statement No. 141, among other matters, amends APB Opinion No. 28 and FASB Statement No. 128. FASB Statement No. 141 applies to business combinations initiated after June 30, 2001 and prescribes the use of the purchase method for those business combinations. FASB Statement No. 141, however, does not apply to certain combinations, including a combination involving two or more not-for-profit organizations, or the acquisition of a for-profit business entity by a not-for-profit organization. For those combinations, pronouncements that are amended by FASB Statement No. 141 should be applied as though FASB Statement No. 141 had not amended them, and this appendix does not reflect those amendments.

- The provisions of FASB Statement No. 142 shall be applied in fiscal years beginning after December 15, 2001, to all goodwill and other intangible assets recognized in an entity's statement of financial position at the beginning of that fiscal year. Early application is permitted in certain circumstances. Certain provisions of FASB Statement No. 142 shall be applied to goodwill and other acquired intangible assets for which the acquisition date is after June 30, 2001, even if an entity has not adopted FASB Statement No. 142 in its entirety. The provisions of FASB Statement No. 141 and FASB Statement No. 142 should not be applied to goodwill and intangible assets arising from a combination between two or more not-for-profit organizations or acquired in the acquisition of a for-profit business entity by a not-for-profit organization until the FASB completes its project on those types of combinations and acquisitions. Thus, the guidance in APB Opinions No. 16 and No. 17 remains in effect for such assets. In addition, when applying APB Opinions No. 16 and No. 17, not-for-profit organizations should continue to apply the amendments to those Opinions found in other literature even though that other literature may have been superseded by FASB Statements No. 141, No. 142, and No. 144. For example, when applying APB Opinion No. 17, not-for-profit organizations should continue to apply the amendments to that Opinion found in FASB Statement No. 121, even though that Statement was superseded by FASB Statement No. 144. Readers should be alert to the issuance of a final Standard on combinations of not-for-profit organizations.
- *FASB exposure drafts.* The FASB has released exposure drafts of proposed statements of financial accounting standards that would amend or replace certain pronouncements that are listed in this appendix. Readers should be alert to the issuance of final Standards.

Pronouncement	Other References, if Any *	Status of Other References
APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, as amended by APB Opinions No. 23 and No. 30 and FASB Statements No. 13, No. 58, No. 94, No. 115, No. 128, No. 142, and No. 144, and including FASB Interpretation No. 35	This Guide	Chapter 11 of this Guide provides guidance concerning the equity method of accounting for investments in common stock
APB Opinion No. 28, *Interim Financial Reporting*, as amended by FASB Statements No. 3, No. 95, No. 109, No. 128, No. 130, No. 131, No. 132 (revised 2003), No. 135, No. 144, No. 145, and No. 148 and including FASB Interpretation No. 18	None	None
FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*, as amended by FASB Statement No. 135	None	None
FASB Statement No. 89, *Financial Reporting and Changing Prices*, as amended by FASB Statements No. 109, No. 135, and No. 139	None	None
FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, as amended by FASB Statements No. 124, No. 130, No. 133, No. 134, No. 135, No. 140, No. 144, and No. 145	FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*; Chapter 4 of this Guide	Currently effective
FASB Statement No. 128, *Earnings per Share*, as amended by FASB Statements No. 135, No. 145, and No. 150	None	None
FASB Statement No. 130, *Reporting Comprehensive Income*, as amended by FASB Statement No. 135	FASB Statement No. 117	Currently effective
FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*	None	None
FASB Statement No. 141, *Business Combinations*, as amended by FASB Statements No. 144, No. 145, and No. 147	Chapter 1 and Chapter 11 of this Guide	Currently effective

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Pronouncement	*Other References, if Any* *	*Status of Other References*
FASB Interpretation No. 18, *Accounting for Income Taxes in Interim Periods*, as amended by FASB Statements No. 71, No. 109, No. 111, No. 135, and No. 144	None	None
FASB Interpretation No. 35, *Criteria for Applying the Equity Method of Accounting for Investments in Common Stock*	See APB Opinion No. 18	See APB Opinion No. 18
FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*	None	None

* References in this column are provided as a guide to other sources of information about the topic covered by the listed pronouncement.

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Appendix B—Financial Reporting Pronouncements That, by the Nature of Their Subject Matter, Generally Do Not Apply to Not-for-Profit Organizations

Note regarding effective dates of recently issued pronouncements that are listed in this appendix, or that amend pronouncements listed in this appendix; the applicability of FASB Statement No. 141, *Business Combinations*; and outstanding FASB exposure drafts of proposed statements of financial accounting standards:

- FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, is effective for financial instruments entered into or modified after May 31, 2003 and otherwise at the beginning of the first interim period beginning after June 15, 2003 except for mandatorily redeemable financial instruments of a nonpublic entity. See FSP No. 150-3, *Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150*, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, issued November 7, 2003, for additional effective date information.
- FASB Statement No. 141, an amendment of FASB Statement No. 123, applies to business combinations initiated after June 30, 2001, and prescribes the use of the purchase method for those combinations. FASB Statement No. 141, however, does not apply to certain combinations, including a combination involving two or more not-for-profit organizations, or the acquisition of a for-profit business entity by a not-for-profit organization.
- *FASB exposure drafts*. The FASB has released exposure drafts of proposed statements of financial accounting standards that would amend or supersede pronouncements that are listed in this appendix. Readers should be alert to the issuance of final standards.

- APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*
- APB Opinion No. 25, *Accounting for Stock Issued to Employees*, as amended by FASB Statements No. 109 and No. 123, and including FASB Interpretations No. 28, No. 38, and No. 44
- FASB Statement No. 84, *Induced Conversions of Convertible Debt*
- FASB Statement No. 123, *Accounting for Stock-Based Compensation*, as amended by FASB Statements No. 128, No. 135, No. 141, No. 144, and No. 148
- FASB Statement No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure*
- FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*

- FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*, as amended by FASB Statements No. 123 and No. 128
- FASB Interpretation No. 38, *Determining the Measurement Date for Stock Option, Purchase, and Award Plans Involving Junior Stock*, as amended by FASB Statements No. 123 and No. 128
- FASB Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation*, as amended by FASB Statement No. 141

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Appendix C—Financial Reporting Pronouncements Whose Application to Not-for-Profit Organizations Is Subject to Additional FASB or AICPA Guidance

Note regarding the applicability of FASB Statement No. 141, *Business Combinations* and FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*; and outstanding FASB exposure drafts of proposed statements of financial accounting standards:

- FASB Statement No. 141, among other matters, amends APB Opinion No. 29. FASB Statement No. 141 applies to business combinations initiated after June 30, 2001 and prescribes the use of the purchase method for those business combinations. FASB Statement No. 141, however, does not apply to certain combinations, including a combination involving two or more not-for-profit organizations, or the acquisition of a for-profit business entity by a not-for-profit organization. For those combinations, pronouncements that are amended by FASB Statement No. 141 should be applied as though FASB Statement No. 141 had not amended them, and this appendix does not reflect those amendments.
- FASB Interpretation No. 46 (revised December 2003), an interpretation of ARB No. 51, *Consolidated Financial Statements*, exempts not-for-profit organizations from its scope, except that they may be related parties for purposes of applying paragraphs 16 and 17 of that Interpretation. Also, if a not-for-profit entity is used by business enterprises in a manner similar to a variable interest entity in an effort to circumvent the provisions of FASB Interpretation No. 46 (revised December 2003), that not-for-profit entity is subject to that Interpretation. For information about FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, which was replaced by FASB Interpretation No. 46 (revised 2003) and information about the effective date of FASB Interpretation No. 46 (revised December 2003), see paragraph 1.55 in this chapter.
- *FASB exposure drafts*. The FASB has released exposure drafts of proposed statements of financial accounting standards that would amend or supersede certain pronouncements that are listed in this appendix. Readers should be alert to the issuance of final Standards.

Pronouncement	*Additional Guidance*
ARB No. 51, *Consolidated Financial Statements*, as amended by APB Opinions No. 10, No. 16, No. 18, and No. 23, and FASB Statements No. 58, No. 71, No. 94, No. 111, No. 131, and No. 144	This Guide
APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, as amended by FASB Statements No. 71, No. 109, No. 123, and No. 144 and including FASB Interpretation No. 30	FASB Statement No. 116 and Chapters 5 and 10 of this Guide provide accounting guidance for contributions

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Pronouncement	*Additional Guidance*
FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, as amended by FASB Statement No. 131	See ARB No. 51
FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*	FASB Statement No. 136, this Guide and the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*
FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, as amended by FASB Statements No. 124, and No. 144	This Guide
FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, as amended by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*	This Guide
FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, as amended by FASB Statement No. 140	This Guide and the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*
FASB Interpretation No. 30, *Accounting for Involuntary Conversions of Nonmonetary Assets to Monetary Assets*, as amended by FASB Statement No. 109	See APB Opinion 29

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Appendix D—Financial Reporting Pronouncements Pertaining to Specialized Industry Practices of Business Enterprises

Note regarding effective dates of recently issued pronouncements that are listed in this appendix, or that amend pronouncements listed in this appendix; the applicability of FASB Statement No. 141, *Business Combinations*, and FASB Statement No. 142, *Goodwill and Other Intangible Assets*; and outstanding FASB exposure drafts of proposed statements of financial accounting standards:

- FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, amends FASB Statements No. 35, No. 60, No. 65, and No. 91. FASB Statement No. 149 is effective for contracts entered into or modified after June 30, 2003, with certain exceptions, and for hedging relationships designated after June 30, 2003, with certain exceptions.

- FASB Statement No. 141, among other matters, amends FASB Statements No. 44, No. 45, and No. 72 and FASB Interpretation No. 9. FASB Statement No. 141 applies to business combinations initiated after June 30, 2001 and prescribes the use of the purchase method for those business combinations. FASB Statement No. 141, however, does not apply to certain combinations, including a combination involving two or more not-for-profit organizations, or the acquisition of a for-profit business entity by a not-for-profit organization. For those combinations, pronouncements that are amended by FASB Statement No. 141 should be applied as though FASB Statement No. 141 had not amended them, and this appendix does not reflect those amendments.

- The provisions of FASB Statement No. 142 shall be applied in fiscal years beginning after December 15, 2001, to all goodwill and other intangible assets recognized in an entity's statement of financial position at the beginning of that fiscal year. Early application is permitted in certain circumstances. Certain provisions of FASB Statement No. 142 shall be applied to goodwill and other acquired intangible assets for which the acquisition date is after June 30, 2001, even if an entity has not adopted FASB Statement No. 142 in its entirety. The provisions of FASB Statement No. 141 and FASB Statement No. 142 should not be applied to goodwill and intangible assets arising from a combination between two or more not-for-profit organizations or acquired in the acquisition of a for-profit business entity by a not-for-profit organization until the FASB completes its project on those types of combinations and acquisitions. Thus, the guidance in APB Opinions No. 16 and No. 17 remains in effect for such assets. In addition, when applying APB Opinions No. 16 and No. 17, not-for-profit organizations should continue to apply the amendments to those Opinions found in other literature even though that other literature may have been superseded by FASB Statements No. 141, No. 142, and No. 144. For example, when applying APB Opinion No. 17, not-for-profit organizations should continue to apply the amendments to that Opinion found in FASB Statement No. 121,

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even though that Statement was superseded by FASB Statement No. 144. Readers should be alert to the issuance of a final Standard on combinations of not-for-profit organizations.

- *FASB exposure drafts.* The FASB has released exposure drafts of proposed statements of financial accounting standards that would amend or supersede certain pronouncements that are listed in this appendix. Readers should be alert to the issuance of final Standards.

This appendix includes pronouncements that apply only to entities operating in certain industries, generally business enterprises. However, some not-for-profit organizations conduct activities in some of those industries and should apply the guidance concerning recognition and measurement of assets, liabilities, revenues, expenses, and gains and losses in those pronouncements to the transactions unique to those industries. In addition, those not-for-profit organizations should follow the financial statement display guidance in FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, and this Guide, although it may conflict with display that would result from applying the guidance in the pronouncements included in this appendix.

- APB Opinion No. 12, *Omnibus Opinion—1967* (guidance under the heading "Capital Changes")
- APB Opinion No. 13, *Amending Paragraph 6 of APB Opinion No. 9, Application to Commercial Banks*
- FASB Statement No. 7, *Accounting and Reporting by Development Stage Enterprises*, as amended by FASB Statements No. 71 and No. 95, and including FASB Interpretation No. 7
- FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, as amended by FASB Statements No. 25, No. 69, No. 71, No. 109, No. 143, No. 144, and No. 145, and including FASB Interpretations No. 33 and No. 36
- FASB Statement No. 25, *Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies (an amendment of FASB Statement No. 19)*, as amended by FASB Statement No. 111
- FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, as amended by FASB Statements No. 75, No. 110, No. 135, and No. 149
- FASB Statement No. 45, *Accounting for Franchise Fee Revenue*
- FASB Statement No. 50, *Financial Reporting in the Record and Music Industry*
- FASB Statement No. 51, *Financial Reporting by Cable Television Companies*, as amended by FASB Statements No. 71, No. 131, No. 142, and No. 144
- FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, as amended by FASB Statements No. 91, No. 97, No. 109, No. 113, No. 114, No. 115, No. 120, No. 124, No. 133, No. 135, No. 144, No. 145, and No. 149, and including FASB Interpretation No. 40
- FASB Statement No. 61, *Accounting for Title Plant*, as amended by FASB Statement No. 144
- FASB Statement No. 63, *Financial Reporting by Broadcasters*, as amended by FASB Statement No. 139
- FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, as amended by FASB Statements No. 91, No. 115, No. 124, No. 133, No. 134, No. 140, and No. 149

- FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, as amended by FASB Statements No. 111 and No. 144
- FASB Statement No. 69, *Disclosures about Oil and Gas Producing Activities (an amendment of FASB Statements 19, 25, 33, and 39)*, as amended by FASB Statements No. 89, No. 95, No. 109, and No. 131
- FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*, as amended by FASB Statements No. 90, No. 92, No. 109, No. 135, No. 142, and No. 144
- FASB Statement No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions (an amendment of APB Opinion No. 17, an interpretation of APB Opinions 16 and 17, and an amendment of FASB Interpretation No. 9)*, as amended by FASB Statements No. 142 and No. 147
- FASB Statement No. 73, *Reporting a Change in Accounting for Railroad Track Structures (an amendment of APB Opinion No. 20)*
- FASB Statement No. 90, *Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs (an amendment of FASB Statement No. 71)*, as amended by FASB Statements No. 92 and No. 109
- FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases (an amendment of FASB Statements No. 13, 60, and 65 and a rescission of FASB Statement No. 17)*, as amended by FASB Statements No. 98, No. 114, No. 115, No. 124, and No. 149
- FASB Statement No. 92, *Regulated Enterprises—Accounting for Phase-in Plans (an amendment of FASB Statement No. 71)*
- FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, as amended by FASB Statements No. 113, No. 115, and No. 120
- FASB Statement No. 101, *Regulated Enterprises—Accounting for the Discontinuation of Application of FASB Statement No. 71*, as amended by FASB Statements No. 109 and No. 144
- FASB Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts (an amendment of FASB Statement No. 35)*
- FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, as amended by FASB Statements No. 120 and No. 133, and including FASB Interpretation No. 40
- FASB Statement No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts (an amendment of FASB Statement Nos. 60, 97, and 113 and Interpretation No. 40)*
- FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise (an amendment of FASB Statement No. 65)*
- FASB Statement No. 139, *Rescission of FASB Statement No. 53 and amendments to FASB Statements No. 63, 89, and 121*
- FASB Statement No. 147, *Acquisitions of Certain Financial Institutions*
- FASB Interpretation No. 7, *Applying FASB Statement No. 7 in Financial Statements of Established Operating Enterprises*

- FASB Interpretation No. 9, *Applying APB Opinions No. 16 and 17 When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method*, as amended by FASB Statements No. 72, No. 142, and No. 147
- FASB Interpretation No. 33, *Applying FASB Statement No. 34 to Oil and Gas Producing Operations Accounted for by the Full Cost Method*
- FASB Interpretation No. 36, *Accounting for Exploratory Wells in Progress at the End of a Period*
- FASB Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises*, as amended by FASB Statements No. 115, No. 120, and No. 135

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Appendix E—Financial Reporting Pronouncements Not Subsequently Superseded and Not Included in Appendixes A through D of This Chapter

Note regarding effective dates of recently issued pronouncements that are listed in this appendix, or that amend pronouncements listed in this appendix; the applicability of FASB Statement No. 141, *Business Combinations*, and FASB Statement No. 142, *Goodwill and Other Intangible Assets*; and outstanding FASB exposure drafts of proposed statements of financial accounting standards:

- FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, amends FASB Statements No. 15, No. 87, No. 95, No. 106, and No. 126. FASB Statement No. 149 is effective for contracts entered into or modified after June 30, 2003, with certain exceptions, and for hedging relationships designated after June 30, 2003, with certain exceptions.
- FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, amends FASB Statement No. 133. FASB Statement No. 150 is effective for financial instruments entered into or modified after May 31, 2003 and otherwise at the beginning of the first interim period beginning after June 15, 2003 except for mandatorily redeemable financial instruments of a nonpublic entity. See FSP No. 150-3, *Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150,* Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, issued November 7, 2003, for additional effective date information.
- FASB Statement No. 132 (revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits*, supersedes FASB Statement No. 132 and carries forward the amendments made by FASB Statement No. 132 to FASB Statements No. 87, No. 88, and No. 106, with minor changes. FASB Statement No. 132 (revised 2003) is effective for fiscal years ending after December 15, 2003, with certain exceptions. Interim-period disclosures are effective for interim periods beginning after December 15, 2003. The provisions of FASB Statement No. 132 remain in effect until the provisions of FASB Statement No. 132 (revised 2003) are adopted.
- FASB Statement No. 141, among other matters, supersedes APB Opinion No. 16 and FASB Statements No. 10, No. 38, and No. 79; and amends APB Opinions No. 20 and No. 30, FASB Statements No. 15, No. 16, No. 68, No. 87, No. 95, No. 106, No. 109, and No. 133 and FASB Interpretations No. 4 and No. 21. (The amendment of FASB Statement No. 68 was subsequently deleted by the technical corrections in FASB Statement No. 145). FASB Statement No. 141 applies to business combinations initiated after June 30, 2001 and prescribes the use of the purchase method for those business combinations. FASB Statement No. 141, however, does not apply to certain combinations, including a combination involving two or more not-for-profit organizations, or the

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acquisition of a for-profit business entity by a not-for-profit organization. For those combinations, pronouncements that are superseded or amended by FASB Statement No. 141 should be applied as though FASB Statement No. 141 had not superseded or amended them, and this appendix does not reflect those amendments or supersessions.

- The provisions of FASB Statement No. 142 shall be applied in fiscal years beginning after December 15, 2001, to all goodwill and other intangible assets recognized in an entity's statement of financial position at the beginning of that fiscal year. Early application is permitted in certain circumstances. Certain provisions of FASB Statement No. 142 shall be applied to goodwill and other acquired intangible assets for which the acquisition date is after June 30, 2001, even if an entity has not adopted FASB Statement No. 142 in its entirety. The provisions of FASB Statement No. 141 and FASB Statement No. 142 should not be applied to goodwill and intangible assets arising from a combination between two or more not-for-profit organizations or acquired in the acquisition of a for-profit business entity by a not-for-profit organization until the FASB completes its project on those types of combinations and acquisitions. Thus, the guidance in APB Opinions No. 16 and No. 17 remains in effect for such assets. In addition, when applying APB Opinions No. 16 and No. 17, not-for-profit organizations should continue to apply the amendments to those Opinions found in other literature even though that other literature may have been superseded by FASB Statements No. 141, No. 142, and No. 144. For example, when applying APB Opinion No. 17, not-for-profit organizations should continue to apply the amendments to that Opinion found in FASB Statement No. 121 even though that Statement was superseded by FASB Statement No. 144. Readers should be alert to the issuance of a final Standard on combinations of not-for-profit organizations.

- *FASB exposure drafts.* The FASB has released exposure drafts of proposed statements of financial accounting standards that would amend or replace certain pronouncements that are listed in this appendix. Readers should be alert to the issuance of final Standards.

As stated in paragraph 1.40 of this Guide, not-for-profit organizations should follow the guidance in effective provisions of ARBs, APB Opinions, and FASB Statements and Interpretations, except for specific pronouncements that explicitly exempt not-for-profit organizations and pronouncements for which this Guide provides guidance. This appendix includes pronouncements, not subsequently superseded, that (*a*) do not exempt not-for-profit organizations from their application, (*b*) by the nature of their subject matter, apply to the kinds of transactions not-for-profit organizations engage in, (*c*) are subject to no additional FASB or AICPA guidance, and (*d*) do not pertain to specialized industry practices of business enterprises. Not-for-profit organizations should follow the guidance in the effective provisions of the pronouncements included in this appendix.

- ARB No. 43, *Restatement and Revision of Accounting Research Bulletins,* as amended by APB Opinions No. 6, No. 9, No. 10, No. 16, No. 17, No. 20, No. 21, No. 25, and No. 26, and FASB Statements No. 5, No. 6, No. 52, No. 78, No. 94, No. 109, No. 111, No. 115, No. 123, No. 131, No. 133, No. 135, and No. 142
- ARB No. 45, *Long-Term Construction-Type Contracts*

- ARB No. 46, *Discontinuance of Dating Earned Surplus*
- APB Opinion No. 2, *Accounting for the "Investment Credit,"* as amended by APB Opinion No. 4 and FASB Statements No. 71 and No. 109
- APB Opinion No. 4 (amending Opinion No. 2), *Accounting for the "Investment Credit"*
- APB Opinion No. 6, *Status of Accounting Research Bulletins*, as amended by APB Opinions No. 16, No. 17, and No. 26, and FASB Statements No. 52, No. 71, No. 109, No. 111, and No. 135
- APB Opinion No. 9, *Reporting the Results of Operations* (paragraph 1.51 of this Guide discusses this pronouncement), as amended by APB Opinions No. 13, No. 15, No. 20, and No. 30, and FASB Statement No. 16
- APB Opinion 10, *Omnibus Opinion—1966*, as amended by APB Opinions No. 12, No. 14, No. 16, and No. 18, and FASB Statements No. 111 and No. 129, and including FASB Interpretations No. 39 and No. 41
- APB Opinion No. 12, *Omnibus Opinion—1967* (except guidance under the heading, "Capital Changes"), as amended by APB Opinion No. 14 and FASB Statements No. 87, No. 106, and No. 111
- APB Opinion No. 16, *Business Combinations* (paragraph 1.49 of this Guide discusses this pronouncement), as amended by FASB Statements No. 10, No. 38, No. 71, No. 79, No. 87, No. 106, No. 109, No. 121, and No. 135, and including FASB Interpretations No. 4, No. 9, and No. 21
- APB Opinion 17, *Intangible Assets*, as amended by APB Opinion No. 30 and FASB Statements No. 2, No. 71, No. 72, No. 109, No. 121, and No. 135, and including FASB Interpretation No. 9
- APB Opinion No. 20, *Accounting Changes*, as amended by FASB Statements No. 16, No. 58, No. 71, No. 73, No. 95, No. 111, and No. 128, and including FASB Interpretations No. 1 and No. 20
- APB Opinion No. 21, *Interest on Receivables and Payables*, as amended by FASB Statements No. 34 and No. 109
- APB Opinion No. 22, *Disclosure of Accounting Policies*, as amended by FASB Statements No. 2, No. 52, No. 95, and No. 111
- APB Opinion No. 23, *Accounting for Income Taxes—Special Areas*, as amended by FASB Statements No. 60, No. 71, No. 94, and No. 109
- APB Opinion No. 26, *Early Extinguishment of Debt* (paragraph 1.51 of this Guide discusses this pronouncement), as amended by APB Opinion No. 30 and FASB Statements No. 15, No. 71, No. 84, and No. 140
- 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* (paragraph 1.51 of this Guide discusses this pronouncement), as amended by FASB Statements No. 16, No. 60, No. 97, No. 101, No. 109, No. 128, No. 144, and No. 145, and including FASB Interpretation No. 27
- FASB Statement No. 2, *Accounting for Research and Development Costs*, as amended by FASB Statements No. 71, No. 86, and No. 142, and including FASB Interpretations No. 4 and No. 6
- FASB Statement No. 5, *Accounting for Contingencies*, as amended by FASB Statements No. 11, No. 16, No. 60, No. 71, No. 87, No. 111, No. 112, No. 113, No. 114, and No. 123, and including FASB Interpretations No. 14, No. 34, and No. 45

- FASB Statement No. 6, *Classification of Short-Term Obligations Expected to Be Refinanced (an amendment of ARB No. 43, Chapter 3A)*, and including FASB Interpretation No. 8
- FASB Statement No. 10, *Extension of "Grandfather" Provisions for Business Combinations (an amendment of APB Opinion No. 16)*
- FASB Statement No. 11, *Accounting for Contingencies—Transition Method (an amendment of FASB Statement No. 5)*
- FASB Statement No. 13, *Accounting for Leases*, as amended by FASB Statements No. 22, No. 23, No. 27, No. 28, No. 29, No. 34, No. 71, No. 91, No. 94, No. 98, No. 109, No. 135, No. 140, and No. 145, and including FASB Interpretations No. 19, No. 21, No. 23, No. 24, No. 26, and No. 27
- FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, as amended by FASB Statements No. 71, No. 111, No. 114, No. 135, No. 144, No. 145, and No. 149
- FASB Statement No. 16, *Prior Period Adjustments*, as amended by FASB Statements No. 71 and No. 109
- FASB Statement No. 22, *Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt (an amendment of FASB Statement No. 13)*, as amended by FASB Statements No. 71, No. 140, and No. 145
- FASB Statement No. 23, *Inception of the Lease (an amendment of FASB Statement No. 13)*
- FASB Statement No. 27, *Classification of Renewals or Extensions of Existing Sales-Type or Direct Financing Leases (an amendment of FASB Statement No. 13)*
- FASB Statement No. 28, *Accounting for Sales with Leasebacks (an amendment of FASB Statement No. 13)*, as amended by FASB Statement No. 66
- FASB Statement No. 29, *Determining Contingent Rentals (an amendment of FASB Statement No. 13)*, as amended by FASB Statement No. 98
- FASB Statement No. 34, *Capitalization of Interest Cost*, as amended by FASB Statements No. 42, No. 58, No. 62, No. 71, and No. 144, and including FASB Interpretation No. 33
- FASB Statement No. 37, *Balance Sheet Classification of Deferred Income Taxes (an amendment of APB Opinion No. 11)*, as amended by FASB Statement No. 109
- FASB Statement No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises (an amendment of APB Opinion No. 16)*, as amended by FASB Statement No. 109
- FASB Statement No. 42, *Determining Materiality for Capitalization of Interest Cost (an amendment of FASB Statement No. 34)*
- FASB Statement No. 43, *Accounting for Compensated Absences*, as amended by FASB Statements No. 71, No. 112, No. 123, No. 135, and No. 144
- FASB Statement No. 47, *Disclosure of Long-Term Obligations*
- FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*
- FASB Statement No. 49, *Accounting for Product Financing Arrangements*, as amended by FASB Statement No. 71

- FASB Statement No. 52, *Foreign Currency Translation* (paragraph 1.51 of this Guide discusses this pronouncement), as amended by FASB Statements No. 95, No. 109, No. 130, No. 133, No. 135, and No. 142, and including FASB Interpretation No. 37
- FASB Statement No. 57, *Related Party Disclosures*, as amended by FASB Statements No. 95 and No. 109, and including FASB Interpretation No. 45
- FASB Statement No. 58, *Capitalization of Interest in Financial Statements That Include Investments Accounted for by the Equity Method (an amendment of FASB Statement No. 34)*
- FASB Statement No. 62, *Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants (an amendment of FASB Statement No. 34)*
- FASB Statement No. 66, *Accounting for Sales of Real Estate*, as amended by FASB Statements No. 98, No. 135, and No. 144
- FASB Statement No. 68, *Research and Development Arrangements*, as amended by FASB Statement No. 142
- FASB Statement No. 78, *Classification of Obligations That Are Callable by the Creditor (an amendment of ARB No. 43, Chapter 3A)*
- FASB Statement No. 79, *Elimination of Certain Disclosures for Business Combinations by Nonpublic Enterprises (an amendment of APB Opinion No. 16)*
- FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*
- FASB Statement No. 87, *Employers' Accounting for Pensions*, as amended by FASB Statements No. 106, No. 109, No. 130, No. 132 (revised 2003), No. 135, and No. 149
- FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, as amended by FASB Statements No. 132 (revised 2003) and No. 144
- FASB Statement No. 93, *Recognition of Depreciation by Not-for-Profit Organizations*, as amended by FASB Statements No. 99 and No. 135
- FASB Statement No. 95, *Statement of Cash Flows*, as amended by FASB Statements No. 102, No. 104, No. 117, No. 133, No. 145, and No. 149
- FASB Statement No. 98, *Accounting for Leases:*
  - *Sale-Leaseback Transactions Involving Real Estate*
  - *Sales-Type Leases of Real Estate*
  - *Definition of the Lease Term*
  - *Initial Direct Costs of Direct Financing Leases*

  (an amendment of FASB Statements No. 13, 66, and 91 and a rescission of FASB Statement No. 26 and Technical Bulletin No. 79-11)
- FASB Statement No. 99, *Deferral of the Effective Date of Recognition of Depreciation by Not-for-Profit Organizations (an amendment of FASB Statement No. 93)*
- FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale (an amendment of FASB Statement No. 95)*, as amended by FASB Statements No. 115, No. 135, and No. 145

- FASB Statement No. 104, *Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions (an amendment of FASB Statement No. 95)*
- FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, as amended by FASB Statements No. 132 (revised 2003), No. 135, No. 144, and No. 149
- FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, as amended by FASB Statements No. 112, No. 123, No. 126, No. 133, and No. 140, and including FASB Interpretation No. 45
- FASB Statement No. 109, *Accounting for Income Taxes* (paragraph 1.51 of this Guide discusses this pronouncement), as amended by FASB Statements No. 115, No. 123, No. 130, and No. 135
- FASB Statement No. 111, *Rescission of FASB Statement No. 32 and Technical Corrections*
- FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits (an amendment of FASB Statements No. 5 and 43)*, as amended by FASB Statement No. 123
- FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan (an amendment of FASB Statements No. 5 and 15)*, as amended by FASB Statement No. 118
- FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures (an amendment of FASB Statement No. 114)*
- FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, as amended by FASB Statements No. 139 and No. 142 (FASB Statement No. 121 was superseded by FASB Statement No. 144)
- FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*, as amended by FASB Statements No. 133 and No. 149
- FASB Statement No. 129, *Disclosure of Information about Capital Structure*
- FASB Statement No. 132 (revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits* (supersedes FASB Statement No. 132)
- FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by FASB Statements No. 137, No. 138, No. 140, No. 145, No. 149, and No. 150
- FASB Statement No. 135, *Rescission of FASB Statement No. 75 and Technical Corrections*, as amended by FASB Statement No. 145
- FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*
- FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*
- FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- FASB Statement No. 142, *Goodwill and Other Intangible Assets*, as amended by FASB Statements No. 144, No. 145, and No. 147
- FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, as amended by FASB Statement No. 144

- FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, as amended by FASB Statements No. 145 and No. 147
- FASB Statement No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*
- FASB Statement No. 146, *Accounting for Costs Associated With Exit or Disposal Activities*
- FASB Statement No. 149, *Amendment of Statement No. 133 on Derivative Instruments and Hedging Activities*
- FASB Interpretation No. 1, *Accounting Changes Related to the Cost of Inventory*
- FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*
- FASB Interpretation No. 6, *Applicability of FASB Statement No. 2 to Computer Software*, as amended by FASB Statement No. 86
- FASB Interpretation No. 8, *Classification of a Short-Term Obligation Repaid Prior to Being Replaced by a Long-Term Security*
- FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*
- FASB Interpretation No. 19, *Lessee Guarantee of the Residual Value of Leased Property*
- FASB Interpretation No. 20, *Reporting Accounting Changes under AICPA Statements of Position*, as amended by FASB Statement No. 111
- FASB Interpretation No. 21, *Accounting for Leases in a Business Combination*, as amended by FASB Statement No. 145
- FASB Interpretation No. 23, *Leases of Certain Property Owned by a Governmental Unit or Authority*
- FASB Interpretation No. 24, *Leases Involving Only Part of a Building*
- FASB Interpretation No. 26, *Accounting for Purchase of a Leased Asset by the Lessee during the Term of the Lease*
- FASB Interpretation No. 27, *Accounting for a Loss on a Sublease*, as amended by FASB Statements No. 135 and No. 144
- FASB Interpretation No. 37, *Accounting for Translation Adjustments upon Sale of Part of an Investment in a Foreign Entity*
- FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, as amended by FASB Statements No. 113, No. 135, and No. 144 and FASB Interpretation No. 41
- FASB Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*
- FASB Interpretation No. 43, *Real Estate Sales*, as amended by FASB Statement No. 140
- FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*

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Appendix F—All Financial Reporting Pronouncements, Cross-Referenced by Appendix

Note regarding effective dates of pronouncements and the applicability of FASB Statement No. 141, *Business Combinations*, and FASB Statement No. 142, *Goodwill and Other Intangible Assets*:

- See *Appendixes A* through *E* of this chapter for effective date information for recently issued pronouncements.
- FASB Statement No. 141 supersedes or amends certain pronouncements that are listed in this appendix. FASB Statement No. 141 applies to business combinations initiated after June 30, 2001 and prescribes the use of the purchase method for those business combinations. FASB Statement No. 141, however, does not apply to certain combinations, including a combination involving two or more not-for-profit organizations, or the acquisition of a for-profit business entity by a not-for-profit organization. For those combinations, pronouncements that are superseded or amended by FASB Statement No. 141 should be applied as though FASB Statement No. 141 had not superseded or amended them.
- The provisions of FASB Statement No. 142 shall be applied in fiscal years beginning after December 15, 2001, to all goodwill and other intangible assets recognized in an entity's statement of financial position at the beginning of that fiscal year. Early application is permitted in certain circumstances. Certain provisions of FASB Statement No. 142 shall be applied to goodwill and other acquired intangible assets for which the acquisition date is after June 30, 2001, even if an entity has not adopted FASB Statement No. 142 in its entirety. The provisions of FASB Statement No. 141 and FASB Statement No. 142 should not be applied to goodwill and intangible assets arising from a combination between two or more not-for-profit organizations or acquired in the acquisition of a for-profit business entity by a not-for-profit organization until the FASB completes its project on those types of combinations and acquisitions. Thus, the guidance in APB Opinions No. 16 and No. 17 remains in effect for such assets. In addition, when applying APB Opinions No. 16 and No. 17, not-for-profit organizations should continue to apply the amendments to those Opinions found in other literature even though that other literature may have been superseded by FASB Statements No. 141, No. 142, and No. 144. For example, when applying APB Opinion No. 17, not-for-profit organizations should continue to apply the amendments to that Opinion found in FASB Statement No. 121, even though that Statement was superseded by FASB Statement No. 144. Readers should be alert to the issuance of a final Standard on combinations of not-for-profit organizations.

Pronouncement	*Appendix*
ARB No. 1 to ARB No. 42	Superseded
ARB No. 43	E
ARB No. 44	Superseded
ARB No. 44 (Revised)	Superseded
ARB No. 45	E

Pronouncement	*Appendix*
ARB No. 46	E
ARB No. 47 to ARB No. 50	Superseded
ARB No. 51	C
APB Opinion No. 1	Superseded
APB Opinion No. 2	E
APB Opinion No. 3	Superseded
APB Opinion No. 4	E
APB Opinion No. 5	Superseded
APB Opinion No. 6	E
APB Opinions No. 7 and No. 8	Superseded
APB Opinion No. 9	E
APB Opinion No. 10	E
APB Opinion No. 11	Superseded
APB Opinion No. 12	D, E
APB Opinion No. 13	D
APB Opinion No. 14	B
APB Opinion No. 15	Superseded
APB Opinion No. 16	E
APB Opinion No. 17	E
APB Opinion No. 18	A
APB Opinion No. 19	Superseded
APB Opinion No. 20	E
APB Opinion No. 21	E
APB Opinion No. 22	E
APB Opinion No. 23	E
APB Opinion No. 24	Superseded
APB Opinion No. 25	B
APB Opinion No. 26	E
APB Opinion No. 27	Superseded
APB Opinion No. 28	A
APB Opinion No. 29	C
APB Opinion No. 30	E
APB Opinion No. 31	Superseded
FASB Statement No. 1	Superseded
FASB Statement No. 2	E
FASB Statement No. 3	A
FASB Statement No. 4	Superseded
FASB Statement No. 5	E
FASB Statement No. 6	E
FASB Statement No. 7	D
FASB Statements No. 8 and No. 9	Superseded
FASB Statement No. 10	E
FASB Statement No. 11	E
FASB Statement No. 12	Superseded
FASB Statement No. 13	E
FASB Statement No. 14	Superseded
FASB Statement No. 15	E
FASB Statement No. 16	E
FASB Statement No. 17	Superseded
FASB Statement No. 18	Superseded
FASB Statement No. 19	D

Pronouncement	*Appendix*
FASB Statement No. 20	Superseded
FASB Statement No. 21	Superseded
FASB Statement No. 22	E
FASB Statement No. 23	E
FASB Statement No. 24	Superseded
FASB Statement No. 25	D
FASB Statement No. 26	Superseded
FASB Statement No. 27	E
FASB Statement No. 28	E
FASB Statement No. 29	E
FASB Statement No. 30	Superseded
FASB Statements No. 31 to No. 33	Superseded
FASB Statement No. 34	E
FASB Statement No. 35	D
FASB Statement No. 36	Superseded
FASB Statement No. 37	E
FASB Statement No. 38	E
FASB Statements No. 39 to No. 41	Superseded
FASB Statement No. 42	E
FASB Statement No. 43	E
FASB Statement No. 44	Superseded
FASB Statement No. 45	D
FASB Statement No. 46	Superseded
FASB Statement No. 47	E
FASB Statement No. 48	E
FASB Statement No. 49	E
FASB Statement No. 50	D
FASB Statement No. 51	D
FASB Statement No. 52	E
FASB Statement No. 53	Superseded
FASB Statements No. 54 to No. 56	Superseded
FASB Statement No. 57	E
FASB Statement No. 58	E
FASB Statement No. 59	Superseded
FASB Statement No. 60	D
FASB Statement No. 61	D
FASB Statement No. 62	E
FASB Statement No. 63	D
FASB Statement No. 64	Superseded
FASB Statement No. 65	D
FASB Statement No. 66	E
FASB Statement No. 67	D
FASB Statement No. 68	E
FASB Statement No. 69	D
FASB Statement No. 70	Superseded
FASB Statement No. 71	D
FASB Statement No. 72	D
FASB Statement No. 73	D
FASB Statement No. 74	Superseded
FASB Statement No. 75	Superseded
FASB Statement No. 76	Superseded

Pronouncement	*Appendix*
FASB Statement No. 77	Superseded
FASB Statement No. 78	E
FASB Statement No. 79	E
FASB Statement No. 80	Superseded
FASB Statements No. 81 to No. 83	Superseded
FASB Statement No. 84	B
FASB Statement No. 85	Superseded
FASB Statement No. 86	E
FASB Statement No. 87	E
FASB Statement No. 88	E
FASB Statement No. 89	A
FASB Statement No. 90	D
FASB Statement No. 91	D
FASB Statement No. 92	D
FASB Statement No. 93	E
FASB Statement No. 94	C
FASB Statement No. 95	E
FASB Statement No. 96	Superseded
FASB Statement No. 97	D
FASB Statement No. 98	E
FASB Statement No. 99	E
FASB Statement No. 100	Superseded
FASB Statement No. 101	D
FASB Statement No. 102	E
FASB Statement No. 103	Superseded
FASB Statement No. 104	E
FASB Statement No. 105	Superseded
FASB Statement No. 106	E
FASB Statement No. 107	E
FASB Statement No. 108	Superseded
FASB Statement No. 109	E
FASB Statement No. 110	D
FASB Statement No. 111	E
FASB Statement No. 112	E
FASB Statement No. 113	D
FASB Statement No. 114	E
FASB Statement No. 115	A
FASB Statement No. 116	C
FASB Statement No. 117	C
FASB Statement No. 118	E
FASB Statement No. 119	Superseded
FASB Statement No. 120	D
FASB Statement No. 121	E, Superseded
FASB Statement No. 122	Superseded
FASB Statement No. 123	B
FASB Statement No. 124	C
FASB Statement No. 125	Superseded
FASB Statement No. 126	E
FASB Statement No. 127	Superseded
FASB Statement No. 128	A
FASB Statement No. 129	E

Pronouncement	*Appendix*
FASB Statement No. 130	A
FASB Statement No. 131	A
FASB Statement No. 132 (revised 2003)	E
FASB Statement No. 133	E
FASB Statement No. 134	D
FASB Statement No. 135	E
FASB Statement No. 136	C
FASB Statement No. 137	E
FASB Statement No. 138	E
FASB Statement No. 139	D
FASB Statement No. 140	E
FASB Statement No. 141	A
FASB Statement No. 142	E
FASB Statement No. 143	E
FASB Statement No. 144	E
FASB Statement No. 145	E
FASB Statement No. 146	E
FASB Statement No. 147	D
FASB Statement No. 148	B
FASB Statement No. 149	E
FASB Statement No. 150	B
FASB Interpretation No. 1	E
FASB Interpretations No. 2 and No. 3	Superseded
FASB Interpretation No. 4	E
FASB Interpretation No. 5	Superseded
FASB Interpretation No. 6	E
FASB Interpretation No. 7	D
FASB Interpretation No. 8	E
FASB Interpretation No. 9	D
FASB Interpretations No. 10 to No. 13	Superseded
FASB Interpretation No. 14	E
FASB Interpretations No. 15 to No. 17	Superseded
FASB Interpretation No. 18	A
FASB Interpretation No. 19	E
FASB Interpretation No. 20	E
FASB Interpretation No. 21	E
FASB Interpretation No. 22	Superseded
FASB Interpretation No. 23	E
FASB Interpretation No. 24	E
FASB Interpretation No. 25	Superseded
FASB Interpretation No. 26	E
FASB Interpretation No. 27	E
FASB Interpretation No. 28	B
FASB Interpretation No. 29	Superseded
FASB Interpretation No. 30	C

Pronouncement	*Appendix*
FASB Interpretation No. 31	Superseded
FASB Interpretation No. 32	Superseded
FASB Interpretation No. 33	D
FASB Interpretation No. 34	Superseded
FASB Interpretation No. 35	A
FASB Interpretation No. 36	D
FASB Interpretation No. 37	E
FASB Interpretation No. 38	B
FASB Interpretation No. 39	E
FASB Interpretation No. 40	D
FASB Interpretation No. 41	E
FASB Interpretation No. 42	Superseded
FASB Interpretation No. 43	E
FASB Interpretation No. 44	B
FASB Interpretation No. 45	E
FASB Interpretation No. 46 (revised December 2003)	A

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Appendix G—The Hierarchy of GAAP

SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, establishes the hierarchy of GAAP.

For financial statements of entities ***other than governmental entities***, the hierarchy is summarized as follows:

Category (a). Rule 203 literature consists of officially established accounting principles, which are FASB Statements and Interpretations, APB Opinions, and ARBs.

Category (b). This consists of FASB Technical Bulletins and, if cleared by the FASB, AICPA Industry Audit and Accounting Guides, and AICPA SOPs.

Category (c). This consists of AICPA AcSEC Practice Bulletins that have been cleared by the FASB and consensus positions of the FASB EITF.

Category (d). This consists of AICPA accounting interpretations and implementation guides ("Qs and As") published by the FASB staff, and practices that are widely recognized and prevalent either generally or in the industry.

If the accounting treatment of a transaction or event is not specified by Rule 203 literature, the auditor should consider whether the accounting treatment is specified by another source of established accounting principles. If an established accounting principle from one or more sources in category (b), (c), or (d) is relevant to the circumstances, the auditor should be prepared to justify a conclusion that another treatment is generally accepted. If there is a conflict between accounting principles relevant to the circumstances from one or more sources in category (b), (c), or (d), the auditor should follow the treatment specified by the source in the higher category—for example, follow category (b) treatment over category (c)—or be prepared to justify a conclusion that a treatment specified by a source in the lower category better presents the substance of the transaction in the circumstances.

For financial statements of ***State and Local governmental entities***,[1] the hierarchy is summarized as follows:

Category (a). Officially established accounting principles, consists of GASB Statements and Interpretations, as well as AICPA and FASB pronouncements specifically made applicable to state and local governmental entities by GASB Statements or Interpretations. GASB Statements and Interpretations are periodically incorporated in the *Codification of Governmental Accounting and Financial Reporting Standards.*

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[1] State and local governmental entities include public benefit corporations and authorities; public employee retirement systems; and governmental utilities, hospitals and other health care providers, and colleges and universities. SAS No. 91, *Federal GAAP Hierarchy*, amends SAS No. 69 to establish a hierarchy for federal governmental entities. Federal health care organizations are not included in the scope of this Guide.

Category (b). This consists of GASB Technical Bulletins and, if specifically made applicable to state and local governmental entities by the AICPA and cleared[2] by the GASB, AICPA Industry Audit and Accounting Guides and AICPA SOPs.

Category (c). This consists of AICPA AcSEC Practice Bulletins if specifically made applicable to state and local governmental entities and cleared[3] by the GASB, as well as consensus positions of a group of accountants organized by the GASB that attempts to reach consensus positions on accounting issues applicable to state and local governmental entities.[4]

Category (d). Includes implementation guides ("Qs and As") published by the GASB staff, as well as practices that are widely recognized and prevalent in state and local government.

In the absence of a pronouncement covered by Rule 203 or another source of established accounting principles, the auditor of financial statements of state and local governmental entities may consider other accounting literature, depending on its relevance in the circumstances. Other accounting literature includes, for example, GASB Concepts Statements; the pronouncements referred to in categories (a) through (d) above that relate to other than governmental entities when not specifically made applicable to state and local governmental entities either by the GASB or by the organization issuing them; FASB Concepts Statements; Federal Accounting Standards Advisory Board (FASAB) Statements, Interpretations, Technical Bulletins, and Concepts Statements; AICPA Issues Papers; International Accounting Standards of the International Accounting Standards Committee; pronouncements of other professional associations or regulatory agencies; Technical Information Service Inquiries and Replies included in AICPA *Technical Practice Aids*; and accounting textbooks, handbooks, and articles. The appropriateness of other accounting literature depends on its relevance to particular circumstances, the specificity of the guidance, and the general recognition of the issuer or author as an authority. For example, GASB Concepts Statements would normally be more influential than other sources in this category.

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[2] The auditor should assume that such pronouncements specifically made applicable to state and local governments have been cleared by the GASB unless the pronouncement indicates otherwise.

[3] See footnote 2.

[4] As of the date of this Guide, the GASB had not organized such a group.

Chapter 2

General Auditing Considerations

Auditing Guidance in the Audit and Accounting Guide *State and Local Governments*

2.01 This Guide is not the only industry-specific AICPA Audit and Accounting Guide that auditors should consider when performing an audit of a governmental health care entity. The Audit and Accounting Guide *State and Local Governments,* includes governmental health care entities in its scope and the auditing guidance in that Guide should also be considered during an audit of a governmental health care entity that is included in the scope of this Guide.

Registered Public Accounting Firms

2.02 Registered public accounting firms must comply with the standards of the Public Company Accounting Oversight Board (PCAOB) in connection with the preparation or issuance of any audit report on the financial statements of an issuer, as defined by the Sarbanes-Oxley Act, and other entities when prescribed by the rules of the SEC (collectively referred to as "issuers").

Scope of the Engagement

2.03 SAS No. 83, *Establishing an Understanding With the Client,* as amended by SAS No. 89, *Audit Adjustments* (AICPA, *Professional Standards,* vol. 1, AU sec. 310), provides that, for each audit engagement, the independent auditor and the health care organization should establish a clear understanding regarding the services to be performed. The understanding should include the objectives of the engagement, management's responsibilities, the auditor's responsibilities, and limitations of the engagement. Such an understanding should be documented in the audit documentation preferably through a written communication with the client. If the auditor believes an understanding with the client has not been established, he or she should decline to accept or perform the engagement. In addition to reporting on the entity's basic financial statements, the independent auditor may be asked to report on the following special reports: (*a*) cost-reimbursement reports; (*b*) cost reports related to research grants; (*c*) reports for contributors; (*d*) reports for local, state, or federal authorities; (*e*) reports related to bond indentures and other debt instruments; and (*f*) other special-purpose reports. The nature, timing, and extent of auditing procedures to be performed and the type of reports to be issued are based on the scope of services required by the entity. Chapter 4 in the Audit and Accounting Guide *State and Local Governments* (see paragraph 2.01 in this chapter of the Guide), also discusses the need to establish an understanding with the client. That discussion states that the auditor should consider holding a preaudit conference with the auditee to discuss the responsibilities of both the auditee and the auditor. That discussion also provides a listing of topics for the preaudit conference that have elements that are unique to or significant in a governmental audit.

Planning the Audit

2.04 The nature, timing, and extent of planning usually vary with the size and complexity of the entity, as well as with the independent auditor's experience

with the entity and with the industry. SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), contains guidance on planning an audit in accordance with generally accepted auditing standards (GAAS).

2.05 The independent auditor's work in forming an opinion on financial statements consists of obtaining and evaluating evidential matter regarding management's assertions. Assertions are representations by management that are embodied in the financial statements. They can be either explicit or implicit and can be classified according to the following broad categories: existence and occurrence, completeness, rights and obligations, valuation and allocation, and presentation and disclosure.

2.06 The purpose of specific audit objectives and examples of control activities in the auditing sections of the following chapters is to illustrate how the independent auditor might obtain an understanding of internal control, assess control risk, and perform audit procedures. There is not necessarily a one-to-one relationship between audit objectives and procedures. Some procedures may relate to more than one objective. On the other hand, a combination of procedures may be needed to achieve a single objective. The illustrations are not intended to be all-inclusive or to suggest that specific audit objectives, control activities, and audit procedures should be applied. Some of the objectives may not be relevant to a particular entity because of the nature of its operations or the absence of certain types of transactions. The absence of one or more of the illustrative controls would not necessarily indicate a deficiency in internal control. The auditor performs procedures that are responsive to the auditor's risk assessment.

2.07 The illustrations are arranged by broad audit objectives. These classifications may be useful in the evaluation process, but the classifications are of secondary importance. Some specific objectives may serve to achieve more than one broad objective.

2.08 Many of the illustrative control activities are premised on the existence of certain essential characteristics of internal control (for example, authorization of transactions, segregation of duties, documentation, supervision and review, and timeliness of procedures). To avoid repetition, these characteristics have not been emphasized in the illustrations.

Inherent Risk

2.09 In determining the scope of audit procedures to be performed, the independent auditor should be aware of certain aspects of the health care organization's operations that are usually subject to higher or lower levels of inherent risk. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), provides guidance on the consideration of audit risk and materiality when planning and performing an audit of financial statements. SAS No. 96, *Audit Documentation*, amends SAS No. 47 (AICPA, *Professional Standards*, vol. 1, AU sec. 312.40), to require that the auditor should document the nature and effect of aggregated misstatements, and his or her conclusion as to whether the aggregated misstatements cause the financial statements to be materially misstated. SAS No. 98, *Omnibus Statement on Auditing Standards—2002* (AICPA, *Professional Standards*, vol. 1, AU sec. 312.34–.41), amends the section "Evaluating Audit Findings" of SAS No. 47, to clarify the auditor's responsibility with respect to evaluating auditing adjustments. SOP 00-1, *Auditing Health Care Third-Party Revenues and Related Receivables*, provides guidance to auditors regarding uncertainties

inherent in health care third-party revenue recognition. SOP 00-1 is included as Appendix E to this Guide. The Audit and Accounting Guide *State and Local Governments* (see paragraph 2.01 in this chapter of the Guide), provides additional guidance on audit materiality determinations, including *opinion units*, as that term is described in *State and Local Governments.*

2.10 In many health care organizations, certain accounts typically (*a*) will have a low volume of transactions, (*b*) will consist of transactions that are not complex, and (*c*) do not require the use of significant accounting estimates. Accounts such as inventories, marketable securities, assets whose use is limited, property and equipment, long-term debt, and equity frequently have these characteristics and may allow the auditor to assess inherent risk as being at a relatively low level. However, in certain circumstances, such as investments in complex derivative financial instruments, inherent risk may be higher. The auditor should use professional judgment in evaluating the factors relevant to assessments of inherent risk. SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), among other matters, provides guidance to auditors in planning and performing auditing procedures for assertions about derivative instruments that are made in an entity's financial statements, and presents examples of factors that affect inherent risk for assertions about derivatives. In addition, a companion Audit Guide, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, provides practical guidance for implementing SAS No. 92.

2.11 Because of the large monetary amounts and the complexity of determining health care service revenue and receivables, there are risks associated with health care service revenue recognition and the valuation of the related receivables. A significant portion of services usually is paid for by third parties such as Medicare, Medicaid, and various health insurance carriers under statutory provisions or other arrangements in amounts that can be significantly different from, and frequently less than, the entity's established rates.

2.12 Risks are associated with recognizing the liability for costs incurred by providers of prepaid health care services (for example, HMOs) because such costs may have been incurred but not yet reported to the providers. It is therefore necessary to estimate the liability for those costs. These estimates often require a high degree of management judgment. Management must consider historical experience as well as the effects of any changes in conditions such as seasonality trends and changes in subscriber population and in the services and benefits provided.

2.13 Risks also are associated with contingencies for uninsured medical malpractice losses and obligations under continuing care contracts. A high degree of management judgment and complex analyses usually are involved in evaluating the related financial statement assertions.

2.14 The risk of material misstatements, whether caused by error or fraud, and illegal acts by clients is present in all audit engagements. SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), describes the auditor's responsibilities for detecting illegal acts in an audit of financial statements and the auditor's responsibilities for communicating detected illegal acts to parties within and external to the entity.

Consideration of Fraud in a Financial Statement Audit

2.15 SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), is the primary source of

authoritative guidance about an auditor's responsibilities concerning the consideration of fraud in a financial statement audit. SAS No. 99 supersedes SAS No. 82, *Consideration of Fraud in a Financial Statement Audit,* and amends SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230). SAS No. 99 establishes standards and 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 as stated in SAS No. 1, section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1, AU sec. 110.02). SAS No. 99 also amends SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), as amended.

2.16 There are two types of misstatements relevant to the auditor's consideration of fraud in a financial statement audit:

- Misstatements arising from fraudulent financial reporting
- Misstatements arising from misappropriation of assets

2.17 Three conditions generally are present when fraud occurs. First, management or other employees have an *incentive* or are under *pressure*, which provides a reason to commit fraud. Second, circumstances exist—for example, the absence of controls, ineffective controls, or the ability of management to override controls—that provide an *opportunity* for a fraud to be perpetrated. Third, those involved are able to *rationalize* committing a fraudulent act.

The Importance of Exercising Professional Skepticism

2.18 Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred.

Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud

2.19 Members of the audit team should discuss the potential for material misstatement due to fraud in accordance with the requirements of paragraphs 14 through 18 of SAS No. 99 (AU sec. 316.14–.18). The discussion among the audit team members about the susceptibility of the entity's financial statements to material misstatement due to fraud should include a consideration of the known external and internal factors affecting the entity that might (*a*) create incentives/pressures for management and others to commit fraud, (*b*) provide the opportunity for fraud to be perpetrated, and (*c*) indicate a culture or environment that enables management to rationalize committing fraud. Communication among the audit team members about the risks of material misstatement due to fraud also should continue throughout the audit.

Obtaining the Information Needed to Identify the Risks of Material Misstatement Due to Fraud

2.20 SAS No. 22 (AICPA, *Professional Standards*, vol. 1, AU sec. 311.06–.08), provides guidance about how the auditor obtains knowledge about the entity's business and the industry in which it operates. In performing that work, information may come to the auditor's attention that should be considered in identifying risks of material misstatement due to fraud. As part of this work, the auditor should perform the following procedures to obtain information that is used (as described in paragraphs 35 through 42 of SAS No. 99 [AU sec. 316.35–.42]) to identify the risks of material misstatement due to fraud:

a. Make inquiries of management and others within the entity to obtain their views about the risks of fraud and how they are addressed. (See paragraphs 20 through 27 of SAS No. 99 [AU sec. 316.20–.27].)

b. Consider any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit. (See paragraphs 28 through 30 of SAS No. 99 [AU sec. 316.28–.30].)

c. Consider whether one or more fraud risk factors exist. (See paragraphs 31 through 33 of SAS No. 99 [AU sec. 316.31–.33], the Appendix to SAS No. 99, and paragraph 2.22 in this chapter.)

d. Consider other information that may be helpful in the identification of risks of material misstatement due to fraud. (See paragraph 34 of SAS No. 99 [AU sec. 316.34].)

2.21 In planning the audit, the auditor also should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that may indicate a material misstatement due to fraudulent financial reporting.

2.22 *Considering Fraud Risk Factors.* As indicated in paragraph 2.20(*c*) in this chapter, the auditor may identify events or conditions that indicate incentives/pressures to perpetrate fraud, opportunities to carry out the fraud, or attitudes/rationalizations to justify a fraudulent action. Such events or conditions are referred to as "fraud risk factors." Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances where fraud exists.

2.23 SAS No. 99 provides fraud risk factor examples that have been written to apply to most enterprises. Remember that fraud risk factors are only one of several sources of information an auditor considers when identifying and assessing risk of material misstatement due to fraud.

Identifying Risks That May Result in a Material Misstatement Due to Fraud

2.24 In identifying risks of material misstatement due to fraud, it is helpful for the auditor to consider the information that has been gathered in accordance with the requirements of paragraphs 19 through 34 of SAS No. 99 (AU sec. 316.19–.34). The auditor's identification of fraud risks may be influenced by characteristics such as the size, complexity, and ownership attributes of the entity. In addition, the auditor should evaluate whether identified risks of material misstatement due to fraud can be related to specific financial-statement

account balances or classes of transactions and related assertions, or whether they relate more pervasively to the financial statements as a whole. Certain accounts, classes of transactions, and assertions that have high inherent risk because they involve a high degree of management judgment and subjectivity also may present risks of material misstatement due to fraud because they are susceptible to manipulation by management.

A Presumption That Improper Revenue Recognition Is a Fraud Risk

2.25 Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period). Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition (see paragraph 41 of SAS No. 99 [AU sec. 316.41]).

A Consideration of the Risk of Management Override of Controls

2.26 Even if specific risks of material misstatement due to fraud are not identified by the auditor, there is a possibility that management override of controls could occur, and accordingly, the auditor should address that risk (see paragraph 57 of SAS No. 99 [AU sec. 316.57]) apart from any conclusions regarding the existence of more specifically identifiable risks. Specifically, the procedures described in paragraphs 58 through 67 of SAS No. 99 (AU sec. 316.58–.67) should be performed to further address the risk of management override of controls. These procedures include (1) examining journal entries and other adjustments for evidence of possible material misstatement due to fraud, (2) reviewing accounting estimates for biases that could result in material misstatement due to fraud, and (3) evaluating the business rationale for significant unusual transactions.

Assessing the Identified Risks After Taking Into Account an Evaluation of the Entity's Programs and Controls That Address the Risks*

2.27 Auditors should comply with the requirements of paragraphs 43 through 45 of SAS No. 99 (AU sec. 316.43–.45) concerning an entity's programs and controls that address identified risks of material misstatement due to fraud.

2.28 The auditor should consider whether such programs and controls mitigate the identified risks of material misstatement due to fraud or whether specific control deficiencies exacerbate the risks. After the auditor has evaluated whether the entity's programs and controls have been suitably designed

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* In March 2004, the Public Company Accounting Oversight Board (PCAOB) issued Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements,* which was subsequently approved by the Securities and Exchange Commission (SEC). This Standard applies to audits of issuers, as defined by the Sarbanes-Oxley Act, and other entities when prescribed by the rules of the SEC (collectively referred to as "issuers"). PCAOB Auditing Standard No. 2 establishes requirements that apply when an auditor is engaged to audit both an issuer's financial statements and management's assessment of the effectiveness of internal control over financial reporting. Auditing Standard No. 2 specifically addresses and emphasizes the importance of controls over possible fraud and requires the auditor to test controls specifically intended to prevent or detect fraud that is reasonably likely to result in material misstatement of the financial statements. See the Preface to this Guide for more detailed information, and paragraph 2.02 of this chapter.

and placed in operation, the auditor should assess these risks taking into account that evaluation. The assessment should be considered when developing the auditor's response to the identified risks of material misstatement due to fraud.

Responding to the Results of the Assessment

2.29 Paragraphs 46 through 67 of SAS No. 99 (AU sec. 316.46–.67) provide requirements and guidance about an auditor's response to the results of the assessment of the risks of material misstatement due to fraud. The auditor responds to risks of material misstatement due to fraud in the following three ways:

a. A response that has an overall effect on how the audit is conducted—that is, a response involving more general considerations apart from the specific procedures otherwise planned (see paragraph 50 of SAS No. 99 [AU sec. 316.50]).

b. A response to identified risks involving the nature, timing, and extent of the auditing procedures to be performed (see paragraphs 51 through 56 of SAS No. 99 [AU sec. 316.51–.56]).

c. A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur (see paragraphs 57 through 67 of SAS No. 99 [AU sec. 316.57–.67] and paragraph 2.26 in this chapter).

Evaluating Audit Evidence

2.30 Paragraphs 68 through 78 of SAS No. 99 (AU sec. 316.68–.78) provide requirements and guidance for evaluating audit evidence. The auditor should evaluate whether analytical procedures that were performed as substantive tests or in the overall review stage of the audit indicate a previously unrecognized risk of material misstatement due to fraud. The auditor also should consider whether responses to inquiries throughout the audit about analytical relationships have been vague or implausible, or have produced evidence that is inconsistent with other evidential matter accumulated during the audit.

2.31 At or near the completion of fieldwork, the auditor should evaluate whether the accumulated results of auditing procedures and other observations affect the assessment of the risks of material misstatement due to fraud made earlier in the audit. As part of this evaluation, the auditor with final responsibility for the audit should ascertain that there has been appropriate communication with the other audit team members throughout the audit regarding information or conditions indicative of risks of material misstatement due to fraud.

Responding to Misstatements That May Be the Result of Fraud

2.32 When audit test results identify misstatements in the financial statements, the auditor should consider whether such misstatements may be indicative of fraud. See paragraphs 75 through 78 of SAS No. 99 (AU sec. 316.75–.78) for requirements and guidance about an auditor's response to misstatements that may be the result of fraud. If the auditor believes that misstatements are or may be the result of fraud, but the effect of the misstatements is not material to the financial statements, the auditor nevertheless

should evaluate the implications, especially those dealing with the organizational position of the person(s) involved.

2.33 If the auditor believes that the misstatement is or may be the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to evaluate whether the effect is material, the auditor should:

a. Attempt to obtain additional evidential matter to determine whether material fraud has occurred or is likely to have occurred, and, if so, its effect on the financial statements and the auditor's report thereon.[1]

b. Consider the implications for other aspects of the audit (see paragraph 76 of SAS No. 99 [AU sec. 316.76]).

c. Discuss the matter and the approach for further investigation with an appropriate level of management that is at least one level above those involved, and with senior management and the audit committee.[2]

d. If appropriate, suggest that the client consult with legal counsel.

2.34 The auditor's consideration of the risks of material misstatement and the results of audit tests may indicate such a significant risk of material misstatement due to fraud that the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to the audit committee or others with equivalent authority and responsibility. The auditor may wish to consult with legal counsel when considering withdrawal from an engagement.

Communicating About Possible Fraud to Management, the Audit Committee, and Others

2.35 Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. See paragraphs 79 through 82 of SAS No. 99 (AU sec. 316.79–.82) for further requirements and guidance about communications with management, the audit committee, and others.

Documenting the Auditor's Consideration of Fraud

2.36 Paragraph 83 of SAS No. 99 (AU sec. 316.83) requires certain items and events to be documented by the auditor. Auditors should comply with those requirements.

Practical Guidance

2.37 The AICPA Practice Aid *Fraud Detection in a GAAS Audit—Revised Edition*, provides a wealth of information and help on complying with the provisions of SAS No. 99. Moreover, this Practice Aid will assist auditors in understanding the requirements of SAS No. 99 and whether current audit practices effectively incorporate these requirements. This Practice Aid is an

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[1] See Statement on Auditing Standards (SAS) No. 58, Reports on Audited Financial Statements (AICPA, *Professional Standards*, vol. 1, AU sec. 508), for guidance on auditor's reports issued in connection with audits of financial statements.

[2] If the auditor believes senior management may be involved, discussion of the matter directly with the audit committee may be appropriate.

Other Auditing Publication as defined in SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply SASs.

Internal Control†

2.38 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, and SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), describes the components of internal control and explains how an independent auditor should consider internal control in planning and performing an audit. Internal control is a process—effected by an entity's board of directors, management, and other personnel—designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (*a*) reliability of financial reporting, (*b*) effectiveness and efficiency of operations, and (*c*) compliance with applicable laws and regulations. Internal control consists of the following five interrelated components:

a. Control environment

b. Risk assessment

c. Control activities

d. Information and communication

e. Monitoring

2.39 The auditor should obtain an understanding of each of the five components of internal control sufficient to plan the audit. A sufficient understanding is obtained by performing procedures to understand the design of controls relevant to an audit of financial statements and whether the controls have been placed in operation. In obtaining this understanding, the auditor considers how an entity's use of information technology (IT) and manual procedures may affect controls relevant to the audit. IT encompasses automated means of originating, processing, storing, and communicating information, and includes recording devices, communication systems, computer systems, and other electronic devices. The auditor is primarily interested in the entity's use of IT to initiate, record, process, and report transactions or other financial data.

2.40 After obtaining an understanding of the components of internal control, the independent auditor assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements. The independent auditor uses the understanding of internal control and the assessed level of control risk in determining the nature, timing, and extent of substantive tests for financial statement assertions.

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† In March 2004, the PCAOB issued Auditing Standard No. 2, which was subsequently approved by the SEC. This Standard applies to audits of the financial statements of issuers, as defined by the Sarbanes-Oxley Act, and other entities when prescribed by the rules of the SEC (collectively referred to as "issuers"). PCAOB Auditing Standard No. 2 establishes requirements that apply when an auditor is engaged to audit both an issuer's financial statements and management's assessment of the effectiveness of internal control over financial reporting. Due to the issuance of PCAOB Auditing Standard No. 2, a related proposed Standard (PCAOB Release No. 2004-002), would amend and supersede certain sections of the PCAOB Interim Standards. See the Preface to this Guide for more detailed information, and paragraph 2.02 of this chapter. Registered public accounting firms auditing the financial statements of issuers should keep alert to final SEC approval of this PCAOB Standard.

Analytical Procedures

2.41 SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), provides guidance on the use of analytical procedures and requires their use in the planning and overall review stages of all audits. The AICPA Audit Guide *Analytical Procedures*, provides practical guidance to auditors on the effective use of analytical procedures. That Audit Guide includes a discussion of SAS No. 56; concepts and definitions; a series of questions and answers; and a case study illustrating trend analysis, ratio analysis, reasonableness testing, and regression analysis. For planning purposes, these procedures should focus on (*a*) enhancing the independent auditor's understanding of the client's business and the transactions and events that have occurred since the last audit date and (*b*) identifying areas that may represent specific risks relevant to the audit. Thus, the objective of the procedures is to identify such things as the existence of unusual transactions and events, as well as amounts, ratios, and trends that might indicate matters that have financial statement and audit planning ramifications. For overall review purposes, these procedures should focus on considering the adequacy of the evidence gathered in response to unusual or unexpected balances or relationships. The objective of the procedures is to assist the auditor in assessing the conclusions reached and evaluating the overall financial statement presentation. Analytical procedures also may be used as substantive tests to identify potential misstatements. These procedures focus on comparing actual balances with expected balances and investigating and evaluating significant differences from the balances expected. SAS No. 96 amends SAS No. 56 (AICPA, *Professional Standards*, vol. 1, AU sec. 329.22), to add a requirement that the auditor document all of the following when an analytical procedure is used as the principal substantive test of a significant financial statement assertion:

a. The expectation, where that expectation is not otherwise readily determinable from the documentation of the work performed, and factors considered in its development

b. Results of the comparison of the expectation to the recorded amounts or ratios developed from recorded amounts

c. Any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures

2.42 Examples of sources of information for developing expectations include prior-period financial information, budgets, and health care financial and statistical ratios. Additional information is available from the Center for Healthcare Industry Performance Studies' (CHIPS) Financial Analysis Service, which is published annually, as well as other health care industry associations.

2.43 Following are examples of analytical procedures the independent auditor may find useful:

- Comparison of account balances with budget and prior-period amounts
- Analysis of changes in revenues during the current period based on statistical data (for example, admissions, patient days, visits, and professional service procedure counts for laboratory, radiology, and surgery) and information concerning price changes
- Comparison between periods of the number of days of revenue in receivables
- Relationship between periods of the allowance for uncollectible accounts to the balance of patient accounts receivable in the aggregate,

based on known changes in the accounts receivable's aging and composition by payor

- Relationship between periods of the liability for claims incurred but not reported (IBNR) to the related expense

Accounting Estimates

2.44 In determining the scope of audit procedures to be performed, the independent auditor should recognize that certain areas of health care organization operations require accounting estimates that may be material in the preparation and presentation of financial statements. SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*,[3] requires entities to include in their financial statements information about the use of estimates in the preparation of financial statements. In addition, if certain specified disclosure criteria are met, the SOP requires entities to include disclosures about certain significant estimates in their financial statements. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), provides guidance on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates in an audit of financial statements in accordance with GAAS. SOP 00-1 provides guidance for auditors regarding the sufficiency of evidential matter supporting accounting estimates recorded for the proper valuation of health care third-party revenues and related receivables. SOP 00-1 is included as Appendix E to this Guide.

2.45 Although management is responsible for making estimates, the independent auditor is responsible for evaluating the reasonableness of estimates and should consider appropriate procedures in planning and performing the audit. These procedures should include both subjective and objective factors.

2.46 The independent auditor should acquire an understanding of the relevance of internal control to the accumulation of data and the preparation of accounting estimates. Internal control should also provide for adequate review and approval of accounting estimates by appropriate levels of authority.

2.47 Although significant accounting estimates may affect many elements of a health care organization's financial statements, they most often affect the following:

a. The provision for third-party payor contractual adjustments and allowances and the provision for estimated receivables and payables for final settlements with those payors

b. The provision for uncollectible accounts

c. Accruals for uninsured medical malpractice claims

d. Accruals for obligations under continuing care contracts

e. Accruals by providers of prepaid health care services for IBNR costs

Individual Practice Associations

2.48 In planning the audit of an individual practice association (IPA), the auditor usually considers the following matters:

- The size of a typical IPA accounting department and business office often is not large enough to result in effective segregation of duties.

[3] SOP 94-6 does not pertain to governmental entities, unless the entity has elected to follow all FASB pronouncements under paragraph 7 of GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*. (See Chapter 1, footnote 1.)

However, most IPAs have an active office manager who can exercise a high degree of influence and control over the operations.

- Physician compensation arrangements often use incentives or other features with complicated methodologies and formulas.
- Contracts with managed care plans, often with capitated payment and risk pool settlement terms, frequently represent a significant amount of revenue for the IPA.

2.49 IPAs with capitated contracts accrue costs when the services are rendered, including cost estimates of IBNR claims. The IBNR accrual includes an estimate of the costs of services for which the IPA is responsible, including referrals outside the IPA. Risk pool settlements should be accrued during the contract period based on relevant factors, such as experience to date.

Other Planning Considerations

2.50 In planning the audit, the independent auditor also should consider—

- Matters relating to the entity's business and the health care industry.
- Financial statement items likely to require adjustment.
- Conditions that might require extension or modification of audit tests (such as the existence of related party transactions or the existence of uninsured malpractice risks).
- The entity's experience with payment denials and other matters subject to review by medical review organizations.
- The nature of reports expected to be rendered. Examples include reports on consolidated or consolidating financial statements, reports on financial statements filed with the Securities and Exchange Commission (SEC), reports filed with third-party payors or other regulatory bodies, and other special reports.

2.51 Planning procedures usually include reviewing the independent auditor's files relating to the entity and holding discussions with audit personnel and the personnel of the entity. Examples of these procedures include the following:

- Review correspondence files, the prior year's audit documentation, permanent files, financial statements, and independent auditors' reports.
- Review the minutes of meetings of the governing board of directors and board committees.
- Review the relationship of affiliated organizations to the health care organization and determine the extent to which their financial information should be included in the financial statements of the entity. (See the related discussion in Chapter 11.)
- Review the status of unsettled cost (reimbursement) reports for prior periods filed with third-party payors.
- Discuss matters that may affect the audit with the firm's personnel responsible for any nonaudit services to the entity.
- Identify situations for which accounting estimates are required and relevant factors that may affect those estimates.
- Inquire about current business developments affecting the entity.
- Read the current year's interim financial statements and 10-Q forms.
- Review periodic reports to third-party payors or other regulatory bodies.

- Discuss the nature, scope, and timing of the engagement with the entity's management, board of directors, or audit committee.
- Consider the effects of all applicable accounting and auditing pronouncements, particularly recent pronouncements.
- Coordinate the assistance of entity personnel in data preparation.
- Determine the extent of involvement, if any, of consultants, specialists, and internal auditors.
- Establish the timing of the audit work.

2.52 SAS No. 96 (AICPA, *Professional Standards*, vol. 1, AU sec. 339), provides guidance regarding the content, ownership, and confidentiality of audit documentation. Audit documentation should include abstracts or copies of significant contracts or agreements that were examined to evaluate the accounting for significant transactions.[‡]

2.53 The independent auditor may find it helpful to maintain a permanent file that includes copies of the following documents relating to the health care organization:

a. Articles of incorporation

b. Bylaws

c. Chart of accounts

d. Organization chart

e. Specific documents concerning restrictions on donor gifts and bequests

f. Contracts and agreements, including leases, agreements with physicians, agreements with third-party payors, and agreements with affiliated organizations

g. Description of internal control

h. Loan agreements, bond indentures, and other debt instruments

2.54 The independent auditor should understand the specific cost-finding or other rate-setting methods used by third-party payors to determine final amounts reimbursable to the health care organization. These payment methods may require that a health care organization accumulate and report various statistical data, such as admissions, discharges, patient days, visits, beds, square footage, and pounds of laundry.

2.55 The independent auditor intending to use audit-sampling procedures should refer to SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350), when planning the work to be done. The AICPA Audit Guide *Audit Sampling* presents recommendations on the application of generally accepted auditing standards to audits involving the use of audit sampling

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[‡] The PCAOB has issued 1) Auditing Standard No. 3, *Audit Documentation*, and an amendment to their Interim Auditing Standards, and 2) Auditing Standard No. 2. These Standards apply to audits of financial statements of issuers, as defined by the Sarbanes-Oxley Act, and other entities when prescribed by the rules of the SEC (collectively referred to as "issuers").

The *Audit Documentation* Standard supersedes AU sec. 339 of the PCAOB's Interim Standards. The Standard establishes general requirements for documentation the auditor should prepare and retain in connection with any engagement conducted in accordance with auditing and related professional practice Standards of the PCAOB.

PCAOB Auditing Standard No. 2 establishes requirements that apply when an auditor is engaged to audit both an issuer's financial statements and management's assessment of the effectiveness of internal control over financial reporting. PCAOB Auditing Standard No. 2 provides that in addition tc the documentation requirements contained in AU sec. 339 of the PCAOB's Interim Standards, the auditor should document certain items related to their audit of internal control over financial reporting.

See the Preface to this Guide for more detailed information, and paragraph 2.02 of this chapter.

methods, and guidance on applying audit sampling in accordance with SAS No. 39.

2.56 If the health care organization has an internal audit function, the independent auditor should also refer to SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 322).

Transactions Processed by Service Organizations

2.57 Health care organizations may engage outside service organizations to perform services that are part of the health care provider's *information system*. A service organization's services are part of an entity's information system if they affect any of the following—

- The classes of transactions in the entity's operations that are significant to the entity's financial statements
- The procedures, both automated and manual, by which the entity's transactions are initiated, recorded, processed, and reported from their occurrence to their inclusion in the financial statements
- The related accounting records, whether electronic or manual, supporting information, and specific accounts in the entity's financial statements involved in initiating, recording, processing and reporting the entity's transactions
- How the entity's information system captures other events and conditions that are significant to the financial statements
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures

Examples of service organizations used by health care organizations include the following:

- Bank trust departments that invest and service assets for health care organizations
- Service organizations that process payroll
- Billing entities that prepare reimbursement claims to insurers and other third parties
- Administrators of employee benefit plans who process and pay benefit claims and maintain participant records

2.58 SAS No. 55, as amended by SAS No. 78, and SAS No. 94 states that the auditor should obtain an understanding of an entity's internal control sufficient to plan the audit. This understanding may encompass controls placed in operation by the health care organization and service organizations whose services are part of the health care organization's information system. In planning the audit, such information should be used to—

- Identify types of potential misstatements.
- Consider factors that affect the risk of material misstatement.
- Design tests of controls, when applicable.
- Design substantive tests.

2.59 SAS No. 70, *Service Organizations*, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 324), explains the considerations an auditor should make in obtaining an understanding of internal control and assessing control risk for entities that use a service organization to process transactions.

The AICPA Audit Guide *Service Organizations: Applying SAS No. 70, as Amended,* provides additional guidance for user auditors engaged to audit the financial statements of entities that use service organizations.

2.60 The auditor of a health care organization should determine whether the health care organization uses a service organization. Information about the nature of the services provided by the service organization and the service organization's controls over those services may be available from sources such as user manuals, system overviews, technical manuals, the contract between the health care organization and the service organization, and reports by service auditors, internal auditors, or regulatory authorities on the service organization's controls.

2.61 After considering the available information, the auditor of the health care organization may conclude that he or she has the means to obtain a sufficient understanding of internal control to plan the audit. If the auditor of the health care organization concludes that information is not available to obtain a sufficient understanding to plan the audit, he or she may consider contacting the service organization, through the health care organization, to obtain specific information or request that a service auditor be engaged to perform procedures that will supply the necessary information, or the auditor of the health care organization may visit the service organization and perform such procedures. If the auditor of the health care organization is unable to obtain sufficient evidence to achieve his or her audit objectives, the auditor of the health care organization should qualify his or her opinion or disclaim an opinion on the financial statements because of a scope limitation.

2.62 After obtaining an understanding of internal control, the auditor may assess control risk at the maximum level for some or all financial statement assertions related to the service organization's processing because, he or she believes controls are unlikely to pertain to an assertion, are unlikely to be effective, or because evaluating their effectiveness would be inefficient. Procedures to evaluate operating effectiveness include one or any combination of the following:

a. Performing tests of controls over the activities of the service organization at the health care organization

b. Performing tests of controls at the service organization

c. Obtaining a service auditor's report that describes the results of tests of the operating effectiveness of controls performed by the service auditor

Other Audit Considerations

Illegal Acts

2.63 The Social Security Act provides for criminal penalties for individuals or entities that offer, pay, solicit, or receive remuneration to induce business that is reimbursed under Medicare or state health care programs. The types of remuneration covered by the Medicare Anti-Kickback Statute include, with certain exceptions, kickbacks, bribes, and rebates made directly or indirectly, overtly or covertly, and in cash or in kind. In addition, prohibited conduct includes not only remuneration intended to induce referrals or patients but also remuneration intended to induce the purchasing, leasing, ordering, or arranging for any good, facility, service, or item paid for by Medicare or state health care programs. In addition, fraudulent activities may exist that are unrelated to Medicare or state programs, such as fraudulent billing and admitting practices.

2.64 The auditor's procedures will vary based on his or her assessment of the risk of material misstatement resulting from such illegal acts. SAS No. 54 states that the auditor should plan and perform the audit to provide reasonable assurance of detecting illegal acts having a direct and material effect on the determination of financial statement amounts. SAS No. 54 also notes that an audit in accordance with GAAS does not include audit procedures specifically designed to detect illegal acts that have only an indirect effect on the financial statements (for example, illegal acts that have a material effect as the result of fines or penalties that may be imposed on the entity) and provides guidance on the auditor's responsibilities when specific information concerning the possible existence of this type of illegal act comes to the auditor's attention.

2.65 Examples of laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of amounts in financial statements of health care organizations include tax laws affecting tax accruals and tax expense as well as Medicare and Medicaid laws directly affecting the amount of revenue recognized during the accounting period (such as those concerning the submission of bills for fictitious patients).

2.66 Health care organizations also may be affected by many other laws and regulations such as those related to Medicare and Medicaid fraud and abuse, securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment opportunities, and price-fixing or other antitrust violations. Generally, these laws and regulations relate more to an entity's operating aspects than to its financial and accounting aspects, and their financial statement effect is only indirect. An auditor ordinarily does not have sufficient basis for recognizing possible violations of such laws and regulations. Their indirect effect is normally the result of the need to disclose a contingent liability because of the allegation or determination of illegality. For example, patients may be obtained based on illegal arrangements with physicians or other providers. While the direct effects of the services rendered may be recorded appropriately, their indirect effects, the possible contingent liability for violating Medicare and Medicaid fraud and abuse statutes, may not be appropriately disclosed. Even when violations of such laws and regulations can have consequences material to the financial statements, auditors may not become aware of the existence of the illegal act unless he or she is informed by the client, or there is evidence of a governmental agency investigation or enforcement proceeding in the records, documents, or other information normally inspected in an audit of financial statements.

2.67 Whether an act is, in fact, illegal is a determination that is normally beyond the auditor's professional competence. 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. However, determining whether a particular client 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. For example, determining whether admitting a patient or providing a service is medically necessary or whether a particular procedure or device was properly approved is not within the auditor's professional competence.

Use of a Specialist

2.68 SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), provides guidance to the auditor who uses the work of a specialist in performing the audit of a health care organization's financial statements. Guidance is provided on deciding when to use a specialist, the auditor's responsibilities for evaluating the qualifications and the work

of the specialist, and using the findings of the specialist. The Statement requires the auditor to evaluate the relationship of the specialist to the client and states that the auditor should perform additional procedures if the auditor concludes that the objectivity of the specialist may be impaired by such a relationship.

Clinical Coding Validations

2.69 Typically, a number of clinicians (e.g., the attending physician, consulting physicians, radiologists, pathologists, therapists, and nurses) add documentation to a patient's medical record. Provider personnel generally review the medical record and assign a code (ICD-9-CM or CPT-4 code) to the record. The provider prepares and submits a bill that includes, among other things, the assigned ICD-9-CM or CPT-4 code. The Medicare Fiscal Intermediary or other third-party payor typically reviews the bill and assigns it a specific payment code, such as a Diagnostic Related Group (DRG) number. Payment is based on the DRG or other payment code assigned. The provider may check the payment code assigned and follow up on any discrepancies identified. However, since the assignment of the payment code is made by the third-party payor, responsibility for correct assignment rests with that payor.

2.70 Errors can occur throughout this process. Physicians or other clinicians may not document the appropriate procedure. Coding personnel may not notice or interpret certain items in the medical record correctly. Accordingly, an incorrect code may be assigned and an erroneous amount may be paid.

2.71 An auditor ordinarily would not find it necessary to consider the process of assigning codes in planning and performing an audit of the provider's financial statements. However, the auditor should be alert for indications of potential material misstatements of the financial statements resulting indirectly from such matters. For example, the auditor may become aware that a retrospective review has been performed or that an investigation has been completed or is in process. In such circumstances, the auditor should consider whether performance of additional substantive audit procedures is necessary to reduce audit risk to an acceptable level.

Going-Concern Considerations

2.72 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 guidance to the independent auditor conducting an audit on how to evaluate 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 revision of its operations, or similar actions. SAS No. 59 states that the independent auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. SAS No. 96 amends SAS No. 59 (AICPA, *Professional Standards*, vol. 1, AU sec. 341.17), to add a requirement that the auditor document certain matters if, after considering the identified conditions and events in the aggregate, the auditor believes there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited.

2.73 Noncompliance with donor-imposed restrictions should be disclosed if there is a reasonable possibility that a material contingent liability has been incurred at the date of the financial statements or there is at least a reasonable possibility that the noncompliance could lead to a material loss of revenue or could cause an entity to be unable to continue as a going concern. If the noncompliance results from an organization's failure to maintain an appropriate composition of assets in amounts needed to comply with all donor restrictions, the amounts and circumstances should be disclosed.

Communication

Communication of Matters Related to Internal Control

2.74 SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), provides guidance in identifying and reporting conditions related to an entity's internal control that are observed during an audit of the financial statements.[||] It is contemplated that the communication generally would be to the audit committee or, in organizations that do not have an audit committee, to those with an equivalent level of authority and responsibility such as the board of directors, the owner in an owner-managed enterprise, or the individuals who engaged the independent auditor. Conditions noted by the independent auditor that are considered reportable under SAS No. 60 should be reported, preferably in writing. If information is communicated orally, the independent auditor should document the communication by appropriate memoranda or notations in the audit documentation.

Communication With Audit Committees

2.75 SAS No. 61, *Communication With Audit Committees*, as amended by SAS No. 89, *Audit Adjustments*, and SAS No. 90, *Audit Committee Communications* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), establishes a requirement for the independent auditor to determine that certain matters related to the conduct of an audit are communicated to those with responsibility for oversight of the financial reporting process. The communications required by SAS No. 61 are applicable to (*a*) entities that either have an audit committee or otherwise have formally designated oversight of the financial reporting process to a group equivalent to an audit committee (such as a finance committee or a budget committee) and (*b*) all SEC engagements as defined in SAS No. 61. In addition, communication with the audit committee or its equivalent by the independent auditor on certain specified matters when they arise in the conduct of an audit is required by other standards, including SAS No. 99 and SAS No. 54.

Management Representations

2.76 SAS No. 85, *Management Representations*, as amended by SAS No. 89, *Audit Adjustments*, and SAS No. 99 (AICPA, *Professional Standards*, vol. 1, AU sec. 333), establishes a requirement that an auditor performing an audit in accordance with GAAS, obtain written representations from management for

[||] See footnote † to paragraph 2.38. Also, the ASB has released an exposure draft of a proposed Statement on Auditing Standards (SAS), *Communication of Internal Control Related Matters Noted in an Audit.* Among other matters, the proposed SAS would supersede SAS No. 60. This proposed SAS is not applicable to public accounting firms registered with the PCAOB and their associated persons in connection with their audits of issuers, as defined by the Sarbanes-Oxley Act, and other entities when prescribed by the rules of the SEC.

all financial statements and periods covered by the auditor's report. The specific written representations to be obtained depend on the circumstances of the engagement and the nature and basis of presentation of the financial statements. Paragraph 6 of SAS No. 85, as amended by SAS No. 89 and SAS No. 99, lists matters ordinarily included in management's representation letter. SAS No. 85, as amended by SAS No. 89 and SAS No. 99, includes several examples as well. Appendix A of the SAS, as amended by SAS No. 89 and SAS No. 99, includes an illustrative management representation letter, Appendix B provides illustrative wording for additional representations that may be appropriate in certain situations, and Appendix C provides an illustrative updating management representation letter. Auditors of governmental health care entities also should consider obtaining representations concerning the information provided in MD&A, as provided in SAS No. 52, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 558.07*c*). Independent auditors of health care organizations also might obtain representations, if applicable, of the following:

- The health care organization is in compliance with the provisions of Internal Revenue Code (IRC) sec. 501(c)(3) and is exempt from federal income tax under IRC sec. 501(a), as evidenced by a determination letter.
- Information returns have been filed on a timely basis.
- Provision has been made, when material, for estimated retroactive adjustments by third-party payors under reimbursement agreements.
- The health care organization is in compliance with bond indentures or other debt instruments.
- Pending changes in the organizational structure, financing arrangements, or other matters that could have a material effect on the financial statements of the entity are properly disclosed.
- The health care organization is in compliance with contractual agreements, grants, and donor restrictions.
- The health care organization has maintained an appropriate composition of assets in amounts needed to comply with all donor restrictions.
- All assets and liabilities under the entity's control have been included in the financial statements.
- The internal controls over the receipt and recording of contributions received are adequate.
- Reclassifications between net asset classes is proper.

2.77 SOP 00-1 provides the following examples of specific representations for receivables, cost reports filed with third parties, and contingencies related to health care third-party revenue recognition:

- Receivables
  - Adequate consideration has been given to, and appropriate provision made for, estimated adjustments to revenue, such as for denied claims and changes to diagnosis-related group (DRG) assignments.
  - Recorded valuation allowances are necessary, appropriate, and properly supported.
  - All peer review organizations, fiscal intermediary, and third-party payor reports and information have been made available.
- Cost reports filed with third parties
  - All required Medicare, Medicaid, and similar reports have been properly filed.

- Management is responsible for the accuracy and propriety of all cost reports filed.
- All costs reflected on such reports are appropriate and allowable under applicable reimbursement rules and regulations and are patient-related and properly allocated to applicable payors.
- The reimbursement methodologies and principles employed are in accordance with applicable rules and regulations.
- Adequate consideration has been given to, and appropriate provision made for, audit adjustments by intermediaries, third-party payors, or other regulatory agencies.
- All items required to be disclosed, including disputed costs that are being claimed to establish a basis for a subsequent appeal, have been fully disclosed in the cost report.
- Recorded third-party settlements include differences between filed (and to be filed) cost reports and calculated settlements, which are necessary based on historical experience or new or ambiguous regulations that may be subject to differing interpretations. While management believes the entity is entitled to all amounts claimed on the cost reports, management also believes the amounts of these differences are appropriate.

- Contingencies
  - There are no violations or possible violations of laws or regulations, such as those related to the Medicare and Medicaid antifraud and abuse statutes, including but not limited to the Medicare and Medicaid Anti-Kickback Statute, Limitations on Certain Physician Referrals (the Stark law), and the False Claims Act, in any jurisdiction, whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency other than those disclosed or accrued in the financial statements.
  - Billings to third-party payors comply in all material respects with applicable coding guidelines (for example, ICD-9-CM and CPT-4) and laws and regulations (including those dealing with Medicare and Medicaid antifraud and abuse), and billings reflect only charges for goods and services that were medically necessary; properly approved by regulatory bodies (for example, the Food and Drug Administration), if required; and properly rendered.
  - There have been no communications (oral or written) from regulatory agencies, governmental representatives, employees, or others concerning investigations or allegations of noncompliance with laws and regulations in any jurisdiction (including those related to the Medicare and Medicaid antifraud and abuse statutes), deficiencies in financial reporting practices, or other matters that could have a material adverse effect on the financial statements.

Single Audit Act and Related Audit Considerations

2.78 An independent auditor may be engaged to audit the financial statements of a health care organization that expends federal awards from a governmental agency in accordance with the Single Audit Act Amendments of 1996 and Office of Management and Budget (OMB) Circular A-133, *Audits of*

States, Local Governments, and Non-Profit Organizations. Federal awards may take the form of grants, contracts, loans, loan guarantees, property, cooperative agreements, interest subsidies, and insurance or direct appropriations.

2.79 OMB Circular A-133 prescribes policies, procedures, and guidelines to implement the Single Audit Act Amendments of 1996 and requires state and local governments and not-for-profit organizations that expend total federal awards equal to or in excess of $500,000 in a fiscal year to have an audit performed in accordance with the Act and OMB Circular A-133.[#]

2.80 Institutions covered by OMB Circular A-133 include not-for-profit hospitals and public hospitals and institutions of higher education, and their affiliated hospitals, voluntary health and welfare organizations and other community-based organizations.[4] Medicare payments to a non-federal entity for providing patient care services to Medicare eligible individuals are not considered federal awards expended under OMB Circular A-133. Medicaid payments to a subrecipient for providing patient care services to Medicaid eligible individuals are not considered federal awards expended under OMB Circular A-133 unless a state requires the funds to be treated as federal awards expended because reimbursement is on a cost-reimbursement basis.

2.81 OMB Circular A-110 establishes standard requirements (such as insurance, record retention, and banking) for obtaining consistency and uniformity among federal agencies in the administration of grants to and agreements with public and private hospitals and other entities. OMB Circular A-87, *Cost Principles for State and Local Governments*, establishes principles and standards for determining allowable costs incurred by state and local governments under grants, contracts, and other agreements. OMB Circular A-21, *Cost Principles for Educational Institutions*, and OMB Circular A-122, *Cost Principles for Nonprofit Organizations*, establish principles and standards for determining allowable costs incurred by educational institutions and not-for-profit organizations under grants, contracts, and other agreements. Federal research and development awards under grants and contracts administered by hospitals are exempt from OMB's cost principles circulars A-87, A-21 and A-122, but are subject to requirements provided in the U.S. Department of Health and Human Services regulations at 45 CFR part 74, Appendix E, "Principles for Determining Costs Applicable to Research and Development Under Grants and Contracts with Hospitals."

2.82 SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801), provides general guidance for audits of governmental entities and entities that receive federal awards. The Statement explains the requirements of the financial audit standards contained in *Government Auditing Standards*, as amended (the Yellow Book) issued by the Comptroller General of the United States and their relationship to GAAS. It also provides general guidance on testing compliance with requirements applicable to federal awards. The Statement clarifies that the entity, rather than the independent auditor, is responsible for arranging

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[#] This threshold was changed to $500,000 from $300,000, effective for fiscal years ending after December 31, 2003. Early implementation is not permitted.

[4] The Codification of Office of Management and Budget (OMB) Circular A-133 by the U.S. Department of Health and Human Services also includes audit requirements for commercial organizations (including for-profit hospitals) that receive federal awards under HHS programs. Generally, the organization has two options regarding audits: (1) a financial-related audit of a particular award in accordance with *Government Auditing Standards*, or (2) an audit that meets the requirements of OMB Circular A-133. See title 45 of the Code of Federal Regulations (CFR) section 74.26(*d*) for further information.

for audits that meet all applicable requirements and provides guidance on communications the auditor should make upon becoming aware that the entity may be subject to an audit requirement that may not be satisfied by his or her engagement.

2.83 The Audit Guide Government Auditing Standards *and Circular A-133 Audits*, provides guidance on the auditor's responsibilities when conducting a single audit or program-specific audit in accordance with the Single Audit Act Amendments of 1996 and OMB Circular A-133. It discusses the auditor's responsibility for considering internal control and for performing tests of compliance with applicable laws, regulations, and program compliance requirements. Further, it provides reporting guidance including examples of the reports required by *Government Auditing Standards* and OMB Circular A-133.

Statutory Reporting Considerations for Managed Care Organizations

Risk-based Capital Requirements

2.84 Many managed care organizations (MCO) that bear financial risk are regulated by state departments of insurance. The risk-based capital (RBC) formula is one of the tools used by regulators to evaluate the financial health of regulated entities.

2.85 The National Association of Insurance Commissioners (NAIC) formula for the RBC of managed care organizations became effective in the filing of 1998 annual statements. Five principal risk elements to the MCO RBC formula are: affiliated investment risk, asset risk, underwriting risk, credit risk, and general business risk. Four action levels (in order of increasingly stringent level of regulatory response) are: company action level, regulatory action level, authorized control level, and mandatory control level. At a minimum, the company action-level event requires the filing with the respective state insurance commissioner an RBC plan detailing conditions leading to the event and proposals of corrective action. State laws vary as to whether applicable legislation pertaining to compliance with the RBC formula has been passed. Additional information can be found on the NAIC Web site at www.naic.org.

Codification of Statutory Accounting Practices for Managed Care Organizations

2.86 Generally speaking, regulated insurers have been required by their state of domicile to submit annually a set of audited financial statements that were prepared using that state's prescribed or permitted statutory accounting practices. These statutory accounting practices are considered to be an "other comprehensive basis of accounting" (OCBOA) under SAS No. 62, *Special Reports*.

2.87 In 1999, the NAIC completed a process to codify statutory accounting practices for certain insurance entities (including regulated MCO), resulting in a revised Accounting Practices and Procedures Manual effective January 1, 2001 (the "revised Manual"). This Manual has also been updated on an annual basis and a new Accounting Practices and Procedure Manual (Manual) reflecting revisions or additions to SAP is published in March of each year. It is expected that most states will require insurers to comply with most, if not all, provisions of the Manual. States may adopt the Manual in whole, or in part, as an element of prescribed statutory accounting practices in those states. If, however, the requirements of state laws, regulations, and administrative rules differ from guidance provided in the Manual those state laws, regulations, and

administrative rules will take precedence. Preparers of financial statements and auditors should monitor the status of the adoption of the Manual by the domiciliary state insurance regulatory authority.

2.88 Practitioners should consider whether going-concern issues exist as a result of the financial statement effect of adoption. This includes consideration of the effect on RBC.

2.89 Nine of the Statements of Statutory Accounting Principles (SSAPs) included in the revised Manual have been specifically modified or written to address issues related to managed care. These include SSAP No. 25, *Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*, No. 35, *Guaranty Fund and Other Assessments*, No. 47, *Uninsured Plans*, No. 50, *Classifications and Definitions of Insurance or Managed Care Contracts in Force*, No. 54, *Individual and Group Accident and Health Contracts*, No. 55, *Unpaid Claims, Losses and Loss Adjustment Expenses*, No. 66, *Retrospectively Rated Insurance Contracts*, No. 73, *Health Care Delivery Assets—Supplies, Pharmaceuticals and Surgical Supplies, Durable Medical Equipment, Furniture, Medical Equipment and Fixtures, and Leasehold Improvements in Health Care Facilities* and SSAP No. 84, *Health Care Receivables*. All other SSAPs will apply if applicable to the entity.

Chapter 3

Cash and Cash Equivalents

Accounting and Financial Reporting

3.01 Cash and cash equivalents should include all cash and highly liquid investments that are both (*a*) readily convertible to cash and (*b*) so near to maturity that they present insignificant risk of changes in value because of changes in interest rates, in accordance with paragraph 8 of FASB Statement No. 95, *Statement of Cash Flows*, and paragraph 9 of GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*. For fiduciary purposes, separate checking or savings accounts may be maintained for restricted donations. Such accounts, however, are not reported on a line separate from other cash and cash equivalents because donor restrictions generally relate to limitations on the use of net assets rather than on the use of specific assets.[1] However, cash and claims to cash that (*a*) are restricted as to withdrawal or use for other than current operations, (*b*) are designated for expenditure in the acquisition or construction of noncurrent assets, (*c*) are required to be segregated for the liquidation of long-term debts, or (*d*) are required by a donor-imposed restriction that limits their use to long-term purposes are reported separately and are excluded from current assets. (See paragraph 10.10.) Internally designated funds should be reported separately from externally designated funds either on the face of the balance sheet or in the notes to the financial statements. If the form of the assets is not evident from the description on the balance sheet, the form of the assets should be disclosed in the notes to the financial statements. GASB Statement No. 9, paragraph 8, provides that a governmental health care enterprise's statement of cash flows should explain the change in all cash and cash equivalents, regardless of any restrictions on their use. For governmental health care entities, restricted cash and cash equivalents should be reported when restrictions on the use of those assets change the nature or normal understanding of those assets, as discussed in GASB Statement No. 34, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments*, paragraph 99. For example, cash and investments that can only be used to pay debt principal and interest would be reported as restricted cash and investments or as cash and investments held by trustee for debt service. The term restricted is defined by GASB Statement No. 34, paragraphs 34 and 99. A restriction is a constraint placed on the use of assets or net assets that is either externally imposed (such as by creditors through debt covenants) or imposed by law through constitutional provisions or enabling legislation.

Agency Funds

3.02 Health care organizations may receive and hold assets owned by others under agency relationships; for example, they may perform billing and

[1] A columnar presentation that highlights the three classes of net assets (that is, permanently restricted, temporarily restricted, and unrestricted) is not precluded if the totals for the reporting entity as a whole are displayed.

collection services for physicians. In accepting responsibility for those assets, an organization incurs a liability to the principal under the agency relationship to return the assets in the future or, if authorized, to disburse them to another party on behalf of the principal. Such agency funds are reported as unrestricted assets.

3.03 In other cases, not-for-profit health care organizations may act as agents, trustees, or intermediaries helping donors to make a contribution to another entity or individual. When acting in that capacity, those organizations do not receive a contribution when they receive the assets, nor do they make a contribution when they disburse the assets to the other entity or individual. Instead, they act as go-betweens, passing the assets from the donor through their organization to the specified entity or individual. FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*,[2] establishes standards for transactions in which a donor makes a contribution by transferring assets to a recipient organization—a not-for-profit organization or a charitable trust—that accepts the assets from the donor and agrees to use the assets on behalf of or transfer the assets, their investment return, or both to another entity—the beneficiary—named by the donor.[3] In general, if a donor specifies a beneficiary, the recipient organization should not recognize a contribution. (For exceptions, see the discussion of variance power at paragraph 10.05 in this Guide and financially interrelated organizations at paragraphs 11.29 through 11.33 in this Guide.) Instead, as discussed in paragraph 11 of FASB Statement No. 136, the recipient organization should recognize its liability to the specified beneficiary concurrent with its recognition of cash or other financial assets received from the donor. Both the asset and the liability recognized should be measured at the fair value of the assets received. If the assets received from the donor are donated materials, supplies, or other nonfinancial assets, the recipient organization may choose either to (*a*) report the receipt of the assets as a liability to the beneficiary concurrent with recognition of the assets received or (*b*) not report the transaction at all. The choice is an accounting policy that should be applied consistently from period to period. An entity should consider the need for disclosure in the notes to the financial statements pursuant to APB Opinion No. 22, *Disclosure of Accounting Policies*, and paragraph 11 of FASB Statement No. 136. Standards for not-for-profit organizations that act as agents, trustees, or intermediaries are described further in Chapters 5 and 6 of the Audit and Accounting Guide *Not-for-Profit Organizations*.

Disclosures

3.04 If the provider has concentrations of credit risk related to financial instruments such as certificates of deposit or money market mutual funds, the disclosure requirements of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, as amended by FASB Statement No. 133,

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[2] This pronouncement is not applicable to governmental health care enterprises. (See footnote 1 in Chapter 1.)

[3] FASB Statement No. 136 also establishes standards for transactions that take place in a similar manner but are not contributions because the transfers are revocable, repayable, or reciprocal. For example, if a resource provider transfers assets to a recipient organization and names itself or its affiliate as beneficiary, that transaction is reciprocal even if the resource provider grants variance power. Those standards and transactions are discussed in paragraphs 4.14, 4.15, 11.21, 11.23 and 11.24 in this Guide. This Guide does not use the word *donor* in discussing those transactions because they are not contributions.

Accounting for Derivative Instruments and Hedging Activities,[4] should be followed. Examples of potential exposure to credit risk include funds deposited with a single financial institution in excess of Federal Deposit Insurance Corporation (FDIC) limits and investments in obligations that are not insured or guaranteed by the government. For governmental health care enterprises, GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*, requires certain disclosures about deposits, including credit risk classification of bank balances that are not entirely insured.*

Auditing

3.05 There are no unique auditing considerations with respect to cash and cash equivalents recorded by health care organizations.

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[4] This pronouncement is not applicable to governmental health care enterprises that do not apply paragraph 7 of GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*. (See footnote 1 in Chapter 1.)

* In March 2003, the GASB issued GASB Statement No. 40, *Deposit and Investment Risk Disclosures*, an amendment of GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*. Among other matters, GASB Statement No. 40 establishes and modifies disclosure requirements for deposit risks. The provisions of GASB Statement No. 40 are effective for financial statements for periods beginning after June 15, 2004. Earlier application is encouraged. Conforming changes to reflect the issuance of GASB Statement No. 40 will be made in a future edition of this Guide.

Chapter 4

Investments

Accounting

4.01 This chapter discusses the accounting and reporting for investments of health care entities other than (*a*) equity investments accounted for under the equity method or (*b*) investments in consolidated subsidiaries. Discussions pertaining to those two types of investments are included in Chapter 11. In some cases, nongovernmental health care organizations may transfer assets to a not-for-profit organization (such as a community foundation or a financially interrelated organization) or a trust for investment and management. Paragraphs 4.14 and 4.15 discuss a nongovernmental health care organization's reporting of investments held on its behalf by unrelated foundations and trusts or by related organizations that are not financially interrelated. Paragraphs 11.21 through 11.24 and 11.29 through 11.33 discuss the reporting by a nongovernmental health care organization of investments held on its behalf by financially interrelated organizations.

4.02 The accounting for investments in equity securities that have readily determinable fair values and all investments in debt securities is discussed in paragraphs 4.03 through 4.13. Other types of investments that are not financial instruments (such as real estate or certain oil and gas interests) are reported at amortized cost and are subject to impairment considerations consistent with FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets.*[1]

Investments in Debt Securities and Certain Equity Securities

4.03 This section discusses the accounting and reporting for investments in equity securities that have readily determinable fair values and all investments in debt securities held by (*a*) investor-owned entities, (*b*) not-for-profit organizations, and (*c*) governmental entities.

Investor-Owned Entities

4.04 Investor-owned providers are subject to the accounting and reporting requirements of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. FASB Statement No. 115 defines three categories into which an enterprise classifies investments. The accounting and reporting differ by category. Investments in debt securities that the enterprise has the positive intent and ability to hold to maturity are classified as *held-to-maturity securities* and are reported at amortized cost. Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as *trading securities* and reported at fair value, with unrealized holding gains and losses included in income. However, an enterprise is not precluded from classifying at acquisition a security it plans to hold for a longer period as a trading security. Investments in debt securities that

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[1] This pronouncement is not applicable to governmental health care enterprises that do not apply paragraph 7 of GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*. (See footnote 1 in Chapter 1.)

are not classified as held-to-maturity or trading and equity securities that are not classified as trading are classified as *available-for-sale securities and* reported at fair value, with unrealized holding gains and losses excluded from income and reported in a separate component of other comprehensive income until realized, except all or a portion of the unrealized holding gain and loss of an available-for-sale security that is designated as being hedged in a fair value hedge shall be recognized in earnings during the period of the hedge.[2]

4.05 Investor-owned entities should follow the disclosure requirements of FASB Statement No. 115, as amended by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.*[3]

Not-for-Profit Organizations

4.06 Not-for-profit organizations should report investments in equity securities with readily determinable fair values and all debt securities at fair value on the balance sheet consistent with FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations.* FASB Statement No. 124 does not apply to investments in derivative instruments that are subject to the requirements of FASB Statement No. 133. FASB Statement No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. Investment return, including realized and unrealized gains and losses, should be included as changes in net assets consistent with paragraphs 4.07 through 4.10.

4.07 Investment return (including realized and unrealized gains and losses) not restricted by donors or by law should be classified as changes in unrestricted net assets as follows:

a. Included in the performance indicator (see paragraphs 10.19 and 10.20):
- Dividend, interest, and other similar investment income
- Realized gains and losses
- Unrealized gains and losses on trading securities[4]
- Other than temporary impairment losses[5]

b. Excluded from the performance indicator:

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[2] Emerging Issues Task Force (EITF) Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, provides guidance to determine when an investment is considered impaired, whether that impairment is other-than-temporary, and the measurement of an impairment loss. EITF Issue No. 03-1 also provides guidance regarding accounting considerations subsequent to the recognition of an other-than-temporary impairment, and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. EITF No. 03-1 applies to debt and equity securities within the scope of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, (applicable to investments held by a not-for-profit health care organization in the scope of this Guide). See EITF Issue No. 03-1 for further information regarding investments within the scope of this Issue. The recognition and measurement guidance is effective for reporting periods beginning after June 15, 2004. For investments accounted for under FASB Statements No. 115 and No. 124, the disclosure requirements are effective for annual financial statements for fiscal years ending after December 15, 2003. The disclosures for other investments within the scope of this Issue are effective for annual financial statements for fiscal years ending after June 15, 2004.

[3] See footnote 2 in paragraph 4.04.

[4] Trading securities are defined in FASB Statement No. 115, including any interpretations thereof.

[5] See footnote 2 in paragraph 4.04.

- Unrealized gains and losses on other than trading securities

4.08 Except as described in paragraphs 4.09 and 4.10, investment return (including realized and unrealized gains and losses) restricted by donors or by law, should be classified as changes in temporarily or permanently restricted net assets consistent with the applicable restrictions.

4.09 Gains and investment income that are limited to specific uses by donor-imposed restrictions may be reported as increases in unrestricted net assets if the restrictions are met in the same reporting period as the gains and income are recognized, provided that the organization has a similar policy for reporting contributions received, applies the policy consistently from period to period, and discloses its accounting policy. The classification of these gains and investment income in unrestricted net assets should be consistent with paragraph 4.07.

4.10 In the absence of donor stipulations or law to the contrary, losses on the investments of a donor-restricted endowment fund[6] shall reduce temporarily restricted net assets to the extent that donor-imposed temporary restrictions on net appreciation of the fund have not been met before the loss occurs. Any remaining loss shall reduce unrestricted net assets and shall be excluded from the determination of the performance indicator. If losses reduce the assets of a donor-restricted endowment fund below the level required by the donor stipulations or law, gains that restore the fair value of the assets of the endowment fund to the required level shall be classified as increases in unrestricted net assets and shall be excluded from the determination of the performance indicator.

4.11 Not-for-profit organizations should follow the disclosure requirements of FASB Statement No. 124.[7]

Governmental Entities

4.12 Governmental health care entities are subject to the accounting and reporting requirements of GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*. Governmental health care entities should report investments in (*a*) participating interest-earning investment contracts, (*b*) external investment pools, (*c*) open-ended mutual funds, (*d*) debt securities, and (*e*) equity securities, option contracts, stock warrants, and stock rights that have readily determinable fair values at fair value on the balance sheet. Governmental entities are permitted to report certain money market investments and participating interest-earning investment contracts at amortized cost, provided that the investment has a remaining maturity of one year or less at time of purchase. All investment income, including changes in the fair value of investments, shall be recognized as revenue in the statement of revenues, expenses, and changes in net assets/equity. Governmental health care entities are required to distinguish between operating revenues and expenses and nonoperating revenues and expenses. (See further discussion in paragraph 10.23 of this Guide.) Governmental health

[6] Donors that create endowment funds can require that their gifts be invested in perpetuity or for a specified term. Some donors may require that a portion of income, gains, or both be added to the gift and invested subject to similar restrictions. It is generally understood that at least the amount of the original gift(s) and any required accumulations are not expendable, although the value of the investments purchased may occasionally fall below that amount. Future appreciation of the investments generally restores the value to the required level. In states that have enacted its provisions, the Uniform Management of Institutional Funds Act describes "historic dollar value" as the amount that is not expendable.

[7] See footnote 2 in paragraph 4.04.

care entities should follow the disclosure requirements of GASB Statement No. 31. Also, GASB Statement No. 34, paragraph 121, requires that governmental health care entities that receive donor-restricted endowments make certain disclosures about their use of investment income generated by those endowments.

4.13 GASB Statements No. 3, *Deposits with Financial Institutions, Investments (Including Repurchase Agreements), and Reverse Repurchase Agreements,*[*] No. 28, *Accounting and Financial Reporting for Securities Lending Transactions*, and GASB Interpretation No. 3, *Financial Reporting for Reverse Repurchase Agreements,* provide guidance on investment-related disclosures required by governmental entities as well as accounting for securities lending and reverse repurchase agreements.

Transfers of Assets to a Not-for-Profit Organization or Charitable Trust for Investment

4.14 If a nongovernmental health care organization transfers assets to a not-for-profit organization or charitable trust (called a recipient organization) that accepts those assets and agrees to use them on behalf of or transfer them, their investment return, or both back to the health care organization or its affiliate, the transfer is reciprocal and thus is not a contribution (see paragraphs 4, 17 and 18 of FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*).[8] Examples of that type of reciprocal transfer include (*a*) a nongovernmental health care organization transfers assets to a community foundation to establish an endowment for the benefit of the nongovernmental health care organization (or its affiliate) and (*b*) a nongovernmental health care organization transfers assets to a foundation it creates to hold those assets. Paragraphs 17 and 18 of FASB Statement No. 136 describe two types of reciprocal transfers, which are:

- An equity transaction—The nongovernmental health care organization (*a*) specifies itself or its affiliate as the beneficiary, (*b*) the health care organization and the recipient organization are financially interrelated organizations (paragraph 11.22 discusses financially interrelated organizations), and (*c*) neither the health care organization nor its affiliate expects payment of the transferred assets, although payment of investment return on the transferred assets may be expected. (All three criteria must be met.)
- The nongovernmental health care organization specifies itself or its affiliate as the beneficiary and the transfer is not an equity transaction. (The three criteria (*a*), (*b*), and (*c*) in the previous bullet are not met.)

4.15 If the reciprocal transaction is not an equity transaction, the nongovernmental health care organization reports an asset, in exchange for the assets transferred, as discussed in paragraph 17 of FASB Statement No. 136. (Accounting

[*] In March 2003, the GASB issued GASB Statement No. 40, *Deposit and Investment Risk Disclosures*, an amendment of GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements.* Among other matters, GASB Statement No. 40 establishes and modifies disclosure requirements related to investment risks. The provisions of GASB Statement No. 40 are effective for financial statements for periods beginning after June 15, 2004. Earlier application is encouraged. Conforming changes to reflect the issuance of GASB Statement No. 40 will be made in a future edition of this Guide.

[8] This pronouncement is not applicable to governmental health care enterprises. (See footnote 1 in Chapter 1).

for equity transactions is discussed in paragraphs 11.21 through 11.24 of this Guide.) The nongovernmental health care organization should disclose the following information for each period for which a statement of financial position is presented, in accordance with paragraph 19 of FASB Statement No. 136:

- The identity of the recipient organization to which the transfer was made
- Whether variance power was granted to the recipient organization and, if so, a description of the terms of the variance power[9]
- The terms under which amounts will be distributed to the health care organization or its affiliate
- The aggregate amount recognized in the statement of financial position for those transfers and whether that amount is recorded as an interest in the net assets of the recipient organization or as another asset (for example, as a beneficial interest in assets held by others or a refundable advance).

Financial Statement Presentation

Entities Subject to FASB Statement No. 115, FASB Statement No. 124, or GASB Statement No. 31

4.16 Securities should be reported as either current or noncurrent, as appropriate, under the provisions of ARB No. 43, *Restatement and Revision of Accounting Research Bulletins*, Chapter 3A.[10]

4.17 For cash flow reporting purposes by nongovernmental entities, purchases, sales, and maturities of trading securities should be classified as cash flows from operating activities; governmental entities should classify these items as investing activities. Cash flows from purchases, sales, and maturities of all other securities should be classified as cash flows from investing activities. If investments in debt securities are reported as cash equivalents in accordance with FASB Statement No. 95, *Statement of Cash Flows*, or GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*, the notes to the financial statements should reconcile the reporting classifications used in the statement of financial position.

4.18 All health care organizations with investments that meet the definition of financial instruments set forth in FASB Statement No. 107 are subject

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[9] Because of their reciprocal nature, those transfers were presumed by the FASB not to be contributions received or made—even if the health care organization granted variance power at the time of the transfer. See paragraph 96 of FASB Statement No. 136.

[10] Chapter 3A of ARB No. 43 indicates in paragraph 4 that "the term *current assets* is used to designate cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business." That paragraph further indicates that the term also comprehends "marketable securities representing the investment of cash available for current operations." Paragraph 5 indicates that "a one-year time period is to be used as a basis for the segregation of current assets in cases where there are several operating cycles occurring within a year." Paragraph 6 says that the "concept of the nature of current assets contemplates the exclusion from that classification of . . . cash and claims to cash which are restricted as to withdrawal or use for other than current operations, are designated for expenditure in the acquisition or construction of noncurrent assets, or are segregated for the liquidation of long-term debts." Cash and cash equivalents of permanent endowment funds held temporarily until suitable long-term investment opportunities are identified are included in the classification "long-term investments."

to the disclosure requirements of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*.[11] Organizations with derivative instruments that meet the definition of derivative instruments set forth in FASB Statement No. 133, as amended by FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities,* are subject to the disclosure requirements in FASB Statement No. 133.[12] SOP 02-2, *Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations and Clarification of the Performance Indicator*, requires that not-for-profit health care organizations that are within the scope of this Guide provide disclosures that are analogous to those required by paragraph 45 of FASB Statement No. 133 for for-profit enterprises, including the disclosure of anticipated reclassifications into the performance indicator of gains and losses that have been excluded from that measure and reported in accumulated derivative gain or loss as of the reporting date. SOP 02-2 does not apply to governmental entities that are within the scope of this Guide. SOP 02-2 is included as Appendix F to this Guide. Governmental health care entities are also required to disclose information about their investments in accordance with GASB Statements No. 3, No. 28,[†] and No. 31, GASB Technical Bulletin No. 87-1, *Applying Paragraph 68 of GASB Statement No. 3*, No. 03-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets,*[†] No. 97-1, *Classifications of Deposits and Investments into Custodial Credit Risk Categories for Certain Bank Holding Company Transactions*, and GASB Interpretation No. 3.

4.19 The following example illustrates the accounting treatment and financial statement presentation for other-than-trading securities of a not-for-profit health care organization:

Facts

Other than trading securities are purchased in year 1 at a cost of $100. At the end of year 1, the fair value of the securities is $300. In year 2, the securities are sold for $400.

Journal Entries

- *Entry at the end of year 1 to adjust the recorded value of the securities to fair value:*

Valuation allowance	200	
Change in net unrealized gains and losses on investments		200

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[11] Disclosures about the fair value of financial instruments prescribed in FASB Statement No. 107 are optional for an entity that meets the criteria of FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*, as amended by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* and FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities.*

[12] FASB Statements No. 107 and No. 133 are not applicable to governmental health care enterprises that do not apply paragraph 7 of GASB Statement No. 20. (See footnote 1 in Chapter 1.)

[†] See footnote * to paragraph 4.13 in this chapter.

In June 2003, the GASB issued Technical Bulletin (TB) No. 03-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets*. Among other matters, GASB TB No. 03-1 supersedes GASB TB No. 94-1, *Disclosures about Derivatives and Similar Debt and Investment Transactions*. GASB TB No. 03-1 is effective for financial statements for periods ending after June 15, 2003. Earlier application is encouraged.

- *Entry at the end of year 2 to record the sale of the securities*:

Cash	400	
Realized gain		300
Investments		100
Change in net unrealized gains and losses on investments	200	
Valuation allowance		200

As discussed in paragraph 4.07, *unrealized* gains and losses on other than trading securities are reported in the statement of operations *below* the performance indicator and *realized* gains and losses are reported in the statement of operations *above* the performance indicator.

Auditing

4.20 Auditing objectives and procedures for investments of health care organizations generally are similar to those of other organizations. SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), among other matters, provides guidance to auditors in planning and performing auditing procedures for assertions about investments in securities that are made in an entity's financial statements. The guidance in SAS No. 92 applies to all debt and equity securities. SAS No. 92 uses the definitions of debt security and equity security that are in FASB Statement No. 115, but applies to debt and equity securities without regard to whether they are subject to the requirements of FASB Statement No. 115, such as, for example, assertions about securities accounted for under the equity method following the requirements of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. A companion Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, provides practical guidance for implementing SAS No. 92. In addition, the independent auditor may need to consider the examples of specific auditing objectives, selected control activities, and auditing procedures that are presented in Exhibit 4-1.

Exhibit 4-1

Auditing Considerations

Financial Statement Assertions	*Specific Auditing Objectives*	*Selected Control Activities*	*Auditing Procedures*
Existence and completeness; rights and obligations; and valuation	Marketable securities are fairly stated, properly classified, described, and disclosed.	An independent trustee manages the investments. The trustee's reports are reviewed by a responsible employee.	Verify existence through confirmation. Test the valuation of equity and debt securities not intended to be held to maturity by comparing the recorded values with the fair market values reported by the trustee or another independent source. For fair value estimates obtained from third-party sources, the auditor should consider the applicability of the guidance in SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336) or SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324).[13]

[13] Paragraphs 35 through 46 of SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), and paragraphs 6.16 through 6.38 in the companion Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, provide guidance to auditors on audit evidence that may be used to support assertions about the fair value of securities. That guidance should be considered in the context of specific accounting requirements. SAS No. 101, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1, AU sec. 328), provides additional guidance on auditing fair value measurements and disclosures contained in financial statements. SAS No. 101 does not address specific types of assets, liabilities, components of equity, transactions, or industry-specific practices.

Financial Statement Assertions	*Specific Auditing Objectives*	*Selected Control Activities*	*Auditing Procedures*
Valuation, rights, and obligations	Endowment funds are properly stated at their required value and related gains and losses are properly classified.	Value of endowment funds are reviewed periodically to ensure that the balance is at its required level.	Verified that value of endowments are at required levels through confirmation. Review treatment of gains and losses on endowment funds to ensure that they are properly classified.
Accuracy and completeness	Investment income and gains/losses are recorded in accordance with donor restrictions.	Review of investment transactions to ensure they are recorded in compliance with donor restrictions.	Test the recording of selected transactions to ensure amounts are properly classified in accordance with donor restrictions.
Presentation and disclosure	Securities are properly classified.	Classification is monitored periodically and is based on management's intent or ability to dispose of excess funds that are available for operations within an operating cycle.	

Chapter 5

Receivables

5.01 Receivables may include amounts due for (*a*) health care services from patients, residents, third-party payors, and employers; (*b*) premiums and stop-loss insurance recoveries; (*c*) intercompany transactions; (*d*) promises to give in future periods (pledges); and (*e*) amounts due from employees, physicians, or others. All loans, such as loans to physicians, should be evaluated periodically for impairment. Loans that are included in the scope of FASB Statement No. 114, *Accounting by Creditors for Impairments of a Loan*,[1] should be evaluated based on the provisions of that statement. A loan is impaired when, based on current information and events, it is probable that the provider will be unable to collect all amounts due, including principal and interest, according to the contractual terms of the loan agreement. If the provider measures an impaired loan using a present value amount, the creditor should calculate that present value based on an estimate of the expected future cash flows of the impaired loan, discounted at the loan's effective interest rate.

5.02 Amounts realizable from third-party payors for health care services are usually less than the provider's full established rates for those services. The realizable amounts may be determined by (*a*) contractual agreement with others (such as Blue Cross plans, Medicare, Medicaid, or HMOs), (*b*) legislation or regulation (such as workers' compensation or no-fault insurance), or (*c*) provider policy or practice (such as courtesy discounts to medical staff members and employees or other administrative adjustments).

5.03 Revenue and the related receivables for health care services usually are recorded in the accounting records on an accrual basis at the provider's full established rates. The provision for contractual adjustments (that is, the difference between established rates and third-party payor payments) and discounts (that is, the difference between established rates and the amount collectible) are recognized on an accrual basis and deducted from gross service revenue to determine net service revenue. Contractual adjustments, discounts, and an allowance for uncollectibles are recorded to report the receivables for health care services at net realizable value. Estimates of contractual adjustments, other adjustments, and the allowance for uncollectibles are reported in the period during which the services are provided even though the actual amounts may become known at a later date. This later date may be (*a*) when the person is discharged, (*b*) subsequent to discharge or completion of service, (*c*) when the third party is billed, or (*d*) when payment or partial payment is received. As discussed in paragraph 10.03, the provision of charity care does not qualify for recognition as receivables or revenue in the financial statements.

5.04 Nongovernmental health care organizations with loans and trade receivables should follow the recognition and measurement guidance in paragraph 8 of Statement of Position (SOP) 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*, to the extent that that guidance is applicable.

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[1] This pronouncement is not applicable to governmental health care enterprises that do not apply paragraph 7 of GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*. (See footnote 1 in Chapter 1.)

Rate Setting

5.05 The independent auditor should be familiar with the rate-setting environment in which the entity operates and the regulations and contractual agreements that determine payments to be received for health care services. Payment rates established by regulations or contractual agreements may be determined either prospectively or retrospectively.

5.06 Prospective rate setting is a method used to set payment rates in advance of the delivery of health care services. Such payment rates determine what third parties will pay for health care services during the rate period (generally one year). Prospective rate setting may result from a contractual agreement with a third party, such as a Blue Cross plan, or it may be mandated through legislation. The intent of prospective rate setting is to establish payment rates before the period to which they will apply and that are not subject to change. The independent auditor should be aware, however, that some rate-setting methods described as prospective may include provision for retrospective adjustments and that some third parties pay prospective rates for certain services and retrospective rates for other services.

5.07 Under retrospective rate setting, third parties usually determine an interim payment rate and, during the rate period (generally one year), pay the health care organization for services rendered using that rate. After the rate period has ended, a final settlement is made in accordance with federal or state regulations or contractual agreements.

Estimated Final Settlements

5.08 Under a retrospective system, an entity may be entitled to receive additional payments or may be required to refund amounts received in excess of amounts earned under the system. Although final settlements are not made until a subsequent period, they are usually subject to reasonable estimations and are reported in the financial statements in the period in which services are rendered. Differences between original estimates and subsequent revisions (including final settlements) are included in the statement of operations in the period in which the revisions are made and disclosed, if material. Those differences are not treated as prior period adjustments unless they meet the criteria for prior period adjustments as set forth in FASB Statement No. 16, *Prior Period Adjustments*.[2]

5.09 Rate-setting methods that are described as prospective but provide for retrospective adjustments are accounted for as retrospective rate-setting systems for the services to which they apply (see paragraph 5.08).

State Waiver Contingencies Under Medicare

5.10 Certain states (referred to as waiver states) have received permission to determine rates of payment for Medicare patients in accordance with a statewide rate-setting method different from the method used by the federal program. A condition for Medicare participation in a state waiver program typically requires that Medicare expenditures in that state not exceed prescribed limits. If Medicare expenditures exceed prescribed limits, the excess, depending on the conditions of the waiver, may be recoverable by the federal

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[2] Paragraph 37 of SOP 00-1, *Auditing Health Care Third-Party Revenues and Related Receivables*, provides a sample disclosure for material differences between an original estimate and subsequent revisions. SOP 00-1 is included in Appendix E to this Guide.

government. FASB Statement No. 5, *Accounting for Contingencies*, provides guidance with respect to accounting for loss contingencies, such as those arising under state Medicare waivers. GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, provides guidance with respect to accounting for contingencies by governmental entities.

Premiums and Stop-Loss Insurance Receivables

5.11 Some health care organizations contract to provide comprehensive health care services for a fixed period in return for fixed periodic premiums. Many of those organizations may transfer a portion of their financial risks under the contract to another organization by purchasing stop-loss insurance. Receivables of those organizations may include uncollected premiums and amounts recoverable from stop-loss insurers reduced by appropriate valuation allowances. Chapter 13 provides guidance on applying GAAP for stop-loss insurance costs of providers of prepaid health care services. FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, also provides guidance on accounting for reinsurance contracts. Governmental entities should comply with the provisions of GASB Statement No. 10 which provides different guidance on accounting for reinsurance contracts than FASB Statement No. 113.

Promises to Give in Future Periods (Pledges)

5.12 Providers involved in fund-raising campaigns frequently are the recipients of promises to give[3] with payments due in future periods; pledge drives are a common example. FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*,[4] establishes the accounting and financial reporting guidance for pledges and similar promises to pay. Providers may also be the beneficiaries of fund-raising campaigns conducted by others. FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*,[5] establishes standards for transactions in which a donor makes a contribution by transferring assets to a recipient organization—a not-for-profit organization or a charitable trust—that accepts the assets from the donor and agrees to use the assets on behalf of or transfer the assets, their investment return, or both to another entity—the beneficiary—named by the donor.[6] In general, a nongovernmental health care organization that is specified as a beneficiary recognizes its rights to the assets held by a recipient organization as an asset: either a beneficial interest or a receivable. (See paragraph 15 of FASB Statement No. 136.) (For exceptions, see the discussion of variance power at paragraph 10.05 and financially interrelated organizations at paragraphs 11.29 through 11.33 of this Guide.) 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 has a beneficial interest. The beneficiary recognizes that beneficial

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[3] To be recognized in financial statements there must be sufficient evidence in the form of verifiable documentation that a promise was made and received (FASB Statement No. 116, paragraph 6).

[4] This pronouncement is not applicable to governmental health care enterprises. (See footnote 1 in Chapter 1.)

[5] See footnote 4.

[6] FASB Statement No. 136 also establishes standards for transactions that take place in a similar manner but are not contributions because the transfers are revocable, repayable, or reciprocal. Those standards and transactions are discussed in paragraphs 4.14, 4.15, 11.21, 11.23, and 11.24 of this Guide. This Guide does not use the word *donor* in discussing those transactions because they are not contributions.

interest as an asset and a contribution received, measuring and subse- quently remeasuring it at fair value, using a valuation technique such as the present value of the estimated expected future cash flows. If the beneficiary has unconditional rights to receive the value of the transferred assets at a future date, the beneficiary has a receivable that should be recognized in accordance with the provisions of FASB Statement No. 116 for unconditional promises to give.

5.13 A general summary of the provisions of FASB Statement No. 116 for promises to give is presented below. Specific guidance is provided in chapter 5 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*. By specifying that they will adhere to future payment dates, donors implicitly indicate that their gift is to support activities in each period in which a payment is scheduled. Therefore, in any promise to give with payments due in future periods, a time restriction is implicit unless the donor explicitly states that the gift is to support current activities or other circumstances clearly point to that intent.

5.14 Promises to give fall into two broad categories: conditional and unconditional. Conditional promises to give depend on the occurrence of a specified future and uncertain event (for example, a stipulation that the provider must meet a matching requirement) whose occurrence or failure of occurrence gives the donor the right of return of the assets or releases the donor from the obligation to transfer assets in the future. Conditional promises to give are not recognized in financial statements until the conditions on which they depend are substantially met (that is, until the period in which the conditional promise becomes an unconditional promise). A transfer of assets in partial fulfillment of a conditional promise shall be accounted for as a refundable advance (that is, as a liability) until such time as the conditional promise becomes unconditional.[7]

5.15 Unconditional promises to give with payments due in future periods should be reported as receivables and as restricted support in the period the promise is received (unless explicit donor stipulations or circumstances surrounding the receipt of the promise make clear that the donor intended the promise to be used to support activities of the current period). The expiration of those restrictions (or the expiration of a portion of the restriction) is recognized as the donor makes the future payment or payments. If the promise is to be paid in one future payment, the related temporarily restricted net assets will be transferred to unrestricted net assets in the period in which the payment is received. If the donor sets forth a schedule of future payments, a transfer from temporarily restricted net assets to unrestricted net assets is made in each period a payment is received. If other explicit donor restrictions are attached to the promise, such as that the gift be used for a specific purpose, the expiration of the restriction is recognized in the time period(s) when the donor makes the future payment(s) and when the stipulated purpose for which the assets were restricted has been fulfilled. In the period (or periods) that the restrictions expire, the temporarily restricted net assets (or the portion of the temporarily restricted net assets that relate to the particular payment installment) are reclassified as unrestricted net assets and reported in the statement of operations as net assets released from restriction.

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[7] For accounting purposes, a conditional promise to give is considered unconditional if the possibility that the condition will not be met is remote. In the case of ambiguous donor stipulations, if a promise contains stipulations that are not clearly unconditional (that is, if the donor's stipulations are ambiguous), the promise is presumed to be a conditional promise. Additional guidance on distinguishing conditional promises from unconditional promises is provided in FASB Statement No. 116, paragraphs 22 and 23.

5.16 In the year that unconditional promises to give cash are received, they should be measured at the present value[8] of their estimated future cash flows. (Unconditional promises to give cash that are expected to be collected within one year of the financial statement date may be measured at their net realizable value.) In determining the estimated future cash flows of unconditional promises to give cash, not-for-profit organizations should consider when the receivable is expected to be collected, the creditworthiness of the other parties, the organization's past collection experience and its policies concerning the enforcement of promises to give, and other factors concerning the receivable's collectibility. If the present value of unconditional promises to give cash decreases after initial measurement because of decreases in estimated future cash flows, the decrease should be recognized in the period(s) in which the expectation changes. Such decreases should be reported as expenses or losses (bad debt) in the net asset class in which the net assets are represented.[9] Accretion of the discount element of the unconditional promise to give is accounted for as contribution income, which increases unrestricted, temporarily, or permanently restricted net assets, as appropriate.

5.17 With regard to pledges and other promises to pay in future periods, if a provider routinely conducts fund drives, an estimate of the future cash flows of a portfolio of short-term promises resulting from a mass fund-raising appeal may be made based on experience gained from similar appeals in prior years.

5.18 Chapter 5 of the Audit and Accounting Guide *Not-for-Profit Organizations* provides further guidance regarding accounting for promises to give in future periods and for assets held by not-for-profit organizations or charitable trusts that raise or hold contributions for others.

5.19 GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, as amended by GASB Statement No. 36, *Recipient Reporting for Certain Shared Nonexchange Revenues*, provides guidance on accounting and reporting contributions to governmental health care entities. Promises of cash or other assets that nongovernmental entities, including individuals, voluntarily make to governments may be referred to in practice as "pledges," "promises to give," or "promised donations" or by some other term. Promised assets may include permanently nonexpendable additions to endowments and other trusts; term endowments; contributions of works of art and similar assets to capitalized collections; or other kinds of capital or financial assets, with or without purpose restrictions or time requirements. For purposes of reporting under GASB Statement No. 33, these are classifed as "voluntary nonexchange transactions." Governmental health care enterprises that receive promises to give from nongovernmental entities to provide cash or other assets should recognize receivables and revenues (net of estimated uncollectible amounts) when all eligibility requirements are met, provided that the promise is verifiable and the resources are measurable and probable of collection. Transactions that are not recognizable because they are not measureable should be disclosed.

5.20 As discussed in GASB Statement No. 33, paragraph 20, eligibility requirements comprise one or more of the following:

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[8] FASB Statement No. 116 states that present value should be calculated using a discount rate commensurate with the risks involved.

[9] As discussed in FASB Statement No. 116, all expenses should be reported as decreases in unrestricted net assets. Therefore, decreases in contributions because of changes in the estimated future cash flows should be reported as losses if they are decreases in temporarily restricted net assets or permanently restricted net assets.

a. Required characteristics of recipients.

b. Time requirements.

c. Reimbursements.

d. Contingencies.

Detailed guidance on the application of eligibility requirements is provided in GASB Statement No. 33, paragraphs 21 through 26.

Financial Statement Presentation

Accounts Receivable

5.21 Receivables are reported net of an allowance for doubtful accounts. Although the aggregate amount of receivables may include balances due from patients and third-party payors (including final settlements and appeals), the amounts due from third-party payors for retroactive adjustments of items such as final settlements or appeals shall be reported separately in the financial statements.

5.22 Accounts receivable of health care organizations generally are subject to the same financial disclosure requirements as other business organizations.[10] Nongovernmental health care organizations with loans and trade receivables should follow the presentation and disclosure guidance in paragraph 13 of SOP 01-6 to the extent that guidance is applicable. FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*,[11] sets forth disclosure requirements regarding the carrying amount of patient accounts receivable.

5.23 GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, paragraph 13, requires that governmental health care entities provide details in the notes to their financial statements about receivable balances when significant components of those receivables have been obscured by aggregation.

5.24 FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, as amended by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*,[12] provides guidance on the required disclosures about significant concentrations of credit risk arising from all financial instruments, including trade accounts receivable. Concentration of credit risk frequently is an issue because most health care organizations generally tend to treat patients from their local or surrounding communities. Accordingly, disclosure should be made of the primary geographic sources of patients. It should be noted that concentration of credit risk may be a significant issue in stand-alone financial statements issued for a member hospital of a large national multi hospital system but may not be an issue for financial statements prepared for the hospital system. When the individual facilities' financial statements are consolidated into statements prepared for the entire system, the credit risk is dispersed over a much larger base of health plans, patients, and geographies and, therefore, is not as concentrated. Health care organizations with significant concentrations of credit risk should comply with

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[10] See discussion of SOP 00-1 in paragraph 5.32.

[11] This pronouncement is not applicable to governmental health care enterprises that do not apply paragraph 7 of GASB Statement No. 20. (See footnote 1 in Chapter 1.)

[12] See footnote 11.

the disclosure provisions of FASB Statement No. 107, as amended by FASB Statement No. 133.

5.25 Off-balance-sheet risk exists when the possible accounting loss from a financial instrument is not reflected on the balance sheet. Health care organizations (most notably hospitals) may enter into arrangements where they will finance their patient accounts receivable as a cash flow management strategy. Nongovernmental health care organizations should follow the presentation and disclosure guidance in paragraph 13 of SOP 01-6 regarding credit losses on off-balance-sheet instruments to the extent that guidance is applicable.

5.26 FASB Statement No. 133, as amended, provides guidance on the required disclosures by entities that hold or issue derivative instruments.[13] SOP 02-2, *Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations and Clarification of the Performance Indicator*, requires that not-for-profit health care organizations that are within the scope of this Guide provide disclosures that are analogous to those required by paragraph 45 of FASB Statement No. 133 for for-profit enterprises, including the disclosure of anticipated reclassifications into the performance indicator of gains and losses that have been excluded from that measure and reported in accumulated derivative gain or loss as of the reporting date. SOP 02-2 does not apply to governmental entities that are within the scope of this Guide. SOP 02-2 is included as Appendix F to this Guide. GASB Technical Bulletin No. 03-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets*[*] applies to governmental health care enterprises.

Interfund Receivables

5.27 Interfund receivables (or payables) may exist in internal records. However, since general-purpose financial statements of not-for-profit health care organizations do not classify assets and liabilities into fund groups, interfund receivables (or payables) are eliminated. Such interfund balances and transactions are different from interfund transactions between a governmental health care enterprise fund and another fund, such as the general fund or a special revenue fund of a primary government, when the two funds are included in the same financial reporting entity. Governmental health care entities that are funds or component units of another governmental entity may report receivables (or payables) from other funds or from the primary government or other component units. (The term *primary government* is defined in GASB Statement No. 14, *The Financial Reporting Entity*.) Interfund balances are eliminated in the government-wide financial statements of the financial reporting entity, when presented.[14] Discretely presented component units that report amounts receivable (or payable) from the primary government or from other component units should report those assets on a separate line from other receivables (payables), as discussed in GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and*

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[13] See footnote 11.

[*] In June 2003, the GASB issued Technical Bulletin (TB) No. 03-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets*. Among other matters, GASB TB No. 03-1 supersedes GASB TB No. 94-1, *Disclosures about Derivatives and Similar Debt and Investment Transactions*. GASB TB No. 03-1 is effective for financial statements for periods ending after June 15, 2003. Earlier application is encouraged.

[14] If a governmental health care entity reports using multiple enterprise funds, interfund balances between those funds are eliminated in the total enterprise fund column.

Local Governments, paragraph 61. GASB Statement No. 38, paragraph 14, also requires disclosures about interfund balances and transfers.

Promises to Give in Future Periods (Pledges)

5.28 Contributions receivable should be reported net of an allowance for uncollectible amounts. That allowance may be based on the receivable's age, the creditworthiness of the parties, the organization's past collection experience and its policies concerning the enforcement of promises to give, and other factors concerning the receivable's collectibility. After the date of initial measurement, bad debt expense should be reported for the amount of promises to give that are expected to be uncollectible (see paragraphs 5.14 and 5.19).

5.29 Investor owned health care enterprises and not-for-profit health care organizations that are recipients of unconditional pledges (promises to give in future periods) shall disclose—

a. The amounts of promises receivable in less than one year, in one to five years, and in more than five years.

b. The amount of the allowance for uncollectible promises receivable.

5.30 Investor owned health care enterprises and not-for-profit health care organizations that are recipients of conditional pledges (promises to give in future periods) shall disclose—

a. The total of the amounts promised.

b. A description and amount for each group of promises having similar characteristics, such as amounts of promises conditioned on establishing new programs, completing a new building, or raising matching gifts by a specified date.

Auditing

5.31 In general, receivables, particularly those arising from health care services, are material to the financial position of health care organizations. Examples of specific auditing objectives, selected control activities, and auditing procedures that may be considered by the independent auditor as they relate to the major components of receivables of health care organizations are presented in Exhibit 5-1 at the end of this chapter.

5.32 SOP 00-1, *Auditing Health Care Third-Party Revenues and Related Receivables*, provides guidance to auditors in evaluating the reasonableness of management's estimates regarding the proper valuation of health care third-party revenues and receivables embodied in the financial statements.

Accounts Receivable Confirmations

5.33 Direct confirmation of amounts due from discharged patients and third-party payors may be an appropriate audit procedure for obtaining evidence about the existence and accuracy of amounts due. However, many patients whose accounts are expected to be paid by a third-party payor may not have received bills, and many third-party payors may be unable to respond to confirmation requests on specific account balances. In addition, obtaining confirmation of receivables from patients who are not discharged may be impracticable because those patients may not know the amount of their indebtedness until they are discharged.

5.34 If confirmation of amounts due from patients and third-party payors is impracticable or determined not to be effective, the independent auditor

should document this decision in accordance with SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330), and should use alternate procedures such as—

- Performing an analytical procedure or testing the details of subsequent receipts.
- Reviewing third-party contracts or payment agreements.
- Comparing billings with documentation in medical records.
- Reviewing the results of third-party payor audits and, if available, peer review organization (PRO) reports.
- Examining or confirming interim payments with third-party payors.

Exhibit 5-1

Auditing Considerations

Financial Statement Assertions	*Specific Auditing Objectives*	*Selected Control Activities*	*Auditing Procedures*
Receivables for Health Care Services			
Existence	Amounts reported in the financial statements represent valid receivables, which do not include charity care balances.	Charges are generated automatically when services are performed.	Review and test subsequent receipts.
		A medical record is prepared.	Compare billing information to the documentation contained in the medical records.
		Procedures ensure that amounts due from third-party payors for individual accounts are supported properly.	Review the results of PRO, if available, and insurance company reviews for evidence that might indicate receivables may not be realized.
		Procedures ensure the proper recording of cash receipts.	Trace the receipts applicable to patient accounts to the accounts receivable records.
		Procedures ensure charity care balances are identified and excluded from gross receivables.	Review the management policy for determining charity care. Review policy and reasonableness of charity care measurement.
Completeness	Amounts reported in the financial statements are complete and are	Procedures ensure that (*a*) detailed accounts receivable	Compare detailed accounts receivable records with control

Financial Statement Assertions	*Specific Auditing Objectives*	*Selected Control Activities*	*Auditing Procedures*
	calculated and accumulated properly.	records are compared routinely with control accounts and third-party payor logs, (*b*) differences are investigated and reconciled, and (*c*) adjustments, if necessary, are made promptly.	accounts and third-party payor logs, and investigate reconciling items.
Valuation	Receivables are reported in the financial statements at net realizable value.	Allowances for uncollectibles and contractual adjustments are reviewed periodically by management to ensure that receivables are reported at estimated net realizable value.	Review third-party contracts and recompute patient receivables.
			Examine contracts or confirm interim third-party payments with third-party payors.
		Write-offs and allowances for uncollectibles are identified and approved in accordance with the entity's established policy.	Review and test the method used to determine the allowances for uncollectible accounts.
			Determine that patient accounts are classified appropriately by payor (for example, Medicare or self-pay) to evaluate collectibility.
			Test Medicare logs for accuracy and completeness.

Financial Statement Assertions	*Specific Auditing Objectives*	*Selected Control Activities*	*Auditing Procedures*
			Test and analyze aged accounts receivable trial balances, collection trends, delinquent accounts, subsequent period write-offs and economic or other factors used to determine allowance for uncollectible accounts.
			Review pledges and other receivables for collectibility.
Presentation and disclosure	Significant contractual arrangements with third parties are disclosed.		Determine that significant contractual arrangements with third parties are disclosed.
Estimated Third-Party Settlements			
Existence	Amounts reported in the financial statements represent valid receivables and/or payables.	Procedures ensure that estimated third-party settlements are determined in accordance with the reimbursement and rate-setting methodologies applicable to the entity.	Review correspondence from significant third-party payors related to (*a*) interim payment rates applicable to periods for which final settlements have not been made and (*b*) the amount of interim or final settlements made during the period.
Completeness and valuation	Amounts included in the financial statements are accurate and complete.	Procedures ensure that estimated third-party settlements are reasonably	Test the reasonableness of settlement amounts, including specific and unallocated

Financial Statement Assertions	*Specific Auditing Objectives*	*Selected Control Activities*	*Auditing Procedures*
		calculated and reported.	reserves, in light of the payors involved, the nature of the payment mechanism, the risks associated with future audits, and other relevant factors.
			Review third-party payor audit reports and adjustments for prior years' cost reports or settlements to consider whether (*a*) the effect of such adjustments has been reported properly in the financial statements and (*b*) adjustments of a similar nature apply to the current period.
			Obtain a representation from management that provisions for estimated retroactive adjustments by third-party payors under reimbursement agreements for open years are adequate.
Presentation and disclosure	Amounts reported in the financial statements are presented properly and all		Determine that the tentative nature of third-party settlement

Financial Statement Assertions	*Specific Auditing Objectives*	*Selected Control Activities*	*Auditing Procedures*
	required disclosures are made.		amounts is disclosed properly.
			Determine that differences between original estimates and subsequent revisions (including final settlements) are included in the statement of operations in the period in which the revisions are made and disclosed, if material.

Chapter 6

Property and Equipment, Supplies, and Other Assets

Overview

6.01 Health care organizations use various types of property and equipment. Those assets may be material to the financial position of institutional health care organizations, such as hospitals and nursing homes. Typical accounts used to record property and equipment transactions are land, land improvements, buildings and improvements, leasehold improvements, equipment (fixed and movable), leased property and equipment, accumulated depreciation and amortization, and construction in progress.

6.02 Supplies usually are not material to the financial position of health care organizations. However, because of the volume of supply transactions, they may materially affect operations. Supplies typically include medical and surgical supplies; pharmaceuticals; linens, uniforms, and garments; food and other commodities; and housekeeping, maintenance, and office supplies.

6.03 Other assets may include prepaid expenses, deposits, and deferred expenses. Prepaid costs, such as amounts paid to physicians for future services (for example, administering a hospital department or providing community services that further the organization's mission) may be deferred and amortized over the period benefited. Such assets are classified as current or noncurrent as appropriate.

Accounting

6.04 Accounting for property and equipment, supplies, and other assets of health care organizations is similar to that used by other business organizations.

6.05 Depreciation and amortization of property and equipment are recorded in conformity with GAAP. Useful lives assigned to depreciable assets should be reasonable, based on the circumstances. The American Hospital Association publishes useful guidelines for classifications and estimated useful lives for property and equipment used by hospitals. Those guidelines also may be useful to other health care organizations. If there is a potential that an asset is impaired, health care organizations should consider the guidance in FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*.[1,*]

[1] This pronouncement is not applicable to governmental health care enterprises that do not apply paragraph 7 of GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*. (See footnote 1 in Chapter 1.)

[*] In November 2003, the GASB issued GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. GASB Statement No. 42 establishes accounting and financial reporting standards for impairment of capital assets (capital assets are defined in paragraph 19 of GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*), including standards for the assessment of impairment of capital assets and for the measurement of impairment. GASB Statement No. 42 also provides accounting and reporting guidance for insurance recoveries, and requires disclosures about impaired capital assets that are idle at year-end. GASB Statement No. 42 is effective for financial statements for periods beginning after December 15, 2004. Earlier application is encouraged. Conforming changes to reflect the issuance of GASB Statement No. 42 will be made in a future edition of this Guide.

6.06 The recognition of contribution income related to donated long-lived assets (or assets recognized to be acquired with donated funds) is discussed in Chapter 10 of this Guide.

Financial Statement Presentation

6.07 Financial statement presentation of property and equipment of health care organizations is similar to that of other business organizations. Property held for investment purposes should be presented as part of investments. Donor or legal restrictions on the proceeds from the disposition of donated property and equipment (or of property and equipment purchased with cash restricted for acquisition of long-lived assets) are disclosed.

6.08 Financial statement presentation of supplies and other assets of health care organizations is similar to that of other business organizations.

6.09 Capital assets that are not being depreciated, if significant, should be reported separately in the statement of net assets from capital assets being depreciated, as discussed in GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, paragraph 20. GASB Statement No. 34 also establishes two capital-asset related-disclosure requirements for governmental health care entities. First, GASB Statement No. 34, paragraph 115e, requires entities to disclose their policy for capitalizing assets and for estimating the useful lives of those assets in their summary of significant accounting policies. Second, GASB Statement No. 34, paragraphs 116 and 117, require certain information to be presented about major classes of capital assets, including beginning and ending balances, capital acquisitions, sales or other dispositions, current period depreciation expense, and accumulated depreciation. Capital assets that are not being depreciated should be disclosed separately from those that are being depreciated.

Auditing

6.10 Auditing objectives for property and equipment, supplies, and other assets of health care organizations are similar to those in audits of other business organizations. The auditor may be able to assess inherent risk for these accounts as being relatively low because the transactions therein are generally small in number, relatively simple in nature, and do not involve the use of complex estimates. The auditor should consider the characteristics of the entity and of the transactions occurring during the period when assessing inherent risk for these accounts.

6.11 A health care organization may have access to the use of property and equipment under a variety of arrangements. It may (*a*) own property and equipment, (*b*) rent property and equipment from an independent or related organization, (*c*) use property and equipment provided by a related organization (such as a religious order) or by an unrelated organization under an affiliation program, or (*d*) use property and equipment provided by a government agency or unit or a government-related hospital district. The independent auditor should inquire into (and the financial statements should disclose) the nature of any relationship between the health care organization and lessors, bailors, or other owners of property. With respect to leases, FASB Statement No. 13, *Accounting for Leases*, as amended and interpreted, provides

accounting guidance.[2] GASB Statement No. 13, *Accounting for Operating Leases with Scheduled Rent Increases*, provides additional guidance for operating leases of governmental health care enterprises.

6.12 In evaluating capitalization policies, the independent auditor should consider whether interest has been capitalized in accordance with the provisions of FASB Statement No. 34, *Capitalization of Interest Cost*, and related amendments and FASB Statement No. 62, *Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants.*

6.13 In evaluating the entity's depreciation policies, the auditor may wish to refer to the American Hospital Association's *Estimated Useful Lives of Depreciable Hospital Assets*, which is revised periodically and sets forth plant asset classifications and the estimated useful lives of depreciable assets. The auditor also should be aware that social, economic, and scientific advances in the health care industry make obsolescence an important factor to be considered when evaluating depreciation policies and methods.

6.14 FASB Statement No. 144 requires that health care organizations review long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. In considering a health care organization's application of FASB Statement No. 144, auditors should obtain an understanding of the policies and procedures used by management to determine whether all impaired assets have been properly identified. In addition to evaluating the entity's procedures for identifying indicators of impairment, the auditor should consider information obtained during the audit in determining whether the health care organization has identified appropriate indicators of impairment. For example, a change in the use of a facility from an acute-care hospital to an ambulatory surgery center may require that the asset be reviewed for impairment using the method prescribed by FASB Statement No. 144.[*]

6.15 The independent auditor may need to consider the examples of specific auditing objectives, selected control activities, and auditing procedures relating to property and equipment that are presented in Exhibit 6-1.

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[2] For governmental health care enterprises, National Council on Governmental Accounting (NCGA) Statement No. 5, *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments*, requires the application of FASB Statement No. 13 for proprietary activities and provides additional guidance on specific matters unique to governmental entities.

[*] In November 2003, the GASB issued GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. GASB Statement No. 42 establishes accounting and financial reporting standards for impairment of capital assets (capital assets are defined in paragraph 19 of GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*), including standards for the assessment of impairment of capital assets and for the measurement of impairment. GASB Statement No. 42 also provides accounting and reporting guidance for insurance recoveries, and requires disclosures about impaired capital assets that are idle at year-end. GASB Statement No. 42 is effective for financial statements for periods beginning after December 15, 2004. Earlier application is encouraged. Conforming changes to reflect the issuance of GASB Statement No. 42 will be made in a future edition of this Guide.

Exhibit 6-1

Auditing Considerations

Financial Statement Assertions	*Specific Auditing Objectives*	*Selected Control Activities*	*Auditing Procedures*
Donated Property Equipment			
Valuation	Donated property and equipment is reported at fair market value at the date of donation.	Procedures ensure that the donation of property and equipment is known and recorded and that documentation supports the determination of the fair market value.	Review the documentation supporting the determination of the fair market value.[3]
Presentation and disclosure	The receipt of donated property and equipment is properly reported.		Review material donated property and equipment transactions to ensure the propriety of the reporting.
Property and Equipment Not Held for Use in Operations			
Presentation and disclosure	Property and equipment not used for operations is reported separately.	Property records segregate property and equipment not used for operating purposes.	Determine that property held for nonoperating purposes is reported separately.
Property and Equipment Additions			
Rights and obligations	The appropriate health care planning agency or other regulatory agency approvals, if required, have been obtained for property and equipment additions.	Management regularly monitors compliance with health care planning agency regulations related to additions of property and equipment.	For material new construction, determine compliance with health care planning agency or other regulatory agency requirements.

[3] SAS No. 101, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1 AU sec. 328), provides guidance on auditing fair value measurements and disclosures contained in financial statements. SAS No. 101 does not address specific types of assets, liabilities, components of equity, transactions, or industry-specific practices.

Financial Statement Assertions	*Specific Auditing Objectives*	*Selected Control Activities*	*Auditing Procedures*
		Additions are authorized in the capital budget.	
Existence and valuation	Recorded property and equipment are owned by the entity and are carried at the appropriate amounts.	Inventory of fixed assets is taken periodically. Detailed property records periodically are reconciled to the recorded amounts.	Review a summary of property and equipment (cost and accumulated depreciation) including additions, deletions, and transfers.

Chapter 7

Current Liabilities, Tax Considerations, and Long-Term Obligations

Overview

7.01 Current liabilities may include notes payable to banks; the current portion of long-term debt; accounts payable; advances from and amounts payable to third-party payors for estimated and final reimbursement settlements; refunds to and deposits from patients and others; deferred revenue; accrued salaries and payroll taxes; and other accruals such as pension or profit-sharing contributions, compensated absences, and income and other taxes. In addition, there may be a current portion of estimated malpractice costs and risk-contract recognized losses (see Chapter 8).

7.02 Long-term obligations may include notes, mortgages, capital leases, bonds, and obligations under continuing care contracts. They also may include estimated malpractice cost and risk-contract recognized losses.

Accounting for Current Liabilities

7.03 Accounting for current liabilities of health care organizations is similar to that of other business enterprises. Health care organizations are usually labor-intensive and provide employees with compensated absences, such as for holidays, vacations, and illnesses. Liabilities related to such absences are accounted for in accordance with FASB Statement No. 43, *Accounting for Compensated Absences*. Governmental health care entities should follow the guidance in GASB Statement No. 16, *Accounting for Compensated Absences*.

7.04 Liabilities related to postretirement benefits other than pensions should be accounted for in accordance with FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, and postemployment benefits should be accounted for in accordance with FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits.* These two pronouncements are not required to be applied by governmental health care enterprises. GASB Statement No. 12, *Disclosure of Information on Postemployment Benefits Other Than Pension Benefits by State and Local Governmental Employers*, however, does require certain disclosures about postemployment benefits.*

7.05 Governmental health care enterprises sometimes report government-mandated or voluntary nonexchange revenues, such as expenditure-driven grants. These revenues are recognized when all eligibility requirements

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* The GASB released a revised exposure draft of a proposed statement *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions* that addresses how state and local governments should account for and report their costs and obligations related to postemployment health care and other non-pension benefits provided to retirees. A final pronouncement, GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, was issued in the third quarter of 2004. Conforming changes to reflect the issuance of GASB Statement No. 45 will be made in a future edition of this Guide.

have been met, as discussed in GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions.* In some cases, it may become apparent after revenue has been recognized in the financial statements that the eligibility requirements are no longer met, for example, because an audit of a particular grant program determined that certain expenses did not meet purpose restrictions. GASB Statement No. 33 provides that, if it is probable that the recipient must return all or part of the resources, a liability (or reduction of receivables) and an expense should be recognized for the amount that the resource provider (grantor) is expected to cancel or reclaim. (See paragraphs 5.19, 5.20, 10.05 and 10.12 for further discussion of GASB Statement No. 33.)

Tax Considerations for Not-for-Profit Health Care Organizations

7.06 Health care organizations that are owned and operated by a state or local government are exempt from federal income tax pursuant to IRC sec. 115 and also are exempt from the federal income tax filing requirements. Such organizations are exempt not only from regular federal income tax but also from the tax on unrelated business income. If a health care entity is owned and operated by a separately constituted authority or other legal entity, the entity's management should consider whether such authority or other legal entity is organized properly to preserve qualification of the tax exemption pursuant to IRC sec. 115. In some cases, state or local governmental entities will secure tax-exempt status as an IRC sec. 501(c)(3) organization. If such an exemption is secured, the entity may become subject to federal income tax and the related filing requirements on the same basis as other tax-exempt entities.

Tax-Exempt Entities

7.07 Nongovernmental not-for-profit health care organizations usually seek exemption from federal income tax under IRC sec. 501(a). Under IRC sec. 501(a), entities organized and operated exclusively for religious, charitable, or educational purposes, as described in IRC sec. 501(c)(3), are exempt from federal income taxes. The following are additional requirements for such entities:

a. No part of the entity's net earnings, either directly or indirectly, inures to any private shareholder or individual.

b. No substantial part of the entity's activities consists of carrying on propaganda or otherwise attempting to influence legislation. (IRC sec. 501(h) provides a limited exception to the general rule that public charities may not incur expenditures to influence legislation.)

c. The entity does not participate in, or intervene in, any political campaign on behalf of any candidate for public office.

7.08 The term *charitable* is used in IRC sec. 501(c)(3) in its generally accepted legal sense. Providing health care to the community is considered a charitable activity. Therefore, provided a health care entity is not organized or operated for the benefit of private interests (such as designated individuals, the founder or the founder's family, shareholders of the entity, or persons controlled directly or indirectly by such private interests), it generally would qualify as an IRC sec. 501(c)(3) organization.

7.09 The Internal Revenue Service (IRS) has ruled that in order for a nursing home to establish its exemption as a public charitable organization under IRC sec. 501(c)(3), it must be operated to meet the primary needs of the elderly for housing, health care, and financial security. Operating for financial security generally means that an individual will be maintained in residence even if such individual can no longer pay residence fees.

Private Inurement

7.10 Under IRC sec. 501(c)(3) no part of the net earnings of the charitable organization shall inure to the benefit of any private shareholder or individual. A private shareholder or individual refers to a person or persons having a private or personal interest in the activities of the organization. The IRS has stated that physicians have a personal or private interest in the activities of a hospital and could be subject to the private inurement proscription.

Unrelated Business Income Tax

7.11 Although not-for-profit organizations may be exempt from federal income tax, they nevertheless may be subject to tax on unrelated business income. The objective of the tax on unrelated business is to place such activities on the same basis as that of taxable entities. Unrelated business income is the income from any regularly carried-on trade or business, the conduct of which is not substantially related to the exercise or performance of the organization's tax-exempt purpose or function. The fact that proceeds from an activity are used exclusively for the entity's tax-exempt purpose does not make the activity substantially related to its tax-exempt purpose or function. As is the case with most tax-related definitions, there are qualifications and exceptions. Some of the more significant exclusions from this tax include—

- An annual specific deduction for certain limited activities.
- Income from activities of which substantially all the work is performed by unpaid volunteers.
- Income from activities carried on for the convenience of the entity's patients, officers, or employees.
- Dividends, interest, annuities, royalties, capital gains and losses, and rents from real property—with two major exceptions. The first exception is that income from investments that are debt-financed and otherwise not functionally related to the tax-exempt purpose is taxable. The second major exception makes taxable the interest, annuities, royalties, and rents received from a controlled (80-percent-owned) taxable corporation or partnership unless this entity is engaged in an activity that would have been exempt if it were carried on directly by the not-for-profit organization.

Financial Statement Presentation

7.12 Financial reporting and disclosure requirements for current liabilities and long-term obligations of health care organizations are the same as for other business organizations. In addition, with respect to CCRCs, the method of accounting for advance fees, the method of calculating the obligation to provide future services and use of facilities, and the refund policy for refundable fees are disclosed in the financial statements. Chapter 14 describes other disclosure requirements applicable to CCRCs. Taxable entities have the same financial reporting and disclosure requirements as other commercial enterprises. Tax-exempt entities should disclose their tax-exempt status.

7.13 GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments,* and GASB Statement No. 38, *Certain Financial Statement Note Disclosures,* provide guidance about required disclosures for governmental health care entities about current and long-term liabilities, including the following:

- GASB Statement No. 38, paragraph 13, requires disclosures about accounts payable balances when significant components of those balances have been obscured by aggregation.
- GASB Statement No. 38, paragraph 12, requires disclosures about short-term debt activity during the year, even if no short-term debt is outstanding at year-end. For this purpose, short-term debt consists of anticipation notes, use of lines of credit, and similar loans. Disclosures should include a schedule of changes in short-term debt as well as a discussion of the purposes for which short-term debt was issued.
- GASB Statement No. 34, paragraphs 116, 119, and 120, requires information to be presented about both long-term debt, such as bonds payable, and about long-term liabilities, such as compensated absences and claims and judgments. Required disclosures include beginning and ending balances, increases, decreases, and the portions of each item that are due within one year.
- GASB Statement No. 38, paragraphs 10 and 11, requires disclosure of debt service requirements to maturity for each of the five subsequent years and in five-year increments thereafter. Principal and interest requirements are required to be disclosed separately. Similar requirements apply to obligations under capital leases and noncancelable operating leases.
- GASB Statement No. 38, paragraph 9, requires disclosure of actions taken to remedy significant violations of finance-related legal or contractual provisions.

Long-Term Debt

7.14 Significant sums of money are required to replace and upgrade buildings and expand the facilities of health care organizations. As a result, health care organizations are dependent on external sources of funds to satisfy their capital needs. Many health care organizations finance acquisitions, additions, and renovations with long-term debt.

7.15 In addition to serving as a financing source for government operations, tax-exempt debt frequently is issued by state and local governments on behalf of nongovernmental organizations (for example, not-for-profit organizations) to foster private-sector participation in certain desirable community activities such as the provision of health care services. Tax-exempt bonds usually can be issued to obtain a higher ratio of project financing (up to 100 percent), a longer maturity period (up to thirty years), and a lower interest cost than taxable bonds. The majority of tax-exempt bonds issued by health care organizations are revenue bonds, which are bonds secured by a pledge of the entity's revenues. General obligation bonds are secured by the revenues of the issuing authority.

Financing Authorities

7.16 Because most providers legally cannot issue tax-exempt revenue bonds directly, a significant number of states have enacted legislation permitting health care organizations to borrow funds for capital projects by issuing

bonds through financing authorities. Financing authorities are authorized to issue tax-exempt bonds or other obligations and use the proceeds for the benefit of the health care organization. To obtain project financing, a health care organization sometimes is required by a financing authority to enter into a lease arrangement, a sublease arrangement, or both. At other times, a lease or sublease arrangement is not required.

7.17 When a financing authority issues tax-exempt bonds or similar debt instruments and uses the proceeds for the benefit of a health care organization, the obligation is reported as a liability in the organization's balance sheet if the health care organization is responsible for repayment. In some cases, this obligation may take the form of a liability arising from a capital lease. If a health care organization has no obligation to make payments of principal and interest on the debt or capital or operating lease payments on related buildings or equipment, the organization should not reflect the liability on its balance sheet. In such circumstances, proceeds from the bond issue are reported as contributions from the sponsoring organization.

Assets Whose Use Is Limited

7.18 Among the many provisions normally included in the bond indentures of tax-exempt issues are the requirements to set aside funds annually from operations to ensure that bond principal, interest payments, and other requirements are met. The treatment of funds established under the terms of debt-financing instruments is discussed in paragraphs 1.29 and 1.30.

Advance Refundings

7.19 In an advance refunding, new debt is issued for the purpose of replacing an existing debt issue. Advance refundings enable providers to restructure their long-term liabilities, take advantage of reduced interest rates, or terminate restrictive bond covenants. The terms by which the debt may be satisfied legally and the related lien released without the debt necessarily being retired are spelled out in the debt instrument. Under the Tax Reform Act of 1986, bonds issued before January 1, 1986, may be advance refunded only twice. Bonds issued on or after that date may be advance refunded only once.

7.20 The accounting, financial reporting, and disclosure requirements for advance refundings entered into by health care organizations other than governmental entities are described in 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*, FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts.*[1] Generally speaking, these entities are required to report any gain or loss resulting from an

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[1] Emerging Issues Task Force (EITF) Issue No. 96-19, *Debtor's Accounting for a Modification or Exchange of Debt Instruments*, addresses accounting for modifications or exchanges of debt instruments. EITF Issue No. 96-19 requires that (1) an exchange of debt instruments with substantially different terms is a debt extinguishment and should be accounted for in accordance with paragraph 16 of FASB Statement No. 125; and (2) a substantial modification of terms should be accounted for like, and reported in the same manner as an extinguishment. Also, transactions involving the modification or exchange of debt instruments can only result in gain or loss recognition by the debtor if the conditions for extinguishment of debt described in paragraph 16 of FASB Statement No. 125 are satisfied or if the consensus in Issue No. 96-19 requires that accounting. FASB Statement No. 140, among other matters, replaces FASB Statement No. 125. FASB Statement No. 140 does not change the guidance dealing with accounting for extinguishments of liabilities.

advance refunding as an extraordinary item in the financial statements of the period in which the refunding occurred only if the criteria in APB Opinion No. 30 for classification as an extraordinary item are met. The accounting, financial reporting, and disclosure requirements for advance refundings (and for current refundings) entered into by governmental health care entities are set forth in GASB Statements No. 23, *Accounting and Financial Reporting for Refundings of Debt Reported by Proprietary Activities*, and No. 7, *Advance Refundings Resulting in Defeasance of Debt*. Generally speaking, governmental entities are required to amortize any gain or loss resulting from a current or advance refunding to interest expense over the shorter of the life of the new bonds or the remaining life of the old bonds.

7.21 There are several types of advance refundings, including net advance refundings, full cash advance refundings, and crossover refundings (see the Glossary). In a crossover refunding, because the old bonds are not defeased until the crossover date, no immediate gain or loss should be recognized. If the retirement dates of the old debt have been established, the call premium, unamortized premium or discount, and initial issue costs should be recognized systematically in the income statement over the remaining life of the old debt as an adjustment of the cost of borrowing related to the old debt. In addition, the income earned on the funds used to consummate the advance refunding and the interest expense on both the old and new debts should be recognized in the statement of operations. The funds used to consummate the advance refunding should be reported as an asset and both the old and new debts should be reported as liabilities. The assets and liabilities should not be offset.[†]

7.22 FASB Statement No. 140 provides accounting and reporting standards for extinguishments of liabilities. Paragraph 16 of FASB Statement No. 140 says a debtor should derecognize a liability if and only if it has been extinguished. Paragraph 16 says a liability has been extinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds.

b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor [footnote omitted].

Paragraph 114 of FASB Statement No. 140 provides related guidance.

7.23 Paragraph 17b of FASB Statement No. 140 requires that, if an entity had debt that was considered to be extinguished by an in-substance defeasance under the provisions of FASB Statement No. 76 prior to the effective date of FASB Statement No. 125, the entity should provide a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding.

Arbitrage Rebate Liabilities

7.24 Advance refundings involving tax-exempt debt are subject to arbitrage rules under the IRC sec. 103(c) and related regulations that, in general,

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[†] Public companies may also refer to the interpretations in Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 94. This SAB expresses the views of the SEC staff regarding the period in which a gain or loss is recognized on early extinguishments of debt and the periods over which deferred debt issue costs and debt premium or discount should be amortized. SABs represent interpretations and practices followed by the staff of the Office of the Chief Accountant and the Division of Corporation Finance in administering the disclosure requirements of federal securities laws.

prohibit the yield realized from the investment of the proceeds of the new debt from exceeding the yield on the debt itself. Compliance with those rules is necessary for the interest on the debt to be exempt from federal income tax and, possibly, from state and local tax.

7.25 Whenever a provider invests tax-exempt bond proceeds and the ultimate yield is higher than the interest rate on the bonds, the provider may be subject to an arbitrage rebate liability. The arbitrage determination is made as of the date of the issue; however, intentional acts undertaken after the date of the issue can disqualify the issue retroactively. The earnings in excess of interest expense represent a liability that must be paid to the U.S. Treasury in order for the bonds to maintain their tax-exempt status. The arbitrage rebate liability may be a substantial amount if the bond proceeds are not spent as quickly as planned. For example, this may occur if a provider encounters a delay in a major construction project.

Auditing

7.26 Auditing objectives and procedures for long-term debt issued by health care organizations generally are similar to those of other organizations. In addition, the independent auditor may need to consider the examples of specific auditing objectives, selected control activities, and auditing procedures that are presented in Exhibit 7-1.

Exhibit 7-1

Auditing Considerations

Financial Statement Assertions	*Specific Auditing Objectives*	*Selected Control Activities*	*Auditing Procedures*
Tax-Exempt Debt			
Presentation and disclosure	Amounts related to tax-exempt debt are properly classified in the financial statements and related disclosures are adequate.	Procedures ensure that the providers monitor their compliance with restrictive debt covenants.	Review the debt instruments for the presence of any restrictive debt covenants. Test compliance with restrictive debt covenants.
Income Taxes			
Rights and obligations	The not-for-profit organization has obtained a qualifying income tax exemption from the governmental authority.	Management monitors compliance with applicable tax regulations. Transactions are reviewed for their effect on tax status and tax liabilities.	Determine that the not-for-profit organization has obtained a determination of its tax-exempt status. Inquire if tax returns have been filed on a timely basis. Determine the status of the tax returns under examination. Read the prior years' tax returns. Read the minutes and the accounting for evidence of significant unrelated business activities. Review for reasonableness the unrelated business income tax liability.

Financial Statement Assertions	*Specific Auditing Objectives*	*Selected Control Activities*	*Auditing Procedures*
Presentation and disclosure	The entity's tax-exempt status and its tax contingencies are disclosed in the notes to the financial statements.		Determine that the entity's tax-exempt status is disclosed in the notes to the financial statements.

Chapter 8

Commitments and Contingencies

Overview

8.01 Commitments and contingencies may include (*a*) losses arising from litigation, including malpractice and other claims; (*b*) contingencies related to risk contracting; (*c*) third-party payment and rate-setting programs; (*d*) construction contract commitments; (*e*) the Hill-Burton Act obligation to provide uncompensated care; (*f*) commitments and guarantees that include contractual agreements with physicians, specialists, and others who perform services by arrangement with health care organizations; and (*g*) commitments and contingent liabilities related to pension plans, operating leases, purchase commitments, and loan guarantees.

8.02 FASB Statement No. 5, *Accounting for Contingencies*, as amended, and interpreted by FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, and FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, provides guidance on accounting for contingencies. FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, discusses accounting for claims costs, including estimates of costs relating to IBNR claims. Governmental health care entities should consider the accounting and disclosure requirements of GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, as amended by GASB Statement No. 30, *Risk Financing Omnibus*, and Interpretation No. 4, *Accounting and Financial Reporting for Capitalization Contributions to Public Entity Risk Pools.*

Medical Malpractice Claims

8.03 The extent of risk transfer is key in determining whether a liability should be recognized in a provider's financial statements pertaining to malpractice claims. The existence of an insurance policy, by itself, is no assurance that the risk of financial loss is transferred.

8.04 If the entity has purchased a claims-made insurance policy (see paragraph 8.13), there is no transfer of risk for claims not reported to the insurance carrier within the policy term. With regard to retrospectively rated insurance policies (see paragraphs 8.14 and 8.15) and policies by captive insurance companies (see paragraphs 8.16 through 8.19), the economic substance of the terms of the insurance policy may more closely resemble a claims funding mechanism than an instrument that transfers risk of loss to an external third party. If the health care organization has not transferred risk to an external third party, it should evaluate its exposure to losses arising from malpractice claims and record a liability, if appropriate.

Accruing Malpractice Liabilities

8.05 The ultimate costs of malpractice claims, which include costs associated with litigating or settling claims, are accrued when the incidents that give

rise to the claims occur. Estimated losses from asserted and unasserted claims are accrued either individually or on a group basis, based on the best estimates of the ultimate costs of the claims and the relationship of past reported incidents to eventual claims payments. All relevant information, including industry experience, the entity's own historical experience, the entity's existing asserted claims, and reported incidents, is used in estimating the expected amount of claims. The accrual includes an estimate of the losses that will result from unreported incidents, which are probable of having occurred before the end of the reporting period.

8.06 In estimating the probability that unreported incidents have occurred, some health care organizations may develop a range of possible estimates of the number of unreported incidents, including zero. However, the greater the volume of a health care organization's operations, the greater the likelihood that the organization's minimum estimate of the number of probable unreported incidents will be greater than zero.

8.07 If it is probable that a loss has been incurred and the information available indicates the loss is within a range of amounts, the most likely amount of loss in the range is accrued. If no amount in the range is more likely than any other, the minimum amount in the range is accrued. The potential additional loss is disclosed if there is at least a reasonable possibility of a loss in excess of the amount accrued.

8.08 In estimating losses from malpractice claims, a health care organization may need to modify data drawn from industry experience so it is relevant to developing an estimate that is specific to the organization. Various factors (such as the nature of operations, size, and the provider's past experience) are considered in assessing comparability. Further, industry data that are not current may not be relevant.

8.09 Estimated losses are reviewed and changed, if necessary, at each reporting date. The amounts of the changes are recognized currently as additional expense or as a reduction of expense.

8.10 Accrued unpaid claims and expenses that are expected to be paid during the normal operating cycle (generally within one year of the date of the financial statements) are classified as current liabilities. All other accrued unpaid claims and expenses are classified as noncurrent liabilities.

8.11 A health care organization discloses its program of medical malpractice insurance coverages and the basis for any related loss accruals. If the organization cannot estimate losses relating to a particular category of malpractice claims (for example, asserted claims, reported incidents, or unreported incidents) in accordance with paragraphs 8.03 through 8.10, the potential losses related to that category of claims are not accrued. However, the contingency is disclosed in the notes to the financial statements, as required by FASB Statement No. 5.

8.12 Health care organizations that discount accrued malpractice claims should disclose in the notes to the financial statements the carrying amount of accrued malpractice claims that are discounted in the financial statements and the interest rate or rates used to discount those claims. Also, the FASB has issued FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. This Concepts Statement provides useful discussion of general principles governing the use of present value, and of the objective of present value in accounting measurements. Statements of Financial Accounting Concepts are not sources of established accounting principles

as described in SAS No. 69, *The Meaning of* Present Fairly in Conformity with Generally Accepted Accounting Principles, and, thus, do not amend, modify, or justify a change from generally accepted accounting principles currently in effect.

Accounting for Claims-Made Insurance Policies and Tail Coverage

8.13 A claims-made insurance policy represents a transfer of risk within the policy limits to the insurance carrier for asserted claims and incidents reported to the insurance carrier. The policy, however, does not represent a transfer of risk for claims and incidents not reported to the insurance carrier during the policy period. Consequently, a health care organization that is insured under a claims-made insurance policy recognizes the estimated cost of those claims and incidents not reported to the insurance carrier, in accordance with paragraphs 8.03 through 8.10. This estimation is done *unless* the health care organization has bought tail coverage (see the Glossary) and included the cost of the premium as an expense in the financial statements for that period.

Accounting for Retrospectively Rated Premiums

8.14 A health care organization with a retrospectively rated insurance policy whose ultimate premium is based primarily on the health care organization's loss experience accounts for the minimum premium as an expense over the period of coverage under the policy and accrues estimated losses from asserted and unasserted claims in excess of the minimum premium, as indicated in paragraphs 8.03 through 8.10. Such estimated losses, however, are not accrued in excess of a stipulated maximum premium. If the health care organization cannot estimate losses from asserted or unasserted malpractice claims, as indicated in paragraphs 8.03 through 8.10, the health care organization should disclose the existing contingency in the notes to the financial statements, as required by FASB Statement No. 5.

8.15 A health care organization insured under a retrospectively rated policy whose ultimate premium is based primarily on the experience of a group of health care organizations amortizes the initial premium to expense on a pro rata basis over the policy term. The organization also accrues additional premiums or refunds on the basis of the group's experience to date, which includes a provision for the ultimate cost of asserted and unasserted claims before the financial statement date, whether reported or unreported. The health care organization discloses that (*a*) it is insured under a retrospectively rated policy and (*b*) premiums are accrued based on the ultimate cost of the experience to date of a group of organizations. If the health care organization cannot estimate losses from asserted or unasserted malpractice claims, as indicated in paragraphs 8.03 through 8.10, it should disclose the existing contingency in the notes to the financial statements, as required by FASB Statement No. 5.

Accounting for Medical Malpractice Claims Insured by Captive Insurance Companies

8.16 A majority-owned captive insurance company (for example, a wholly owned captive) is consolidated in accordance with FASB Statement No. 94,

Consolidation of All Majority-Owned Subsidiaries.[*] Multi provider captives, in which the ownership percentage is 50 percent or less, are accounted for in accordance with APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. (See Chapter 11 of the Guide for additional discussion of considerations related to consolidation and the use of the equity method.)

8.17 A health care organization insured by an unconsolidated multi provider captive insurance company for medical malpractice claims under a retrospectively rated insurance policy whose ultimate premium is based primarily on the health care organization's experience up to a maximum premium, if any, accounts for such insurance as indicated in paragraph 8.14.

8.18 A health care organization insured by an unconsolidated multi provider captive insurance company for medical malpractice claims under a retrospectively rated policy based primarily on the experience of a group of health care organizations accounts for such insurance as indicated in paragraph 8.15. However, the health care organization considers whether the economic substance of the multi provider captive insurance company is sufficient to relieve the health care organization from further liability. The health care organization should disclose that (*a*) it is insured under a retrospectively rated policy of a multi provider captive insurance company and (*b*) the premiums are accrued based on the captive insurance company's experience to date.

8.19 A health care organization that is insured by a multi provider captive insurance company discloses in its financial statements that it is insured by such a company, and it should disclose its ownership percentage, if significant, in the captive company as well as the method of accounting for its investment in, and the operations of, the captive company. In addition, if the health care organization cannot make the necessary estimates of losses from asserted or unasserted claims, as indicated in paragraphs 8.03 through 8.10, the health care organization discloses the existing contingency in the notes to the financial statements, as required by FASB Statement No. 5.

Accounting for Trust Funds

8.20 In general, a trust fund, whether legally revocable or irrevocable, is included in the financial statements of the health care organization. A portion of

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[*] On February 23, 1999, the FASB released an exposure draft (revised) of a proposed FASB Statement, *Consolidated Financial Statements: Purpose and Policy*—Revision of Exposure Draft issued October 15, 1995, that, in addition to other matters, would supersede FASB Statement No. 94 and amend APB Opinion No. 18. The FASB temporarily suspended work on consolidation policy issues and focused its efforts on developing interpretive guidance for variable interest entities. In 2003, the FASB issued FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, and FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (revised December 2003), to address consolidation by business enterprises of variable interest entities. Special effective date provisions apply to enterprises that have fully or partially applied FASB Interpretation No. 46 prior to the issuance of the revised Interpretation. Otherwise, application of FASB Interpretation No. 46 (revised December 2003) or FASB Interpretation No. 46 is required in financial statements of public entities that have interests in variable interest entities or potential variable interest entities commonly referred to as special-purpose entities for periods ending after December 15, 2003. Application by public entities, other than small business issuers, for all other types of entities is required in financial statements for periods ending after March 15, 2004. Application by small business issuers to entities other than special-purpose entities and by nonpublic entities to all types of entities is required at various dates in 2004 and 2005. In some instances, enterprises have the option of applying or continuing to apply FASB Interpretation No. 46 for a short period of time before applying the revised Interpretation. Not-for-profit organizations are not subject to FASB Interpretation No. 46 (revised December 2003), except that they may be related parties for purposes of applying paragraphs 16 and 17 of that Interpretation. Also, if a not-for-profit entity is used by business enterprises in a manner similar to a variable interest entity in an effort to circumvent the provisions of FASB Interpretation No. 46 (revised December 2003), that not-for-profit entity is subject to that Interpretation.

the fund equal to the amount of assets expected to be liquidated to pay malpractice claims classified as current liabilities is classified as a current asset; the balance of the fund, if any, is classified as a noncurrent asset. Revenues and administrative expenses of the trust fund are included in the statement of operations (see Chapter 10). In some circumstances, the foregoing may not be possible (for example, if a common trust fund exists for a group of health care organizations; if the health care organization is part of a common municipality risk-financing internal service fund; or if the legal, regulatory, or indenture restrictions prevent the inclusion of a trust fund in a health care organization's financial statements). In those circumstances, the provisions of paragraphs 8.21 and 8.22 apply.

8.21 In general, estimated losses from asserted and unasserted claims are accrued and reported, as indicated in paragraphs 8.03 through 8.12. The estimated losses are not based on payments to the trust fund. However, accounting for a health care organization that participates in a pooled fund depends on the extent to which the associated risks and rewards have been transferred to another party. An organization that transfers its risk of loss to the common trust fund and forfeits its rights to any excess funding should expense its contributions and account for its participation in the trust fund based on the type of coverage obtained (for example, occurrence basis, claims-made, or retrospectively rated). Governmental health care entities that are component units of a state or local government reporting entity and that participate in that entity's risk-financing internal service fund should report claims expenses equal to the charges from the internal service fund if those charges meet the requirements of paragraphs 65 through 68, as amended, of GASB Statement No. 10.

8.22 The existence of the trust fund and whether it is irrevocable is disclosed in the financial statements.

Governmental Health Care Enterprises

8.23 Governmental health care enterprises that are component units of a state or local governmental reporting entity and that participate in that entity's risk-financing internal service fund should report claims expenses equal to the charges from the internal service fund if those charges meet the requirements of paragraphs 65 through 68, as amended, of GASB Statement No. 10. A governmental health care enterprise that participates in a public entity risk pool with transfer or pooling of risk should present its premium or required contribution as insurance expense, as discussed in GASB Statement No. 10, paragraphs 69, as amended, and 70. Enterprises participating in public entity risk pools without transfer or pooling of risk should report payments to pools as deposits and recognize and measure claims liabilities in accordance with GASB Statement No. 10, paragraphs 53 through 58, as amended. GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, paragraphs 116, 119, and 120, requires disclosures about long-term liabilities (such as claims and judgments). Information to be presented includes beginning and ending balances, increases, decreases, and the portions of each item that are due within one year.

Auditing Commitments and Contingencies

8.24 Auditing objectives and procedures for commitments and contingencies generally are similar to those of other organizations. The independent auditor may need to consider the specific auditing objectives, selected control activities, and auditing procedures presented in Exhibit 8-1 at the end of this chapter.

Auditing Medical Malpractice Loss Contingencies

8.25 The existence of an insurance policy, by itself, is no assurance that malpractice contingencies are assumed by others. The auditor should review the insurance contracts and determine the extent of the risk retained by the provider. Specific auditing procedures to consider include the following:

- Determine the type (such as occurrence basis or claims-made) and level (per occurrence or in the aggregate) of insurance protection the provider has obtained.
- Determine if the coverage actually transfers the malpractice risks. Is the insurance with a related party (for example, a captive insurance company)? Does it provide for retrospective premiums or similar adjustments?

Once the extent of the risk retained is understood, the auditor will be able to determine the nature, extent, and timing of other auditing procedures.

8.26 If a health care organization has transferred the risk of loss to a financially viable third party by purchasing insurance coverage of sufficient limits on an occurrence basis, no additional auditing procedures are necessary. If the organization retains all or a portion of the risk through self-insurance or has purchased a claims-made policy, the independent auditor should perform additional auditing procedures to obtain reasonable assurance that the organization's accounting for medical malpractice losses is in accordance with GAAP.

8.27 The independent auditor should consider the extent to which the renewal of a claims-made policy or the purchase of tail coverage after the balance-sheet date but prior to the issuance of the financial statements limits the entity's liability exposure as of the balance-sheet date. If an entity either renews a claims-made policy or purchases tail coverage, and the new policy covers claims asserted during the new policy term (regardless of when the incident occurred), the entity has transferred to the insurer the risk for that portion of the entity's claims that is expected to be reported during the new policy term (up to the new policy limits). Accordingly, the entity's liability for the IBNR claims transferred would not exceed the premium on the new policy, except for anticipated claims in excess of the new policy limits.

8.28 Management's intent to renew a claims-made policy is not sufficient to constitute a limit on IBNR claims as of the balance-sheet date unless management contractually obligates itself for renewal before the issuance date of the financial statements and the cost is expensed in the period covered by the financial statements. The requirement to renew a claims-made policy or to purchase and expense tail coverage applies even if state regulations require that renewal of claims-made coverage be offered continually.

8.29 If the insured has the unilateral option to purchase tail coverage at a premium that may not exceed a stipulated maximum, and the provider intends to purchase that coverage, the amount of IBNR loss to be accrued may effectively be limited to the maximum tail-coverage premium stated in the policy. However, providers in these circumstances that do not intend to purchase tail coverage may not accrue the cost of obtaining that coverage as a substitute for the IBNR accrual.

Auditing Accounting Estimates

8.30 Management is responsible for making the accounting estimates that are included in the financial statements. Management is also responsible for providing proper disclosure of (1) the use of estimates in the preparation of financial statements and (2) certain significant estimates (SOP 94-6, *Disclosure of*

Certain Significant Risks and Uncertainties).[1] The auditor is responsible for evaluating the reasonableness of management's estimates and the adequacy of the related disclosures. The auditor does this using one or more of the following approaches:

a. Test the process used by management to develop the estimate.

b. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.

c. Review subsequent events or transactions occurring prior to completion of fieldwork.

8.31 In evaluating management's estimates of asserted and unasserted claims, the auditor should consider factors such as management's description and evaluation of asserted claims and unasserted claims arising from reported incidents; the lawyer's (and, if appropriate, the outside risk manager's) assessment of asserted claims and reported incidents not covered by insurers; and the actuary's evaluations of the aggregate liability covering asserted claims and unasserted claims arising from reported and unreported incidents.

8.32 Written assurances should be obtained from management that it has disclosed all such matters required to be disclosed by FASB Statement No. 5.

8.33 In evaluating the information provided by legal counsel, it may be necessary to supplement the written representations with inquiries if the representations are not clear regarding the probability of the litigation outcome or the potential range of loss.[2]

8.34 The auditor should consider the frequency of losses due to unreported incidents and the magnitude of prior losses and underlying causes for the IBNR claims. If there is a basis for an accrual, the auditor should then determine whether the entity's prior history supports the estimation of the number of claims and the probable settlement value.

Use of Actuaries and Actuarial Methods

8.35 An actuary may be engaged to provide or review the estimate of the medical malpractice loss amount or range of amounts or to assist in developing certain factors and assumptions used in estimating the malpractice liability. The decision to use an actuary should be based on a consideration of whether (*a*) the estimated claim liability is potentially material to the fair presentation of financial statements in conformity with GAAP and (*b*) special knowledge is required to estimate the claim liability.

8.36 If an actuary is involved in a substantial way in determining the amount of a provider's malpractice self-insurance liability, the independent auditor should follow the requirements of SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336). The independent

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[1] See paragraphs 8.40 through 8.43. SOP 94-6 does not pertain to governmental entities unless the entity has elected to follow all FASB pronouncements under paragraph 7 of GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*. (See footnote 1 in Chapter 1.)

[2] According to SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1, AU sec. 337), a letter of audit inquiry to the lawyer handling the claims is the auditor's primary means of obtaining corroboration of the information furnished by management concerning claims made and known incidents for which claims have not been made that are either uninsured or in excess of the insurance coverage. Audit inquiry letters generally would not be required with respect to reported contingencies that were not considered to have a material potential loss. The inability or unwillingness of counsel to evaluate asserted claims and or reported incidents would give rise to a modification of the auditor's opinion.

auditor should consider the actuary's professional qualifications, reputation, prior experience in estimating malpractice claim losses, and relationship to the client. There should be an understanding among the auditor, the client, and the actuary of the objectives and scope of the analysis and the methods and assumptions used. The independent auditor should be aware of (*a*) the limitations of assurances in actuarial calculations due to uncertainties and (*b*) restrictions as to the use of the actuarial reports. The independent auditor is responsible for determining the adequacy of the actuary's report for purposes of corroborating the representations in the financial statements. The independent auditor should perform an appropriate test of the accounting data provided by the client to the actuary. Such accounting data may include historical claim experience, policy terms (such as coverage, expiration, deductibles, presence of retrospectively determined premiums, and indemnity limitations), exposure data (such as the number of beds, high-risk medical specialties, outpatient visits, and emergency room visits), and information about risk management systems, personnel, and procedures.

8.37 An accrual for malpractice losses should be based on estimated ultimate losses and costs associated with settling claims. Accruals should not be based on recommended funding amounts, which in addition to a provision for the actuarially determined liability also includes a provision for (*a*) credit for investment income and (*b*) a margin for risk of adverse deviation. The following are examples of factors to consider and adjustments that may be required to convert actuarially determined malpractice funding amounts to an appropriate loss accrual to be reported in the financial statements:

- The risk of adverse deviation is an additional cost factor applied to bring a funding requirement to a selected confidence level. This factor does not meet the criteria for recognition as a liability in accordance with FASB Statement No. 5.
- An evaluation should be made of the extent and validity of industry data when the credibility factor actuarial technique is used. The lower the credibility factor, the greater the blending of industry data. This may create an unacceptable level of industry data at lower confidence levels. Further, a low credibility factor may indicate that provider-specific data is not sufficient to support the claims liability estimation process.
- A review of the discounting approach used is necessary to develop the required disclosure. The impact on the discounting calculation of any other adjustment made to the actuarially determined amounts (such as risk of adverse deviation or the credibility of the risk management system) has to be evaluated.
- A review of the expenses included in the loss estimation process should be made. Such expenses include the expense of settlement and litigation (that is, allocated loss adjustment expenses).

8.38 Limitations on the availability of provider-specific data, lack of a sufficient patient population for claims projection purposes, a very low credibility factor, and a variety of other factors may cause the actuary's estimate of loss to be of limited value in developing an estimate of the liability under GAAP.

Risks and Uncertainties

8.39 Uncertainties arise when the evidence available is insufficient for a reasonable estimation of the effects of the outcome of a particular future event on the current financial statements. Normally, the resolution of the uncertainty is

prospective, and sufficient evidence cannot be expected to exist at the time of the audit. In these situations, it cannot be determined what adjustments, if any, to the financial statements may be appropriate. The existence of such an uncertainty, if material, ordinarily should result in the inclusion of an explanatory paragraph in the auditor's report. In certain circumstances, the possible effects of the uncertainty on the financial statements may be so pervasive that the balance of the financial statements has little meaning. In these cases, a disclaimer of opinion may be appropriate.

8.40 SOP 94-6 requires entities to include in their financial statements information about—

a. The nature of their operations.

b. Use of estimates in the preparation of financial estimates.

In addition, if certain specified disclosure criteria are met, it requires entities to include in their financial statements disclosures about—

a. Certain significant estimates.

b. Current vulnerability due to certain concentrations.

8.41 Paragraph 18 of SOP 94-6 gives examples of items that may be based on estimates that are particularly sensitive to changes in the near term. Examples of similar estimates that may be included in financial statements of health care organizations include, but are not limited to, the following:

- Third-party revenue and related receivables
- Assets subject to impairment, for example, goodwill
- Environmental remediation-related obligations
- Litigation-related contingencies, for example, fraud and abuse actions by regulators
- Estimated risk pool settlements arising from managed care contracting
- Amounts reported for long-term obligations such as amount reported for pensions and postemployment benefits
- Estimated net proceeds recoverable, the provisions for expected loss to be incurred, or both, on disposition of a business or assets

8.42 SOP 00-1 provides guidance to auditors regarding uncertainties inherent in health care revenue recognition. Examples of risks unique to the government-contracting environment are presented in paragraph 7 of the SOP. Also, 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 example, regulatory action reflecting local or national audit or enforcement initiatives). 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.[3]

8.43 Examples of concentrations that may meet the criteria that require disclosure in the financial statements of health care organizations in accordance with paragraph 21 of the SOP include the following:

- Concentrations in the volume of business transacted with a particular payor, supplier, lender, grantor, or contributor

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[3] A sample disclosure is provided in SOP 00-1 that among other things indicates laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. SOP 00-1 is included as Appendix E to this Guide.

- Concentrations in revenue from particular products, services, or fund-raising events
- Concentrations in the available sources of supply of material, labor, or services, or of licenses or other rights used in the entity's operations
- Concentrations in the market or geographic area in which an entity conducts its operations

Evaluating Lawyers' Responses

8.44 Determining the outcome of pending or threatened litigation, claims and assessments (including unasserted claims and assessments) normally is beyond the auditor's professional competence. Accordingly, the auditor's evaluation of the need for disclosures or report modifications is based primarily on the opinion of the lawyer handling the matter. The American Bar Association (ABA) has adopted a *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information* under which lawyers accept certain responsibility for responses to auditors' inquiries. However, the ABA Statement of Policy is not enforceable by the ABA in the same way the AICPA is able to enforce its standards under the accounting profession's Code of Professional Conduct. As a result, lawyers' responses may vary widely.

8.45 Interpretation No. 7 of SAS No. 12, entitled "Assessment of a Lawyer's Evaluation of the Outcome of Litigation" (AICPA, *Professional Standards*, vol. 1, AU sec. 9337.18–.22) includes the following examples of evaluations of litigation, which may be considered to communicate in a sufficiently clear manner a remote likelihood of an unfavorable outcome:

- "We are of the opinion that this action will not result in any liability to the company."
- "It is our opinion that the possible liability to the company in this proceeding is nominal in amount."
- "We believe the company will be able to defend this action successfully."
- "We believe that the plaintiff's case against the company is without merit."
- "Based on the facts known to us, after a full investigation, it is our opinion that no liability will be established against the company in these suits."

8.46 On the other hand, the lawyer may use terms, such as *meritorious defenses*, that have different meanings to different lawyers. The Interpretation includes the following examples of lawyers' evaluations that are unclear regarding the likelihood of an unfavorable outcome:

- "This action involves unique characteristics wherein authoritative legal precedents do not seem to exist. We believe that the plaintiff will have serious problems establishing the company's liability under the act; nevertheless, if the plaintiff is successful, the award may be substantial."
- "It is our opinion that the company will be able to assert meritorious defenses to this action." (The term *"meritorious defenses"* indicates that the company's defenses will not be summarily dismissed by the court; it does not necessarily indicate the lawyer's opinion that the company will prevail.)
- "We believe the action can be settled for less than the damages claimed."

- "We are unable to express an opinion as to the merits of the litigation at this time. The company believes there is absolutely no merit to the litigation." (If the company's lawyer, with the benefit of all relevant information, is unable to conclude that the likelihood of an unfavorable outcome is "remote", it is unlikely that management would be able to form a judgment to that effect.)
- "In our opinion, the company has a substantial chance of prevailing in this action." (A "substantial chance", a "reasonable opportunity", or similar terms indicate more uncertainty than an opinion that the company will prevail.)

8.47 When the lawyer's response is unclear, the auditor may request a conference to clarify the lawyer's opinion. If the response is still unclear or the materiality of the uncertainty cannot be determined, the auditor should consider the guidance in paragraphs 29 through 32 of SAS No. 58, *Reports on Audited Financial Statements*, as amended by SAS No. 79, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements (AICPA, *Professional Standards*, vol. 1, AU sec. 508).

Auditing

8.48 The independent auditor may need to consider the examples of specific auditing objectives, selected control activities, and auditing procedures for commitments and contingencies that are presented in Exhibit 8-1.

Exhibit 8-1

Auditing Considerations

Financial Statement Assertions	*Specific Auditing Objectives*	*Selected Control Activities*	*Auditing Procedures*
Malpractice Loss Contingencies			
Existence and occurrence, completeness, rights and obligations, and valuation	The liability for malpractice claims is reported properly in the balance sheet.	Insurance coverage is reviewed regularly, including the financial viability of the insurer.	Review the amount of insurance coverage, the type of coverage (claims-made or occurrence), the deductible provisions, and so forth, to determine the level of risk that is retained by the entity. Consider the financial viability of the insurance carrier.
		The risk management system identifies and monitors malpractice incidents and evaluates associated losses.	
		Outside legal counsel and insurance carriers review and monitor all claims.	Send letters of inquiry to malpractice insurance carriers and legal counsel (in accordance with SAS No. 12).
		The adequacy of malpractice accruals is reviewed regularly by management, including information obtained from qualified specialists. Information supplied to specialists is reviewed for accuracy and completeness. Actuarial assumptions are reviewed for compliance with GAAP.	Review and test the method of estimating accruals (for example, review actuarial reports and prior historical loss experience).
			Determine that additional premiums charged by insurers for retrospectively related policies are reported as a liability.

Financial Statement Assertions	*Specific Auditing Objectives*	*Selected Control Activities*	*Auditing Procedures*
		Changes in the risk management system are communicated on a timely basis.	Review prior estimates and historical loss experience.
			Determine whether uncertainties related to medical malpractice claims need to be disclosed in the auditor's report.
Presentation and disclosure	The program of medical malpractice insurance coverage and the basis for any loss accruals are disclosed adequately in the financial statements.		

Chapter 9

Net Assets (Equity)

Investor-Owned Health Care Organizations

9.01 The equity accounts of investor-owned health care entities are similar to those of other investor-owned businesses.

Not-for-Profit Health Care Organizations

9.02 The balance sheets of not-for-profit health care organizations should report separate amounts for each of three classes of net assets:[1] (*a*) permanently restricted net assets, (*b*) temporarily restricted net assets, and (*c*) unrestricted net assets. This is based on the existence or absence of donor-imposed restrictions.

9.03 Unrestricted net assets generally result from revenues from providing or agreeing to provide health care services, receiving unrestricted contributions and grants, or receiving dividends or interest from investing in income-producing assets minus expenses incurred in providing or agreeing to provide health care services, providing other community benefits, and performing administrative functions. The only limits on the use of unrestricted net assets are the broad limits resulting from the nature of the provider's organization; the environment in which the organization operates; the purposes specified in its articles of incorporation or in its bylaws; or limits resulting from contractual agreements with suppliers, creditors, and others entered into in the course of business. Information about significant contractual limits, including the existence of restrictive debt covenants, generally is provided in the notes to the financial statements. Similarly, information about self-imposed limits may be provided either on the face of the balance sheet or in the notes to the financial statements. Such specifics include information about voluntary resolutions by the entity's governing board to designate a portion of its unrestricted net assets for identified purposes (for example, funded depreciation).

9.04 Information about the nature and amounts of different types of permanent restrictions or temporary restrictions should be provided either by reporting their amounts on the face of the financial statements or by including relevant details in the notes to the financial statements. Separate line items may be reported within permanently restricted net assets (or in the notes to the financial statements) to distinguish between permanent restrictions for holdings of (*a*) assets, such as land or works of art, donated with stipulations that they be used for a specified purpose, be preserved, and not be sold, or (*b*) assets donated with stipulations that they be invested to provide a permanent source of income (that is, permanent endowment funds).

9.05 Similarly, separate line items may be reported within temporarily restricted net assets (or in the notes to the financial statements) to distinguish between temporary restrictions for (*a*) support of particular operating activities, (*b*) investment for a specified term, (*c*) use in a specified future period, or (*d*) acquisition of long-lived assets. Donors' temporary restrictions may require

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[1] Though some health care organizations may use other terms, such as *equity*, this Guide uses the term *net assets* to describe residual interest.

that resources be used in a later period or after a specified date (time restrictions) or that resources be used for a specified purpose (purpose restrictions) or both. For example, gifts of cash and other assets with stipulations that they be invested to provide a source of income for a specified term and that the income be used for a specified purpose are restricted both as to time and purpose.

9.06 The nature of the restrictions on donor-restricted resources should be disclosed in the financial statements.

Governmental Health Care Organizations*

9.07 The statements of net assets/balance sheets of governmental health care entities should report net assets/equity in three components: (1) invested in capital assets, net of related debt; (2) restricted, and (3) unrestricted. Either term *net assets* or *equity* may be used to refer to the difference between assets and liabilities. The term *fund balance* should not be reported on the face of the statement. When governmental health care entities first apply GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, classifying net assets into the three required categories should begin by adding together all previously reported fund balance amounts. Calculating each of the three required components is described in paragraphs 9.08 through 9.10.

9.08 As discussed in GASB Statement No. 34, paragraph 33, the net asset component, *invested in capital assets, net of related debt* should be the sum of capital assets (capital assets are defined in paragraph 19 of GASB Statement No. 34), net of accumulated depreciation less any debt issued to finance those assets. *Invested in capital assets, net of related debt* should not include any restricted resources that must be used to acquire capital assets, (such as unexpended debt proceeds, or capital grants and contributions), or debt attributable to significant amounts of unexpended debt proceeds. Capitalized costs of issuance are included with the same category as the related debt, as discussed in the GASB staff document *Comprehensive Implementation Guide—2003* (GASB Q&A 2003 Edition), item 7.130 (see paragraph 1.11 in this Guide).

9.09 The term *restricted* is defined by GASB Statement No. 34, paragraphs 34 and 99. A restriction is a constraint placed on the use of assets or net assets that is either externally imposed (such as by creditors through debt covenants) or imposed by law through constitutional provisions or enabling legislation. Restricted net assets should be reported based on this definition of *restricted*. As discussed in paragraph 98 of GASB Statement No. 34, major categories of restrictions should be reported on the face of the statement of net assets/balance sheet, for example, *net assets restricted for capital acquisitions*. As discussed in the GASB Q&A 2003 Edition, item 7.129, (see paragraph 1.11 in this Guide) unexpended debt proceeds that must be used to acquire or construct capital assets and the portion of the debt attributable to the unexpended proceeds should be included in *restricted net assets*. When a governmental health care entity reports restricted net assets arising from permanent endowments, restricted net assets should be reported in two additional components—expendable and nonexpendable, as discussed in paragraph 35 of GASB Statement No. 34. As discussed in Appendix 7-3, Exercise 3 in the GASB Q&A

* This section contains guidance that is limited to governmental health care organizations that report as proprietary activities. This section does not apply to governmental health care organizations that report using governmental funds.

2003 Edition (see paragraph 1.11 in this Guide), no category of restricted net assets can be negative. If liabilities that relate to restricted assets exceed those assets, no balance should be reported. The negative amount should be reported as a reduction of *unrestricted net assets.*

9.10 GASB Statement No. 34, paragraph 98, prohibits governmental entities from reporting internal designations in the net assets section of their statements of net assets/balance sheets. Designations are management's plans for the use of resources. They should not be afforded the same status as restrictions. Internally designated net assets should be reported as unrestricted net assets and should not be displayed separately in the net assets section of the statement of net assets/balance sheet, as discussed in paragraph 37 of GASB Statement No. 34. (Designated *assets*, however, may be reported in the statement of net assets/balance sheet, as discussed in paragraph 3.01 in this Guide.)

9.11 The nature of the restrictions on donor-restricted resources should be disclosed in the financial statements.

Auditing

9.12 The independent auditor may need to consider the examples of specific auditing objectives, selected control activities, and auditing procedures relating to net assets (equity) that are presented in Exhibit 9-1.

Exhibit 9-1

Auditing Considerations

Financial Statement Assertions	*Specific Auditing Objectives*	*Selected Control Activities*	*Auditing Procedures*
Net Assets (Equity)			
Rights and obligations	Resources are used and accounted for in accordance with donor and grantor restrictions.	Management monitors compliance with these restrictions.	Review the minutes of board and board committee meetings for evidence of donor restrictions.
			Determine compliance with donor and grantor restrictions.
Presentation and disclosure	Net assets are presented and disclosed properly in the financial statements.	Procedures ensure proper authorization, recording, and presentation.	Test significant net asset transactions to determine that they are properly authorized and recorded.

Chapter 10

Revenue, Expenses, Gains, and Losses

Conceptual Framework for Reporting Revenue, Expenses, Gains, and Losses

10.01 FASB Concepts Statement No. 6, *Elements of Financial Statements*, provides a useful conceptual framework for preparers of financial statements to distinguish among elements of financial statements for purposes of display. Additionally, not-for-profit organizations are subject to the requirements of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*.[1] This chapter draws on the concepts contained in FASB Concepts Statement No. 6 and FASB Statement No. 117 in discussing revenue, expenses, gains, and losses with respect to health care organizations. Expenses are not generally netted against revenues, whereas gains and losses may be displayed as net amounts. The application of these concepts to the classification of revenue, expenses, gains, and losses in the statement of operations of health care organizations is discussed in paragraphs 10.02 through 10.10.

10.02 FASB Concepts Statement No. 6, paragraph 78, defines revenues as "inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations." Similarly, paragraph 80 defines expenses as "outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations."

Distinguishing Charity Care From Bad Debt Expense or Allowance

10.03 Charity care represents health care services that are provided but are never expected to result in cash flows. As a result, charity care does not qualify for recognition as receivables or revenue in the financial statements. Distinguishing charity care from bad-debt expense (or allowance, for governmental health care entities[2]) requires the exercise of judgment. Charity care is provided to a patient with demonstrated inability to pay. Each organization establishes its own criteria for charity care consistent with its mission statement and financial ability. Only the portion of a patient's account that meets the organization's charity care criteria is recognized as charity. Although it is not necessary for the entity to make this determination upon admission or registration of an individual, at some point the entity must determine that the individual meets the established criteria for charity care. (See paragraph 10.26 for disclosure requirements relating to charity care.)

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[1] This pronouncement is not applicable to governmental health care enterprises. (See footnote 1 in Chapter 1.)

[2] See paragraph 10.26 in this chapter for a discussion about the reporting of allowances by governmental health care entities.

Revenue

10.04 Revenue usually is recorded when coverage is provided to an enrollee or the service is provided to a patient or resident. Revenue is classified based on the type of service rendered or contracted to be rendered. Examples of revenue include—

- Patient service revenue, which is derived from fees charged for patient care. This may be based on diagnosis related group (DRG) payments, resource-based relative value scales (RBRVS) payments, per diems, discounts, or other fee-for-service arrangements.
- Premium revenue, which is derived from capitation arrangements.
- Resident service revenue, which may be related to maintenance fees, rental fees, or amortization of advance fees.

10.05 Some not-for-profit health care enterprises may receive relatively small amounts of contributions, grants, or tax support. Such amounts, whether temporarily restricted, permanently restricted, or unrestricted, are recognized as revenue or gains when they are received. Special considerations pertaining to revenue recognition of promises to give in future periods (pledges) are discussed in Chapter 5 and in paragraphs 10.07 through 10.10 in this Guide. FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*,[3] establishes standards for transactions in which a donor makes a contribution by transferring assets to a recipient organization—a not-for-profit organization or a charitable trust—that accepts the assets from the donor and agrees to use the assets on behalf of or transfer the assets, their investment return, or both to another entity—the beneficiary—named by the donor.[4] If a donor transfers assets to an agent, trustee, or intermediary (recipient organization) and specifies a nongovernmental health care organization as the ultimate recipient (the specified beneficiary) of the contribution or grant, that specified health care organization should recognize its rights to the assets held by a recipient organization as an asset and contribution revenue unless the recipient organization is explicitly granted variance power. (See paragraph 15 of FASB Statement No. 136.) Variance power is the unilateral power to redirect the use of the transferred assets to an entity or individual other than the specified beneficiary. *Explicitly grants* means that the donor should explicitly refer to the recipient organization's ability to exercise variance power in the instrument that transfers the assets. *Unilateral power* means that the recipient organization can override the donor's instructions without approval from the donor, the specified beneficiary, or any other interested party. (See paragraph 12 of FASB Statement No. 136.) If the recipient organization is explicitly granted variance power, the specified health care organization (beneficiary) should not recognize its potential for future distributions from the assets held by the recipient organization. (See paragraph 16 of FASB Statement No. 136.) Those distributions, if they occur, should be recognized as contributions by the specified health care organization (beneficiary) when received or unconditionally promised.

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[3] This pronouncement is not applicable to governmental health care enterprises. (See footnote 1 in Chapter 1.)

[4] FASB Statement No. 136 also established standards for transactions that take place in a similar manner but are not contributions because the transfers are revocable, repayable, or reciprocal. For example, if a resource provider transfers assets to a recipient organization and names itself or its affiliate as beneficiary, that transaction is reciprocal even if the resource provider grants variance power. Those standards and transactions are discussed in paragraphs 4.14, 4.15, 11.21, 11.23, and 11.24 of this Guide. This Guide does not use the word *donor* in discussing those transactions because they are not contributions.

(See further discussion at paragraph 5.11 in this Guide. Also, special considerations pertaining to transfers between related entities are discussed in paragraphs 10.07, 11.21 through 11.24 and 11.29 through 11.33 in this Guide.) Governmental health care enterprises may also receive contributions, grants, or tax support. Governmental health care enterprises classify these transactions into one of four classes of nonexchange transactions based on their principal characteristics, as discussed in GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, paragraph 7, as amended by GASB Statement No. 36, *Recipient Reporting for Certain Shared Nonexchange Revenues*. (GASB Statement No. 33, as amended, applies to transactions involving financial and capital resources. GASB Statement No. 33, as amended, does not apply to other resources, such as contributed services.) Transactions that are not recognizable because they are not measurable should be disclosed.

10.06 Other revenue, gains, or losses are derived from services other than providing health care services or coverage to patients, residents, or enrollees. These typically include—

- Interest and dividends from all funds held by a trustee, malpractice funds, or other miscellaneous investment activities.
- Certain realized changes in market values of marketable securities (see Chapter 4).
- Fees from educational programs, which include tuition for schools (such as nursing) or laboratory and X-ray technology.
- Rental of health care facility space.
- Sales of medical and pharmaceutical supplies to employees, physicians, and others.
- Fees charged for transcripts for lawyers, insurance companies, and others.
- Proceeds from sale of cafeteria meals and guest trays to employees, medical staff, and visitors.
- Proceeds from sale of scrap, used X-ray film, etc.
- Proceeds from sales at gift shops, snack bars, newsstands, parking lots, vending machines, or other service facilities operated by the health care organization.

10.07 Interest earned and gains and losses on investments and other assets (or liabilities) are reported by not-for-profit organizations as increases or decreases in unrestricted net assets, unless their use is temporarily or permanently restricted by explicit donor stipulation or by law. Net assets released from restriction, such as those related to the fulfillment of time or purpose restrictions, should be reported separately in the financial statements or disclosed in the notes. Additional guidance on accounting for investments can be found in Chapter 4. Occasionally, nongovernmental health care organizations may receive funds from (or transfer funds to) a not-for-profit organization or a charitable trust. If the not-for-profit organization is an affiliate, those transfers generally are either: (*a*) an equity transfer, (*b*) an equity transaction, or (*c*) a loan or advance. Equity transfers are discussed in paragraph 11.20. Equity transactions are discussed in paragraphs 11.21 through 11.24. Loans and advances to related entities are discussed in paragraph 11.26. In limited circumstances, those transfers are contributions. The circumstances in which a distribution from a not-for-profit organization or charitable trust to an affiliated nongovernmental health care organization is a contribution are described in paragraphs 11.32 and 11.33. If the not-for-profit organization or charitable

trust is not an affiliate, the transaction is either (*a*) an investment transaction, (*b*) a refundable advance, or (*c*) a contribution. Investment transactions are discussed in paragraphs 4.14 and 4.15. The transfer is a refundable advance if it is revocable or repayable. The transfer is a contribution only if it meets the definition of a contribution in FASB Statement No. 116; that is, it is an unconditional, voluntary, nonreciprocal transfer by an entity acting other than as an owner.

10.08 Contributions of noncash assets that are not long-lived assets are recognized as revenue or gains in the period received and as assets or a reduction of liabilities or expenses, depending on the form of the benefits received. (For example, a donation of supplies would be reflected as revenue or gains and as an increase in inventory or supply expense.) The donations are measured at fair value.[5] Donations received with no restrictions attached are reported as unrestricted support in the statement of operations. Donations with explicit donor restrictions attached (other than permanent restrictions) are reported as temporarily restricted support. The expiration of these restrictions is recognized in the period when the time stipulated by the donor has elapsed, when the stipulated purpose for which the asset was restricted has been fulfilled, or both. When the restriction expires, the temporarily restricted net assets are reclassified to unrestricted net assets and reported in the statement of operations as "net assets released from restriction." Donor-restricted contributions whose restrictions are met in the same reporting period may be reported as unrestricted support provided that an organization discloses its accounting policy and applies the policy consistently from period to period. Donations with explicit donor restrictions attached that permanently limit the health care organization's use of the contributed assets (for example, permanent endowments) are reported as increases in permanently restricted net assets.

10.09 Contributions of long-lived assets, including the use of long-lived assets such as land, buildings, and equipment, are reported as support or gains in the period received. The donation is measured at its fair value. If the donor places no restrictions on the use of the asset, the contribution is reported as unrestricted support. Contributions of long-lived assets with explicit donor restrictions are reported as temporarily or permanently restricted support. The provider reports expirations of donor restrictions when the stipulation is fulfilled and the assets are placed in service. At that time, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the statement of operations as "net assets released from restriction."

10.10 Donations of cash or other assets that must be used to acquire long-lived assets are reported as temporarily restricted support in the period received. Expirations of donor restrictions are reported when the acquired long-lived assets are placed in service and donor-imposed restrictions are satisfied. The temporarily restricted net assets are reclassified to unrestricted net assets and reported in the statement of operations as "net assets released from restriction." For providers that prepare classified balance sheets, assets that are restricted by donors for acquisition of long-lived assets (such as cash or contributions receivable) are not included in "cash and cash equivalents" or with other "contributions receivable." Rather, those assets are reported in a separate section, such as "assets restricted to investment in property and equipment," and are sequenced near the "property and equipment" section of the balance sheet (see paragraph 3.01).

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[5] Information necessary to estimate the fair value of a donated asset may be obtained from various sources as described in FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, paragraph 19.

10.11 The nature and extent of donated services received by health care organizations varies and can range from the limited participation of many people in fund-raising activities to active participation in the entity's service programs; their values usually are not recorded. Contributed services should be reported as contribution revenue and as assets or expenses if the services create or enhance a nonfinancial (that is, nonmonetary) asset (for example, property and equipment) or meet all of the following criteria:

a. Require specialized skills

b. Are provided by individuals with those skills (such as accounting, financial, construction, educational, electrical, legal, medical, and other services provided by accountants, investment advisers, contractors, teachers, electricians, lawyers, doctors, and other professionals and craftspeople)

c. Would typically need to be purchased by the organization if they had not been provided by contribution

Additional guidance with regard to the accounting for and the reporting of donated services is provided in FASB Statement No. 116.

10.12 Contributions to governmental health care enterprises are governed by GASB Statement No. 33, discussed in paragraph 10.05. GASB Statement No. 33 applies to *external* transactions involving financial and capital resources. As discussed in GASB Statement No. 33, paragraph 14, purpose restrictions on nonexchange revenues (such as grants, contributions, and endowments) do not affect when revenues are recognized. Rather, resulting *net assets* should be reported as restricted until the resources have been used for the specified purpose (see paragraph 9.08 of this Guide) or for as long as the resource provider requires (for example, for endowments). Unlike not-for-profit health care entities, the statement of revenues, expenses, and changes in net assets/equity does not require disaggregation of transactions based on the types of restrictions that may exist (such as unrestricted, temporarily restricted, or permanently restricted revenues). Disaggregations such as *net assets released from restrictions, changes in temporarily restricted net assets,* and *changes in permanently restricted net assets* should not be reported in either the statement of revenues, expenses, and changes in net assets/equity or in the net assets section of the statement of net assets/balance sheet of governmental health care entities. Interfund transfers are reported after *nonoperating revenues and expenses* in the statement of revenues, expenses, and changes in net assets/equity as discussed in paragraphs 101 and 112 of GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments* (see paragraph 1.20 of this Guide). Intra-entity activity between a primary government and its component units are accounted for in accordance with paragraph 61 of GASB Statement No. 34.

10.13 Additional guidance regarding accounting for contributions discussed above can be found in Chapters 5 and 6 of the Audit and Accounting Guide *Not-for-Profit Organizations,* which also addresses the following:

- Permanent endowments
- Split-interest agreements
- Gifts in kind
- Contributed utilities, facilities, or use of long-lived assets
- Transfers to a not-for-profit organization or charitable trust that raises or holds contributions for others (refer to Chapter 5 in the Audit and Accounting Guide *Not-for-Profit Organizations* under the heading "Agency Transactions")

10.14 Foundations, business organizations, and other types of entities may provide resources to health care organizations under programs referred to as grants, awards, or sponsorships. Those asset transfers are contributions if the resource providers receive no value in exchange for the assets transferred or if the value received by the resource provider is incidental to the potential public benefit from using the assets transferred. For governmental health-care organizations, these transactions are referred to as nonexchange transactions, addressed in GASB Statement No. 33. The asset transfers are exchange or exchange-like transactions if the potential public benefit is secondary to the resource providers' potential direct benefits. For example, a research grant made by a foundation to a hospital would likely be a contribution if the research program is to be planned and carried out by the hospital and the hospital has the right to publish the results. If, however, the grant is made by a pharmaceutical manufacturer that provides potential new medications to be tested in the hospital's research facilities and retains the right to any patents or other results, the grant would likely be an exchange transaction.

10.15 For governmental health care entities, capital contributions and contributions to term and permanent endowments are reported as a component of the all-inclusive statement of revenues, expenses, and changes in net assets/equity. Contributions of capital assets or of financial resources required to be used to acquire capital assets are required to be reported as revenues separately after *nonoperating revenues and expenses,* in the statement of revenues, expenses, and changes in net assets/equity, as illustrated in paragraph 1.18 of this Guide. Contributions to term and permanent endowments should be reported in the same manner as capital contributions. Capital contributions received from other funds of the same financial reporting entity should be reported last as interfund transfers, after *nonoperating revenues and expenses* in the statement of revenues, expenses, and changes in net assets/equity, as discussed in paragraph 101 of GASB Statement No. 34 and paragraph 10.12 in this chapter.

10.16 Revenues from capital contributions as well as contributions to the principal of permanent and term endowments should be reported after *nonoperating revenues and expenses,* as discussed in GASB Statement No. 34, paragraph 100. Income from permanent or term endowments should be recorded as *nonoperating revenue*, as discussed in the GASB staff document *Comprehensive Implementation Guide—2003* (GASB Q&A 2003 Edition), item 7.334 (see paragraph 1.11 in this Guide).

Expenses

10.17 The basis and timing of the recognition of expenses for health care organizations generally are the same as for other business enterprises. Expenses arising from nonexchange transactions (such as grants, taxes, and contributions) reported by governmental health care enterprises are recognized based on their appropriate class of nonexchange transactions, as discussed in paragraph 10.05. Not-for-profit organizations report expenses as decreases in unrestricted net assets.

10.18 Statement of Position (SOP) 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and Local Governmental Entities That Include Fund Raising*, provides guidance for not-for-profit and state and local governmental entities (including health care organizations) that conduct fund-raising activities with activities related to other functions, such as program activities or supporting services (joint activities). This SOP establishes financial accounting

standards for accounting for costs of joint activities, and requires financial statement disclosures about the nature of the activities for which joint costs have been allocated and the amounts of joint costs. SOP 98-2 is included as Appendix C to this Guide.

Financial Statement Presentation

10.19 The statement of operations for not-for-profit organizations should include a performance indicator that reports results of operations. This performance indicator and the income from continuing operations reported by for-profit health care enterprises generally are consistent, except for transactions that clearly are not applicable to one kind of entity (for example, for-profit health care enterprises typically would not receive contributions, and not-for-profit health care organizations would not award stock compensation). That is, the performance indicator is analogous to income from continuing operations of a for-profit enterprise. Because of the importance of the performance indicator, it should be clearly labeled with a descriptive term such as *revenues over expenses, revenues and gains over expenses and losses, earned income*, or *performance earnings*. The notes to the financial statements should include a description of the nature and composition of the performance indicator. Not-for-profit organizations should report the performance indicator in a statement that also presents the total changes in unrestricted net assets. Other changes in net assets may be presented separately or in the same statement.

10.20 Health care organizations should report the following items separately from the performance indicator—

a. Transactions with owners acting in that capacity.

b. Equity transfers involving other entities that control the reporting entity, are controlled by the reporting entity, or are under common control with the reporting entity.

c. Receipt of restricted contributions, including temporary restrictions (such as time or purpose) or permanent restrictions.

d. Contributions of (and assets released from donor restrictions related to) long-lived assets.

e. Items that are required to be reported in or reclassified from other comprehensive income, such as a minimum pension liabilities in accordance with paragraph 37 of FASB Statement No. 87, *Employers' Accounting for Pensions*; foreign currency translation adjustments and the effective portion of the gain or loss on derivative instruments designated and qualifying as cash flow hedging instruments.

f. Items that are required to be reported separately under specialized not-for-profit standards. These include extraordinary items, the effect of discontinued operations, and the cumulative effect of accounting changes pursuant to the provisions of FASB Statement No. 117; and unrealized gains and losses on investments not restricted by donors or by law (except for those investments classified as trading securities) and investment returns restricted by donors or by law, as required by paragraphs 4.07 through 4.10 of this Guide.

10.21 Classifying revenues, expenses, gains, and losses within classes of net assets does not preclude incorporating additional classifications within the performance indicator. For example, within a class or classes of changes in net

assets, a not-for-profit organization may classify items as operating and nonoperating, expendable and nonexpendable, earned and unearned, recurring and nonrecurring, or in other ways. This Guide neither requires nor precludes reporting such intermediate measures or subtotals. However, because terms such as operating income are used with different meanings, if an intermediate measure of operations is reported and its use is not apparent from the details provided on the face of the statement, a note to the financial statements should describe the nature of the reported measure of operations or the items excluded from operations.

10.22 Governmental health care entities should separately report special items and extraordinary items at the bottom of the statement of revenues, expenses, and changes in net assets/equity, as illustrated in GASB Statement No. 34, paragraph 101. Governmental health care entities should report special items separately after capital contributions and contributions to permanent and term endowments but before extraordinary items, if any. GASB Statement No. 34, paragraph 56, defines a *special item* as a significant transaction or other event that is within the control of management and that is either unusual in nature or infrequent in occurrence.

10.23 Governmental health care entities are required to distinguish between operating revenues and expenses and nonoperating revenues and expenses and provide an intermediate total for operating income or loss. GASB Statement No. 34, paragraph 102, does not establish a definition of *operating*. Rather, governments are required to establish their own policy defining operating revenues and expenses that is appropriate to the nature of the activity being reported. Once established, an entity's policy should be applied consistently and disclosed in the notes to the financial statements. GASB Statement No. 34, paragraph 102, notes that a consideration for determining which revenues and expenses should be reported as *operating* is how those transactions would be classified in the statement of cash flows. Using this approach, transactions that are considered investing, capital and related financing, and noncapital financing activities would normally not be reported as operating revenues and expenses. This would include investment revenues and interest expense as well as most nonexchange transactions, including most grants, taxes, and contributions.

10.24 For governmental health care entities, changes in accounting principles, addressed in APB Opinion No. 20, *Accounting Changes*, as amended, should be reported as restatements of beginning net assets/equity, as discussed in footnote 13 to paragraph 17 of GASB Statement No. 34.

10.25 For financial reporting purposes, patient service revenue is reported net of provisions for contractual and other adjustments in the operating statement. Significant revenue earned under capitation arrangements is reported separately. The notes to the financial statements disclose the methods of revenue recognition (for example, policies related to capitation revenue, patient service revenue, or contributions). In addition, with regard to contractual adjustments and third-party settlements, identification and explanation of the estimated amounts that are payable or receivable by the entity are disclosed.

10.26 GASB Statement No. 34, paragraph 100, requires revenues to be reported by major source, net of discounts and allowances, and separately identify pledged revenues. The amount of discounts and allowances, including the increase or decrease in the estimate of uncollectible accounts, should be reported parenthetically on the face of the financial statements, as a separate line

directly below the revenue amount, or in the notes, as required by GASB Statement No. 34, footnote 41 to paragraph 100. Paragraph 10.04 in this chapter provides additional discussion on classification of revenue, and examples of revenue, including patient service revenue. As discussed in paragraph 10.25 in this chapter, patient service revenue is reported net of contractual and other adjustments in the operating statement.

10.27 As discussed in paragraph 10.03, patient service revenue does not include charity care. Management's policy for providing charity care, as well as the level of charity care provided, should be disclosed in the financial statements. Such disclosure generally is made in the notes to the financial statements and is measured based on the provider's rates, costs, units of service, or other statistical measure.

10.28 Expenses may be reported on the face of the financial statements using either a natural classification or a functional presentation. Public companies (that is, registrants with the SEC) are required to disclose segment information in accordance with FASB Statement No. 131, *Disclosure about Segments of an Enterprise and Related Information.* Not-for-profit organizations that report using a natural classification of expenses are required to disclose expenses by functional classification. For governmental health care entities, GASB Statement No. 34, paragraph 122, as amended by GASB Statement No. 37, paragraph 17, defines a segment as an identifiable activity (or grouping of activities) reported as or within an enterprise fund or an other stand-alone entity that:

- Has one or more bonds or other debt instruments outstanding with a revenue stream pledged in support of that debt, and
- Is required by an external party (such as through a bond indenture) to account separately for its assets, liabilities, revenues, and expenses.

GASB Statement No. 34, paragraph 122, also details the disclosure required for segments.

10.29 Governmental health care entities that receive restricted resources are required to disclose whether, when both restricted and unrestricted resources are available, it is their policy to use restricted or unrestricted resources first, as discussed in GASB Statement No. 34, paragraph 115(h).

10.30 GASB Statement No. 34, paragraph 121, requires governmental health care entities that receive donor-restricted endowments to make certain disclosures about their policy for use of investment income generated by those endowments.

10.31 As noted in paragraph 10.23 of this chapter, governmental health care entities should disclose their policy for defining operating revenues and expenses.

10.32 The extent of classification and subclassification of expenses depends on many factors, such as the nature and complexity of the health care organization. For example, some entities may present only two categories: (*a*) health services (including inpatient services, outpatient procedures, home health services, etc.) and (*b*) general and administrative. Others may present additional distinctions such as physician services, research, and teaching. Functional allocations should be based on full cost allocations. If a not-for-profit health care organization includes a ratio of fund-raising expenses to amounts raised in its financial statements, it should disclose how that ratio is computed (See paragraph 20 of FASB Statement No. 136).

Auditing[6]

10.33 The independent auditor may need to consider the examples of specific auditing objectives, selected control activities, and auditing procedures to audit revenue, expenses, gains, and losses that are presented in Exhibit 10-1.

[6] SOP 00-1, *Auditing Health Care Third-Party Revenues and Related Receivables*, discusses matters for auditors to consider in testing third-party revenues and related receivables, and provides guidance to auditors regarding the sufficiency of evidential matter and reporting on financial statements of health care entities exposed to material uncertainties. SOP 00-1 is included as Appendix E to this Guide.

Exhibit 10-1

Auditing Considerations

Financial Statement Assertions	*Specific Auditing Objectives*	*Selected Control Activities*	*Auditing Procedures*
Revenue and Gains for Health Care Services			
Existence and occurrence, completeness, and presentation and disclosure	Revenue and gains are reported in the proper period using the accrual basis of accounting and are classified properly by the type of service rendered.	Procedures help ensure that revenue is accrued as services are performed or as contractual obligations are satisfied.	Perform a walk-through of the revenue system. Compare the current period's revenue with prior periods' revenue and/or budgets and obtain explanations for large or unusual variances.
		Management establishes and monitors controls over the recognition of revenue.	Consider the adequacy of the controls over the revenue recognition process.
	In the statement of operations, revenue from health care services is reported, net of contractual adjustments and other adjustments, in the proper period and is classified properly.	Controls ensure that deductions from revenue are recorded in the proper period and are classified properly. Contractual and other adjustments are authorized, controlled, and recorded properly.	Review the financial statements to determine that revenue is reported net of contractual adjustments and other adjustments. Test contractual adjustments, other adjustments, and bad debts to determine that they are accounted for both in accordance with the respective contracts and the

Financial Statement Assertions	*Specific Auditing Objectives*	*Selected Control Activities*	*Auditing Procedures*
		Charity care, bad-debt writeoffs, and courtesy and policy discounts are authorized, controlled, and recorded properly.	entity's policy. Determine that specific and unallocated reserves appear reasonable and comparable to prior year.
			Review third-party payor contracts and methods of payment and test the entity's computation of estimated adjustments to revenue as required under such contracts.

Chapter 11

The Reporting Entity and Related Organizations

Overview

11.01 Networks among health care organizations, both vertical and horizontal, are being formed continually and new organizational structures are being developed. The dynamics of change in the health care industry and their impact on evolving organizational structures must be considered in defining the reporting entity.

11.02 An integrated health care system typically consists of multiple related entities, operating both for-profit and not-for-profit organizations. A not-for-profit parent corporation may be the sole corporate member or, through other means, it may control other entities such as a not-for-profit hospital, a not-for-profit medical foundation that contracts with a for-profit physician group, or other not-for-profit providers such as a long-term care center, a substance abuse center, a surgery center, or an outpatient clinic. The system also may own stock in various for-profit ventures such as HMOs or insurance companies that may or may not provide patient care. Fund-raising typically is accomplished through a separate foundation. Foundations, auxiliaries, guilds, and similar organizations frequently assist and, in many instances, are related to the health care organization.

Financial Reporting of Governmental Health Care Entities

11.03 The GASB has issued GASB Statement No. 14, *The Financial Reporting Entity*, which addresses issues related to consolidations, application of the equity method of accounting, and accounting for various types of joint ventures for governmental entities. GASB Statement No. 14 establishes standards for defining and reporting for the financial reporting entity and for reporting its participation in joint ventures. GASB Statement No. 39, *Determining Whether Certain Organizations Are Component Units*, amended GASB Statement No. 14 to provide additional guidance for assessing potential component units in determining the financial reporting entity. GASB Statement No. 39 may require the reporting of certain hospital foundations in the financial statements of governmental health care entities, regardless of whether the foundations follow FASB or GASB Standards.

Financial Reporting of Nongovernmental Health Care Entities*

11.04 The guidance which follows in this chapter relates to for-profit and not-for-profit consolidations of parent-subsidiary relationships, whether through

* On February 23, 1999, the FASB released an exposure draft (revised) of a proposed FASB Statement, *Consolidated Financial Statements: Purpose and Policy*—Revision of Exposure Draft issued October 16, 1995, that, in addition to other matters, would supersede FASB Statement No. 94 and paragraphs 1–3 and 5 of ARB No. 51, add a sentence to endnote three of ARB No. 51, and amend APB Opinions No. 16 and No. 18 and FASB Statements No. 15, No. 57, and No. 65. The FASB temporarily suspended work on consolidation policy issues and focused its efforts on developing interpretive guidance for variable interest entities. In 2003, the FASB issued FASB Interpretation *(continued)*

stock ownership or other means of control. Other circumstances may exist in the health care industry where combined financial statements involving commonly controlled entities are more meaningful than their separate financial statements. More specific guidance related to combined financial statements can be found in ARB No. 51, *Consolidated Financial Statements*, paragraphs 22 and 23.[1]

11.05 Whether the financial statements of a reporting health care organization and those of one or more other for-profit or not-for-profit entities should be consolidated, whether those other entities should be reported using the equity method, and the extent of disclosure that should be required (if any) if consolidated financial statements are not presented, should be based on the nature of the relationship between the entities.

11.06 Health care organizations may be related to one or more other entities in numerous ways, including ownership, control, and/or economic interest.

11.07 As discussed in paragraphs 11.10 through 11.17, the existence of various forms of control and economic interests result in various financial reporting. Certain kinds of control result in consolidation (see paragraph 11.10). Other kinds of control result in consolidation only if coupled with an economic interest (see paragraph 11.11). Still other kinds of control result in consolidation being permitted but not required, if coupled with an economic interest (see paragraph 11.12). The existence of either control or an economic interest, but not both, is discussed in paragraph 11.13; consolidation of variable interest entities is discussed in paragraph 11.14; disclosures concerning restrictions on distributions are discussed in paragraph 11.15; and reporting under the equity method of accounting is discussed in paragraph 11.17.

11.08 Control is the direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise. However, the rights and powers of the controlling entity may vary depending on the legal structure of the controlled entity and the nature of control. The majority owner of a for-profit entity's voting stock or the sole corporate member of a not-for-profit entity may not only have the ability to determine the direction of the controlled entity but also have the proportionate right to (or the responsibility for) operating

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No. 46, *Consolidation of Variable Interest Entities*, and FASB Interpretation No. 46 (revised December 2003), to address consolidation by business enterprises of variable interest entities. Special effective date provisions apply to enterprises that have fully or partially applied FASB Interpretation No. 46 prior to the issuance of the revised Interpretation. Otherwise, application of FASB Interpretation No. 46 (revised December 2003) (or FASB Interpretation No. 46), is required in financial statements of public entities that have interests in variable interest entities or potential variable interest entities commonly referred to as special-purpose entities for periods ending after December 15, 2003. Application by public entities, other than small business issuers, for all other types of entities is required in financial statements for periods ending after March 15, 2004. Application by small business issuers to entities other than special-purpose entities and by nonpublic entities to all types of entities is required at various dates in 2004 and 2005. In some instances, enterprises have the option of applying or continuing to apply FASB Interpretation No. 46 for a short period of time before applying the revised Interpretation. Not-for-profit organizations are not subject to FASB Interpretation No. 46 (revised December 2003), except that they may be related parties for purposes of applying paragraphs 16 and 17 of that Interpretation. Also, if a not-for-profit entity is used by business enterprises in a manner similar to a variable interest entity in an effort to circumvent the provisions of FASB Interpretation No. 46 (revised December 2003), that not-for-profit entity is subject to that Interpretation.

[1] In some situations, debt agreements may require combined financial statements of affiliated entities, the assets or revenues of which serve as collateral for the related debt (sometimes called an "obligated group"). ARB No. 51 applies to those situations. However, if debt or other agreements prescribe a financial presentation that varies from GAAP (for example, exclusion of entities otherwise required to be consolidated), the auditor should consider SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623), for reporting guidance.

results and a residual interest in the net assets upon dissolution. However, in other situations, the rights of the controlling party may be more limited. For example, in the case of a sole general partner in a limited partnership, the limited partners—and not the general partner—may be entitled to the net assets upon dissolution. Further, the existence of "super-majority" voting rights can entitle the holder to disproportionate voting powers, and could affect the determination of the "controlling entity." As a result, whether the financial statements of a controlled entity should be consolidated with the reporting entity depends on the nature of control and whether an economic interest exists.[2]

11.09 An economic interest in another entity exists if (*a*) the other entity holds or utilizes significant resources that must be used for the unrestricted or restricted purposes of the reporting entity—either directly or indirectly—for producing income or providing services or (*b*) the reporting entity is responsible for the liabilities of the other entity. The following are examples of economic interests:

- Other entities solicit funds in the name of, and with the expressed or implied approval of, the reporting entity. In addition, substantially all of the funds solicited are intended by the contributor or are otherwise required to be transferred to the reporting entity or used at its discretion or direction.
- The reporting entity transfers significant resources to another entity whose resources are held for the benefit of the reporting entity.
- The reporting entity assigns certain significant functions to another entity.
- The reporting entity provides or is committed to provide funds for another entity or the reporting entity guarantees significant debt of another entity.
- The reporting entity has a right to, or the responsibility for, the operating results of another entity. Or, upon dissolution, the reporting entity is entitled to the net assets, or is responsible for any deficit, of another entity.

11.10 Health care organizations with a controlling financial interest in other entities through direct or indirect ownership of a majority voting interest[3] in

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[2] Emerging Issues Task Force (EITF) Issue No. 97-2, *Application of FASB Statement No. 94 and APB Opinion No. 16 to Physician Practice Management Entities and Certain Other Entities with Contractual Management Arrangements*, addresses the issue of consolidation and business combinations among physician practice management entities, and other situations in which one entity manages another under similar circumstances and arrangements. If a physician practice is a variable interest entity as described in FASB Interpretation No. 46 and FASB Interpretation No. 46 (revised December 2003), that entity is subject to the requirements of those Interpretations, and the consensus in EITF Issue No. 97-2 does not apply. Not-for-profit organizations are not subject to FASB Interpretation No. 46 (revised December 2003), except that they may be related parties for purposes of applying paragraphs 16 and 17 of that Interpretation. Also, if a not-for-profit entity is used by business enterprises in a manner similar to a variable interest entity in an effort to circumvent the provisions of FASB Interpretation No. 46 (revised December 2003), that not-for-profit entity is subject to that Interpretation. See footnote * to the heading to paragraph 11.04 in this chapter for information regarding the effective date of FASB Interpretation No. 46 and FASB Interpretation No. 46 (revised December 2003).

[3] Because not-for-profit organizations may exist in various legal forms, ownership of not-for-profit organizations may be evidenced in various ways. Examples include corporations issuing stock, corporations issuing ownership certificates, membership corporations issuing membership certificates, joint ventures, and partnerships. A parent corporation typically owns stock in a for-profit entity, whereas a sole corporate member holds membership rights in a not-for-profit entity. As it relates to health care consolidations, sole corporate membership in a not-for-profit entity is considered to be equivalent to ownership of a majority voting interest in a for-profit entity, unless the sole corporate member's economic interest in the controlled entity is limited by state law or contractual agreement.

those other entities should consolidate those other entities, unless control does not rest directly or indirectly with the majority owner or sole corporate member (for example, if the subsidiary is in legal reorganization or in bankruptcy).[4, †] In such situations consolidation is prohibited, as discussed in paragraph 2 of ARB No. 51, as amended by FASB Statement No. 94, *Consolidation of All Majority Owned Subsidiaries* and FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*.[5]

11.11 In the case of (*a*) control through a majority voting interest in the board of another entity by means other than ownership or sole corporate membership[6] and (*b*) an economic interest in such entities, consolidation is required, unless control is likely to be temporary or does not rest with the majority owner. In this situation consolidation is prohibited.[7]

11.12 Control of a separate not-for-profit organization in which the reporting entity has an economic interest may take forms other than majority ownership or voting interest; for example, control may be through contract or affiliation agreement.[8] In circumstances such as these, consolidation is permitted but not required, unless control is likely to be temporary.[9] In this situation consolidation is prohibited.[10] If the reporting entity controls a separate not-for-profit entity through a form other than majority ownership (paragraph 11.10) or voting interest (paragraph 11.11), has an economic interest in that other entity, and consolidated financial statements are not presented, the notes to the financial statements should include the following disclosures:

a. Identification of the other entity and the nature of its relationship with the reporting entity that results in control

b. Summarized financial data of the other entity, including total assets, liabilities, net assets, revenue, and expenses; and resources that are held for the benefit of the reporting entity or that are under its control

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[4] See footnote 2 in this chapter.

[†] AcSEC has released an exposure draft of a proposed Statement of Position (SOP), *Clarification of the Scope of the Audit and Accounting Guide* Audits of Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies.* Among other matters, this proposed SOP may modify this paragraph in this Guide. Readers should be alert for the issuance of a final Standard.

[5] FASB Statement No. 144, among other matters, amends ARB No. 51 to eliminate the exception to consolidation for a subsidiary for which control is likely to be temporary. This Guide has been conformed to FASB Statement No. 144 to eliminate the exception to consolidation for a temporarily controlled subsidiary in circumstances in which this Guide requires consolidation based on a controlling financial interest (paragraph 11.10 of this Guide). No such conforming change to this Guide is appropriate in circumstances in which consolidation is required or permitted based on control through other than a controlling financial interest (paragraphs 11.11 and 11.12 of this Guide). Accordingly, this Guide retains the exception to consolidation for a temporarily controlled subsidiary in circumstances in which consolidation is required or permitted based on control through other than a controlling financial interest.

[6] For purposes of this Guide, a majority voting interest in the board of another entity by means other than ownership or sole corporate membership is illustrated by the following example. Entity B has a five-member board, and a simple voting majority is required to approve board actions. Entity A will have a majority voting interest in the board of entity B if three or more of its board members, officers, or employees serve on (or may be appointed at entity A's discretion to) the board of entity B. However, if three of entity A's board members serve on the board of entity B but entity A does not have the ability to require that those members serve on entity B's board, entity A does not have a majority voting interest in the board of entity B.

[7] See footnote 5 in this chapter.

[8] Evidence of control may include authority to amend articles of incorporation and bylaws or authority to approve operating, capital, and construction budgets; capital acquisitions; strategic plans, goals, and objectives; and mergers or dissolutions.

[9] See footnote 2 in this chapter.

[10] See footnote 7 in this chapter.

c. The disclosures set forth in FASB Statement No. 57, *Related Party Disclosures*

11.13 In some cases, one entity may have an economic interest in another entity without controlling it (for example, a noncontrolled entity may solicit funds in the name of, and with the expressed or implied approval of, the reporting entity and substantially all of the funds solicited are intended by the contributor to benefit the reporting entity). The existence of control (other than through ownership or sole corporate membership) or an economic interest, but not both, precludes consolidation but requires the disclosures set forth in FASB Statement No. 57.[11]

11.14 FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (revised December 2003), clarifies the application of ARB No. 51 to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support.[‡] An entity subject to consolidation according to the provisions of FASB Interpretation No. 46 (revised December 2003) is referred to in that Interpretation as a variable interest entity. An entity shall be subject to consolidation according to the provisions of FASB Interpretation No. 46 (revised December 2003) if, by design, the conditions in paragraph 5 of that Interpretation exist. Paragraph 14 of FASB Interpretation No. 46 (revised December 2003) provides guidance for consolidation based on variable interests. FASB Interpretation No. 46 (revised December 2003), also requires certain disclosures. Not-for-profit organizations are not subject to FASB Interpretation No. 46 (revised December 2003), except that they may be related parties for purposes of applying paragraphs 16 and 17 of that Interpretation. Also, if a not-for-profit entity is used by business enterprises in a manner similar to a variable interest entity in an effort to circumvent the provisions of FASB Interpretation No. 46 (revised December 2003), that not-for-profit entity is subject to that Interpretation.

11.15 If consolidated financial statements are presented and they include a controlled not-for-profit organization, they should disclose any restrictions made by entities outside of the reporting entity on distributions from the controlled not-for-profit organization to the reporting entity and any resulting unavailability of the net assets of the controlled not-for-profit organization for use by the reporting entity.

11.16 When consolidated financial statements are required or permitted, a minority interest should be provided if such interest is represented by an economic interest whereby the minority interest would share in the operating results or residual interest upon dissolution.

11.17 Investments in common stock of for-profit entities in which the reporting entity has 50 percent or less of the voting stock in the investee should be reported under the equity method in conformity with APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, if the guidance in that opinion requires use of the equity method.[†] The equity method

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[11] The existence of an economic interest does not necessarily cause the entities to be related parties, as defined in FASB Statement No. 57. However, the disclosures required by that statement are required under this Guide if an economic interest exists.

[‡] For information about FASB Interpretation No. 46, which was replaced by FASB Interpretation No. 46 (revised December 2003), and the effective date of FASB Interpretation No. 46 (revised December 2003), see footnote * to the heading to paragraph 11.04 in this chapter.

[†] AcSEC has released an exposure draft of a proposed Statement of Position, *Clarification of the Scope of the Audit and Accounting Guide* Audits of Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies.* Among other matters, this proposed SOP may modify this paragraph in this Guide. Readers should be alert for the issuance of a final Standard.

should be followed by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee. Determining the ability of an investor to exercise significant influence is not always clear, and applying judgment is necessary to assess the status of each investment. However, to achieve a reasonable degree of uniformity, the ownership of 20 percent or more of the voting stock leads to a presumption that the investor can exercise significant influence and, therefore, the investment should be accounted for under the equity method in accordance with APB Opinion No. 18. However, this presumption can be overcome in certain instances. FASB Interpretation No. 35, *Criteria for Applying the Equity Method of Accounting for Investments in Common Stock*, paragraph 4, provides examples of indications that an investor may be unable to exercise significant influence. Health care organizations that report investments on the equity method should make the financial statement disclosures required by APB Opinion No. 18.

11.18 This Guide provides guidance concerning consolidated financial statements. Consolidation of a parent or subsidiary organization requires the presentation of a single set of amounts for the entire reporting entity. Combination, as discussed in paragraphs 22 and 23 of ARB No. 51, refers to financial statements prepared for organizations between which common control exists but for which the parent-subsidiary relationship does not exist. Both consolidation and combination require elimination of interorganization transactions and balances. Paragraph 22 of ARB No. 51 states that "there are circumstances, however, where combined financial statements (as distinguished from consolidated statements) of commonly controlled companies are likely to be more meaningful than their separate statements." This Guide prohibits consolidated financial statements in certain circumstances. However, it provides no guidance concerning combined financial statements of commonly controlled entities, which may be presented in certain circumstances in conformity with the guidance in ARB No. 51.

11.19 Paragraph 15 of FASB Statement No. 94 precludes the use of the parent company's financial statements as the general-purpose financial statements of the primary reporting entity. Similarly, where consolidation is required, this Guide precludes the issuance of parent company financial statements as the general-purpose financial statements of the primary reporting entity. However, neither FASB Statement No. 94 nor this Guide discuss the use of the parent company's financial statements as other than the general-purpose financial statements for the primary reporting entity.[12] GAAP does not preclude the issuance of financial statements for the subsidiary only. However, care should be taken to include all disclosures required by FASB Statement No. 57 and other relevant pronouncements.

Transfers

Equity Transfers

11.20 Equity transfers are similar to ownership transactions between a for-profit parent and its owned subsidiary (for example, additional paid-in capital or dividends).[13] However, equity transfers can occur only between related not-

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[12] Contractual agreements or regulatory provisions may require parent company only financial statements. SAS No. 62 provides guidance for reporting on financial presentations to comply with contractual agreements or regulatory provisions.

[13] See paragraphs 1.12 and 10.12 in this Guide regarding the reporting of transfers by governmental health care entities.

for-profit entities when one controls the other or both are under common control. An equity transfer embodies no expectation of repayment, nor does the transferor receive anything of immediate economic value (such as a financial interest or ownership). Equity transfers are reported separately as changes in net assets, are excluded from the performance indicator, and do not result in any step-up in basis of the underlying assets transferred. (Certain transfers from a foundation to a related nongovernmental health care organization are discussed in paragraphs 11.32 and 11.33.)

Equity Transactions

11.21 Transfers from a nongovernmental health care organization to a not-for-profit organization or charitable trust are equity transactions, as described in FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, (see paragraphs 4 and 18), if the transfer meets all of the following criteria:

- A nongovernmental health care organization transfers assets to a not-for-profit organization or charitable trust (called a recipient organization) that accepts those assets and agrees to use them on behalf of or transfer them, their investment return, or both back to the health care organization or its affiliate.
- The nongovernmental health care organization and the recipient organization are financially interrelated organizations.
- Neither the nongovernmental health care organization nor its affiliate expects payment of the transferred assets, although payment of investment return on the transferred assets may be expected.

11.22 Paragraph 13 of FASB Statement No. 136 provides that organizations are financially interrelated if the relationship between them has both of the following characteristics: (*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. The ability to influence the operating and financial decisions of the other can be demonstrated in several ways:

a. The organizations are affiliates as defined in FASB Statement No. 57.

b. One organization has considerable representation on the governing board of the other organization.

c. The charter or bylaws of one organization limit its activities to those that are beneficial to the other organization.

d. An agreement between the organizations allows one organization to actively participate in the policymaking processes of the other, such as setting organizational priorities, budgets, and management compensation.

An ongoing economic interest in the net assets of another is a residual right to the other organization's net assets that results from an ongoing relationship. The value of those rights increases or decreases as a result of the investment, fundraising, operating, and other activities of the other organization.[14]

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[14] Paragraph 104 of FASB Statement No. 136 notes that although most of the relationships described in the definition of economic interest in the glossary of SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, are potentially ongoing economic interests in the net assets of the other, some are not. (The guidance in SOP 94-3 is incorporated in paragraph 11.09 of this Guide). Only economic interests that are both ongoing and residual interests in the net assets meet the criterion of paragraph 13(b) of FASB Statement No. 136.

11.23 An equity transaction differs from an equity transfer in that an equity transaction, as described in FASB Statement No. 136, involves a financially interrelated party either as a third party in a transfer from an entity to one of its affiliates or as a counterparty in a transfer from an entity to itself. An equity transfer, as described in the Guide, is a transaction directly between a transferor and a transferee. In addition, an equity transaction is reciprocal; the health care organization or its affiliate named as the beneficiary receives an ongoing economic interest in the assets held by the recipient organization. (See paragraphs 18 and 95 of FASB Statement No. 136). An equity transfer is nonreciprocal; there is no expectation of repayment and the transferor does not receive a financial interest or ownership. (See paragraph 11.20 of this Guide).

11.24 The reporting of an equity transaction depends upon whether the resource provider or its affiliate is the specified beneficiary. As discussed in paragraph 18 of FASB Statement No. 136, if the resource provider specifies itself as the beneficiary, the resource provider reports an asset—interest in the net assets of the recipient organization (or an increase in a previously recognized interest),[15] and the recipient organization reports an equity transaction as a separate line in its statement of activities. If the resource provider specifies its affiliate as the beneficiary, the resource provider and the recipient organization report an equity transaction as separate lines in their statements of activities, and the affiliate named as beneficiary reports an interest in the net assets of the recipient organization.[16] The resource provider should disclose the information described in paragraph 4.15 of this Guide for each period for which a statement of financial position is presented.

Other Transfers

11.25 Other transfers may occur among related entities. If the entities are consolidated or combined, such transfers are eliminated in consolidation and/or combination. If the entities are not consolidated or combined (for example, in separate subsidiaries or obligated group financial statements),[17] the method of accounting for such transfers is dictated by the substance of the transaction as well as the legal form. For example, certain transfers by a foundation to a related nongovernmental health care organization are reported as contributions, as discussed in paragraphs 11.32 and 11.33. In other situations, payments may be made for services provided between not-for-profit entities under common control, which should be accounted for as revenues and expenses depending on the types of services provided.

11.26 A health care organization may loan or advance resources to a related entity. If repayment is reasonably assured, a receivable or payable should be recorded by the entities. Subsequent to the time a receivable is recorded, the ability of the receiving entity to repay the receivable should be considered. If the receivable is not to be repaid, or if the receiving entity is perceived as unable to repay, it may be accounted for as an equity transfer with the transferor reducing net assets and the transferee increasing net assets at the date such determination is made (see paragraph 11.20).

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[15] That interest would be eliminated if the beneficiary (resource provider) and the recipient organization were included in consolidated financial statements. See footnote 6 to paragraph 15 of FASB Statement No. 136.

[16] That interest would be eliminated if the beneficiary (affiliate) and the recipient organization were included in consolidated financial statements. See footnote 6 to paragraph 15 of FASB Statement No. 136.

[17] See paragraph 12.10 for additional discussion regarding obligated group financial statements.

11.27 Transfers that result in changes in ownership interest are accounted for as investments in accordance with APB Opinion No. 18 and FASB Statement No. 94.

11.28 Assets transferred from one commonly controlled entity to another should be recorded by the transferee at the carrying value of the transferring entity. This treatment is consistent with the guidance prescribed by Appendix D of FASB Statement No. 141, *Business Combinations.*[11]

Related Fund-Raising Organizations

11.29 A related entity may act as an agent, trustee, or intermediary for contributions to the reporting entity. FASB Statement No. 136 establishes standards for transactions in which a donor makes a contribution by transferring assets to a recipient organization—a not-for-profit organization or a charitable trust—that accepts the assets from the donor and agrees to use the assets on behalf of or transfer the assets, their investment return, or both to another entity—the beneficiary—named by the donor.[18, 19] Paragraph 68 of FASB Statement No. 136 states that a donor may specify the beneficiary (*a*) by name, (*b*) by stating that all entities that meet a set of donor-defined criteria are beneficiaries, or (*c*) by actions surrounding the transfer that made clear the identity of the beneficiary, such as by responding to a request from an organization that exists to raise assets for the beneficiary. Paragraphs 69 through 72 and Appendix A of FASB Statement No. 136 provide examples of donor stipulations and discuss whether those stipulations specify a beneficiary.

11.30 If a recipient organization and a specified beneficiary are financially interrelated organizations (as defined in paragraph 13 of FASB Statement No. 136 and described in paragraph 11.22 of this Guide) and the recipient organization is not a trustee, the recipient organization should recognize the fair value of any assets it receives from the donor that are specified by the beneficiary as a contribution received, rather than as a liability to the beneficiary, as discussed in paragraph 14 of FASB Statement No. 136. For example, a foundation that exists to raise, hold, and invest assets for a specified health care organization or for a group of affiliates of which the specified health care organization is a member generally is financially interrelated with the organization or organizations it supports. A financially interrelated foundation should recognize contribution revenue when it receives assets from the donor.[20] The specified health care organization should recognize its interest in the net assets of the foundation (the recipient organization) and adjust that interest for its share of the change in net assets of the recipient organization using a method

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[11] FASB Statement No. 141, *Business Combinations*, supersedes AICPA Accounting Interpretation No. 39 of APB Opinion No. 16, *Business Combinations*. However, the guidance in that Interpretation, used in past practice to account for transfers of net assets between entities under common control, is carried forward without reconsideration in Appendix D, *Continuing Authoritative Guidance*, of FASB Statement No. 141.

[18] FASB Statement No. 136 also establishes standards for transactions that take place in a similar manner but are not contributions because the transfers are revocable, repayable, or reciprocal. For example, if a resource provider transfers assets to a recipient organization and names itself or its affiliate as beneficiary, that transaction is reciprocal even if the resource provider grants variance power. Those standards and transactions are discussed in paragraphs 4.14, 4.15, 11.21, 11.23, and 11.24 of this Guide. This Guide does not use the word *donor* in discussing those transactions because they are not contributions.

[19] This pronouncement is not applicable to governmental health care enterprises. (See footnote 1 in Chapter 1.)

[20] Foundations that are not providers of health care services are not covered by this Guide and should follow the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.

similar to the equity method of accounting for investments in common stock (see paragraph 15 of FASB Statement No. 136).[21]

11.31 When measuring its interest in the recipient organization, the specified health care organization would include the net assets of the recipient organization that are restricted to use by that health care organization. If the recipient organization supports more than one beneficiary and an agreement with the recipient organization specifies how unrestricted gifts to the recipient organization should be divided between the organizations supported, the specified health care organization would also include its share of the recipient organization's unrestricted assets, computed in accordance with that agreement. Similarly, if a parent organization controls both the recipient organization and the specified health care organization and the parent directed that unrestricted gifts would be distributed to affiliates in accordance with a specified formula, each affiliate would include in its interest its share of unrestricted net assets, computed in accordance with that formula. (See paragraphs 41 through 45 of FASB Statement No. 136).

11.32 Distributions from a financially interrelated recipient organization to a nongovernmental health care organization that it supports are generally reported by the health care organization as a reduction of its interest in the recipient organization. However, if the distribution is made from net assets that are not includable in that interest because the health care organization does not have rights to them (that is, the recipient organization can determine to whom the assets will be distributed), the health care organization reports a contribution from the related recipient organization. For example, assume a foundation's mission is to raise contributions for two financially interrelated health care organizations, Hospital A and Hospital B. The foundation receives $10,000 in contributions from donors that do not specify which of the two hospitals should benefit from their gifts. There is no agreement between the foundation and Hospitals A and B that specifies how gifts to the foundation should be divided between the hospitals if the donor does not specify a beneficiary. Hospital A would report contribution revenue for any portion of the $10,000 that it receives from the foundation. Likewise, Hospital B would report contribution revenue for any portion of the $10,000 that it receives, but neither Hospital A nor Hospital B would record an interest in those assets before the foundation either distributes them or unconditionally promises them.

11.33 As discussed in paragraphs 11 and 12 of FASB Statement No. 136, if the recipient organization and the specified health care organization are not financially interrelated organizations as defined in paragraph 13 of FASB Statement No. 136 (see paragraph 11.22 in this Guide), and the donor specifies a beneficiary, the recipient organization should recognize a liability to the specified beneficiary unless the recipient is explicitly granted variance power. (See discussion of variance power at paragraph 10.05 of this Guide). If the assets received from the donor are donated materials, supplies, or other nonfinancial assets, the recipient organization may choose either to (*a*) report the receipt of the assets as a liability to the beneficiary concurrent with recognition of the assets received or (*b*) not to report the transaction at all. The choice is an accounting policy that should be applied consistently from period to period and disclosed in the notes to the financial statements. The specified health care organization recognizes its rights to the assets (financial or nonfinancial) held by a recipient organization as an asset and contribution revenue

[21] That interest would be eliminated if the beneficiary and the recipient organization were included in consolidated financial statements. See footnote 6 to paragraph 15 of FASB Statement No. 136.

unless the recipient organization is explicitly granted variance power. (See further discussion at paragraphs 5.11 and 10.05.) In contrast, if the donor does not specify a beneficiary (see further discussion at paragraph 11.29) and the foundation and a hospital are under common control, but they are not financially interrelated, the recipient organization should recognize contribution revenue when it receives the gift. The gift should be accounted for as contributions received by the hospital, consistent with FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, and Chapter 10 of this Guide, provided that the foundation is acting other than as an owner.

11.34 Additional guidance regarding accounting for contributions received by agents, trustees, and intermediaries can be found in Chapter 5 of the Audit and Accounting Guide *Not-for-Profit Organizations*.

Disclosure

11.35 Significant relationships and transactions not in the ordinary course of business with directors, management, medical staff, or other related parties (including unconsolidated related organizations) should be disclosed in accordance with FASB Statement No. 57. SAS No. 45, *Omnibus Statement on Auditing Standards—1983*, "Related Parties" (AICPA, *Professional Standards*, vol. 1, AU sec. 334), sets forth procedures for the auditor to consider in determining the existence of transactions with related parties and identifying them.

11.36 Hospital boards may contract with management companies to operate their facilities. Frequently, the management company will employ the administrator as well as other key personnel. Further, services may be acquired from entities related to the management company.[22] The auditor should evaluate the impact of these arrangements on the hospital's internal controls and disclose related party transactions as required by FASB Statement No. 57.

11.37 The reporting and disclosure requirements of the nongovernmental health care organization under the circumstances noted in paragraphs 11.10 through 11.19 are summarized as follows:[23]

Circumstances	*Requirements*
The entity owns a majority of a for-profit entity's voting stock.	Consolidate unless control does not rest with the majority owner or the interest is limited by state law or contractual agreement.
The entity is the sole corporate member of a not-for-profit entity. (See paragraph 11.10, footnote 3.)	Consolidate unless control does not rest with the majority owner or the sole corporate member's interest is limited by state law or contractual agreement.
The entity controls another through a majority voting interest in the board and an economic interest exists.	Consolidate unless control is likely to be temporary or does not rest with the majority owner or the sole corporate member; or the interest is limited by state law or contractual agreement.

(continued)

[22] See footnote 2 in this chapter.

[23] See footnote 5 in this chapter.

Circumstances	*Requirements*
The reporting entity owns 50 percent or less of the common voting stock of an investee and can exercise significant influence over operating and financial policies.	The investment should be accounted for under the equity method in accordance with APB Opinion No. 18.
There have been material transactions between the health care entity and the related organization. (This could be present in any of the foregoing circumstances.)	In the notes to the financial statements (*a*) disclose the existence and nature of the relationship and (*b*) describe and quantify the transactions.
An entity has control over another not-for-profit organization or has an economic interest in the other, but not both.	In the notes to the financial statements (*a*) disclose the existence and nature of the relationship and (*b*) describe and quantify the transactions. Consolidation is prohibited.
The reporting entity controls a separate not-for-profit entity through a form other than majority ownership or voting interest and has an economic interest in that other entity.	Consolidation permitted but not required. If consolidated statements are not presented, the notes to the financial statements should disclose (*a*) the identification of the other entity and the nature of its relationship with the reporting entity, (*b*) summarized financial data of the other entity, and (*c*) the disclosures set forth in FASB Statement No. 57.
The entity is a variable interest entity subject to the provisions of FASB Interpretation No. 46 (revised December 2003).	Apply the guidance in FASB Interpretation No. 46 (revised December 2003), including the disclosure requirements in that Interpretation.[#]

Business Combinations

11.38 As discussed in paragraph 11.02, the dynamics of change in the health care industry have resulted in increased business combinations as new organizational structures are being formed. FASB Statement No. 141 addresses financial accounting and reporting for business combinations. FASB Statement No. 141 applies to business combinations initiated after June 30, 2001 and prescribes the use of the purchase method for those business combinations.[**] FASB Statement No. 141, however, does not apply to certain combinations, including a combination involving two or more not-for-profit

[#] For information about FASB Interpretation No. 46, which was replaced by FASB Interpretation No. 46 (revised December 2003), the effective date of FASB Interpretation No. 46 (revised December 2003), and the applicability of that revised Interpretation's requirements for not-for-profit organizations, see footnote * to the heading to paragraph 11.04 in this chapter.

[**] FASB Statement No. 141 supersedes APB Opinion No. 16. If FASB Statement No. 141 has not been adopted, see APB Opinion No. 16 for guidance concerning business combinations.

organizations, or the acquisition of a for-profit business by a not-for-profit organization. For those combinations, the guidance in APB Opinion Nos. 16 and 17 still apply and APB Opinion No. 16 provides a useful framework when evaluating similar transactions entered into by not-for-profit health care business organizations.[††] A list of possible factors to be considered when evaluating these transactions in relation to APB Opinion No. 16 is summarized as follows:

Circumstances	*Accounting and Disclosure Guidance*
Monetary consideration received or paid, change in legal title to assets, and/or assumption of liabilities.	This is similar to a purchase under APB Opinion No. 16.[24]
Change in control (for example, change in sole corporate member).	This is similar to a pooling of interests transaction under APB Opinion No. 16. No step-up in basis.

See paragraphs 1.47 and 1.48 for additional guidance regarding the application of APB Opinion No. 16 to not-for-profit organizations. Also see footnote * in the section "APB Opinion No. 16, *Business Combinations*" in Chapter 1 in this Guide regarding pronouncements that were superseded by FASB Statement No. 141, including APB Opinion No. 16.

Auditing

11.39 The independent auditor may need to consider the examples of specific auditing objectives, control activities, and auditing procedures for related party organizations, balances, and transactions that are presented in Exhibit 11-1.

[††] The FASB has on its agenda a project on accounting for combinations of not-for-profit organizations. Readers should be alert to the issuance of a final Standard.

[24] FASB Statement No. 141 supersedes AICPA Accounting Interpretation No. 39 of APB Opinion No. 16. Appendix D of FASB Statement No. 141 carries forward without reconsideration guidance in APB Opinion No. 16 and an interpretation that has been used in past practice to account for transfers of net assets or exchanges of shares between entities under common control. Paragraph D12 of FASB Statement No. 141 discusses the accounting for a transfer of assets or exchange of shares between entities under common control.

Exhibit 11-1

Auditing Considerations

Financial Statement Assertions	*Specific Auditing Objectives*	*Selected Control Activities*	*Auditing Procedures*
Reporting Entity and Related Organizations			
Existence and occurrence, completeness, and presentation and disclosure	The reporting entity is appropriate.	Procedures ensure that investees, affiliates, and other related entities are accounted for appropriately.	Review the articles of incorporation, bylaws, and minutes of directors' meetings, shareholder lists, and filings with regulatory authorities to determine the existence of related parties. Obtain representations from management as to whether all investees, affiliates, and related entities have been accounted for properly or disclosed. Review transactions with investees, affiliates, and other related entities to determine that they are reported properly.
	Relationships and transactions with related organizations are identified and disclosed, if appropriate, because of economic	Procedures ensure that conflict-of-interest policies, procedures, and disclosure requirements are met.	Test significant related party transactions as follows: • Determine substance. • Examine

Financial Statement Assertions	*Specific Auditing Objectives*	*Selected Control Activities*	*Auditing Procedures*
	dependence of the entity.		documents (invoices, contracts, and agreements). • Determine the basis of pricing. • Determine the collectibility of receivables and advances. Review related party transactions for completeness by— • Considering previously identified transactions or relationships. • Reviewing the minutes of directors' and other meetings. • Discussing related-party transactions with entity personnel. • Reviewing unusual transactions. • Reviewing the responses to related party (conflict-of-interest) questionnaires.
Presentation and disclosure	Related party transactions and organizations are reported properly.		Review the presentation and disclosure of related party information for completeness.

Chapter 12

Independent Auditor's Reports

Overview

12.01 The guidance in SAS No. 58, *Reports on Audited Financial Statements*, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 508), applies to audit reports on the financial statements of health care organizations.* Such a report may contain an unqualified opinion, an unqualified opinion with an explanatory paragraph, a qualified opinion, a disclaimer of opinion, or an adverse opinion. The facts and circumstances of each particular audit govern the appropriate form of the report.[1] Report examples appearing in this chapter illustrate the form of certain auditor's reports issued by the independent auditor in auditing the financial statements of a health care organization. The Audit and Accounting Guide *State and Local Governments,* provides guidance on audit reports for state and local governments as well as on assessing materiality (opinion units). See paragraph 2.01 of this Guide.

Registered Public Accounting Firms

12.02 As discussed in paragraph 2.02 in this Guide, registered public accounting firms must comply with the standards of the Public Company Accounting Oversight Board (PCAOB) in connection with the preparation or issuance of any audit report on the financial statements of an issuer, as defined by the Sarbanes-Oxley Act, and other entities when prescribed by the rules of the Securities and Exchange Commission (SEC) (collectively referred to as "issuers"). On May 14, 2004, the SEC approved PCAOB Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board*, effective for auditors' reports issued or reissued on or after May 24, 2004. PCAOB Standard No. 1 replaces in auditors' reports the sentence "We conducted our audits in accordance with auditing standards generally accepted in the United States of America." with the following sentence: "We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States)." The SEC simultaneously issued interpretive guidance in Release No. 33-8422 under the Securities Act of 1933 (1933 Act) (Release No. 34-49708 under the Securities Act of 1934) (1934 Act) to address certain implementation issues relating to the Standard. See the "Preface" of this Guide for additional information about the Sarbanes-Oxley Act and the PCAOB.

Unqualified Opinion

12.03 The independent auditor's standard report states that the financial statements present fairly, in all material respects, an entity's financial position,

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* The AICPA Auditing Standards Board (ASB) plans to issue in the second quarter in 2004 a series of new audit interpretations of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508). Readers should be alert for the issuance of these Interpretations.

[1] SAS No. 79, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements (AICPA, *Professional Standards*, vol. 1, AU sec. 508), amends SAS No. 58 to eliminate the requirement that when certain criteria are met, the auditor add an uncertainties explanatory paragraph to the auditor's report. It also clarifies and reorganizes the guidance in SAS No. 58 concerning emphasis paragraphs, uncertainties, and disclaimers of opinion.

results of operations, changes in net assets, and cash flows in conformity with GAAP. The opinion should include an identification of the United States of America as the country of origin of those accounting principles. This conclusion may be expressed only when the independent auditor has formed such an opinion on the basis of an audit performed in accordance with GAAS and an identification of the United States of America as the country of origin of those standards. An example of the independent auditor's standard report is presented in Exhibit 12-1 at the end of this chapter.

Qualified Opinion

12.04 SAS No. 58 states that certain circumstances may require a qualified opinion. A qualified opinion states that except for the effects of the matter to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows in conformity with GAAP. Such an opinion is expressed when—

a. There is a lack of sufficient competent evidential matter or there are restrictions on the scope of the audit that have led the independent auditor to conclude that an unqualified opinion cannot be expressed and the independent auditor has concluded not to disclaim an opinion (see Exhibit 12-2).

b. The independent auditor believes, on the basis of the audit, that the financial statements contain a departure from GAAP, the effect of which is material, and has concluded not to express an adverse opinion (see Exhibit 12-3).

Additional Information

12.05 SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551), contains useful guidance on reporting on additional information. The information covered by SAS No. 29 is presented to accompany the basic financial statements in an independent auditor-submitted document and is not considered necessary for a fair presentation of financial position, results of operations, changes in net assets, and cash flows in conformity with GAAP. Such information includes additional details or explanations of items in, or related to, the basic financial statements, consolidating/combining information, historical summaries of items extracted from the basic financial statements, statistical data, and other material, some of which may be from sources outside the accounting system or outside the health care organization.

12.06 With respect to supplementary and other information, guidance is contained in SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550), and SAS No. 52, *Omnibus Statement on Auditing Standards—1987*, "Required Supplementary Information" (AICPA, *Professional Standards*, vol. 1, AU sec. 558). Among other changes, SAS No. 52 amends SAS No. 29 regarding required supplementary information. SAS No. 8 (AICPA, *Professional Standards*, vol. 1, AU sec. 550.07), SAS No. 29 (AICPA, *Professional Standards*, vol. 1, AU secs. 551.12 and .15), and SAS No. 52 (AICPA, *Professional Standards*, vol. 1, AU secs. 558.08 and .10), were also amended by SAS No. 98, *Omnibus Statement on Auditing Standards—2002*, to address the appropriate reporting for supplementary information and other information. The amendments to SAS No. 8 and SAS No. 52, among other matters, clarify that an auditor may issue a report providing an opinion, in relation to the basic financial statements taken as a whole,

on supplementary information and other information that has been subjected to the auditing procedures applied in the audit of those basic financial statements. The amendments to SAS No. 29, among other matters, clarify the reporting guidance with respect to required supplementary information in an auditor-submitted document. In addition, SAS No. 42, *Reporting on Condensed Financial Statements and Selected Financial Data* (AICPA, *Professional Standards*, vol. 1, AU sec. 552), contains guidance on reporting in a client-prepared document when condensed financial statements or selected financial data are presented by a public entity.

12.07 GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, paragraphs 8 through 11, require presentation of management's discussion and analysis as required supplementary information. Paragraph 8 of SAS No. 52 (AU sec. 558.08), as amended, and paragraph 16 of SAS No. 29 (AU sec. 551.16), as amended, require auditor reporting on required supplementary information if (*a*) the supplementary information that GAAP requires to be presented in the circumstances is omitted; (*b*) the auditor has concluded that the measurement or presentation of the supplementary information departs materially from prescribed guidelines; (*c*) the auditor is unable to complete the prescribed procedures; or (*d*) the auditor is unable to remove substantial doubts about whether the supplementary information conforms to prescribed guidelines. Paragraph 8 of SAS No. 52 (AU sec. 558.08), as amended, provides example language for explanatory paragraphs that, except for an explanatory paragraph because all required supplementary information is omitted, include a disclaimer on the information.

12.08 When an auditor-submitted document contains required supplementary information and the conditions listed in paragraph 12.06 in this chapter do not exist, the auditor should (*a*) express an opinion on the information if engaged to examine the information; (*b*) report on such information using the guidance in AU sec. 551.12 and .14, provided such information has been subjected to the auditing procedures applied in the audit of the basic financial statements; or (*c*) disclaim an opinion on the information, as discussed in paragraph 15 of SAS No. 29 (AU sec. 551.15).

12.09 When a client-prepared document contains required supplementary information and the conditions listed in paragraph 12.07 in this chapter do not exist, the auditor has no reporting requirement but may voluntarily disclaim an opinion on the required supplementary information.[2] Paragraph 7 of SAS No. 8 (AICPA, *Professional Standards*, vol. 1, AU sec. 550.07), as amended, permits an auditor to issue a report providing an opinion, in relation to the financial statements taken as a whole, when required supplementary information has been subjected to auditing procedures applied in the audit of the basic financial statements.

Special Reports

12.10 If a health care organization is required to follow reporting requirements of a regulatory agency, to report under a cash receipts and disbursements basis of accounting, or to report on another comprehensive basis of accounting other than GAAP, the auditor should follow the guidance in SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623). SAS No. 62 also provides reporting guidance when reporting on specified elements,

[2] Some auditors voluntarily disclaim an opinion on required supplementary information to inform the report user of the extent of auditor responsibility for the information.

accounts, or items of a financial statement; compliance with aspects of contractual agreements or regulatory requirements related to audited financial statements; financial presentations to comply with contractual agreements or regulatory provisions; and financial information presented in prescribed forms (see Exhibit 12-4). Accountants' reports on regulatory basis financial statements generally are prescribed by professional standards as restricted-use reports as described in SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532). Where obligated group financial statements exclude entities that are required under GAAP to be consolidated in order to comply with loan agreements, the accountants' report should restrict the use to specified parties (see Exhibit 12-4).[3] Use should be restricted to the company and other parties to the agreement. Health care providers that receive federal financial assistance should also refer to the Audit Guide Government Auditing Standards *and Circular A-133 Audits.*

[3] Obligated group is a term used to denote a group of entities, sometimes a parent corporation and several of its subsidiaries, that is liable for the repayment of obligations, such as tax-exempt bonds.

Exhibit 12-1

Unqualified Opinion—Comparative Financial Statements

Independent Auditor's Report

To the Board of Trustees
XYZ Health Care Organization

We have audited the accompanying balance sheets of XYZ Health Care Organization as of September 30, 20X2, and 20X1, and the related statements of operations, changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of XYZ Health Care Organization's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Health Care Organization as of September 30, 20X2, and 20X1, and the results of its operations, changes in net assets, and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

Exhibit 12-2

Qualified Opinion—Scope Limitation

Independent Auditor's Report

To the Board of Trustees
XYZ Health Care Organization

[*Include same first paragraph as the standard report—see Exhibit 12-1*]

Except as discussed in the following paragraph, we conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We were unable to obtain audited financial statements supporting XYZ's investment in an affiliate stated at $XXX,XXX and $XXX,XXX at September 30, 20X2, and 20X1, respectively, or its equity in earnings of that affiliate of $XXX,XXX and $XXX,XXX, which is included in the statement of operations for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the affiliate or the equity in its earnings by other auditing procedures.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the affiliate investment and earnings, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of XYZ Health Care Organization as of September 30, 20X2, and 20X1, and the results of its operations, changes in net assets, and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

Exhibit 12-3

Qualified Opinion—Departure From Generally Accepted Accounting Principles That Have a Material Effect on the Financial Statements

Independent Auditor's Report

To the Board of Trustees
XYZ Health Care Organization

[*Include same first and second paragraphs as the standard report—see Exhibit 12-1*]

XYZ Health Care Organization has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by $XXX,XXX and $XXX,XXX, long-term debt would be increased by $XXX,XXX and $XXX,XXX, and unrestricted net assets would be increased by $XXX,XXX and $XXX,XXX as of September 31, 20X2, and 20X1, respectively. In addition, earnings would be increased by $XXX,XXX and $XXX,XXX, respectively, for the years then ended.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of XYZ Health Care Organization as of September 30, 20X2, and 20X1, and the results of its operations, changes in net assets, and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

Exhibit 12-4

Report on Financial Statements Prepared Pursuant to a Master Trust Indenture That Results in a Presentation Not in Conformity With Generally Accepted Accounting Principles or Other Comprehensive Basis of Accounting

Independent Auditor's Report

To the Board of Directors
Sample Health Care Corporation

We have audited the accompanying special-purpose combined balance sheets of the Obligated Group (as defined in the Master Trust Indenture dated December X, 20X0, between Sample Health Care Corporation and Any Bank as Trustee) of Sample Health Care Corporation and Affiliates as of December 31, 20X2, and 20X1, and the related special-purpose combined statements of operations, changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note 1, these special-purpose financial statements were prepared in accordance with the accounting requirements set forth in the Master Trust Indenture and are not intended to be a presentation in conformity with generally accepted accounting principles.

In our opinion, the special-purpose financial statements of the Obligated Group as of and for the years ended December 31, 20X2, and 20X1, are fairly presented, in all material respects, on the basis of accounting described in Note 1.

This report is intended solely for the information and use of the board of directors and management of Sample Health Care Corporation, the Trustee under the Master Trust Indenture, and bondholders, and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

Corporate Compliance Programs

12.11 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 to assist a health care provider in evaluating the effectiveness of its corporate compliance program consistent with the requirements of a Corporate Integrity Agreement entered into with the Office of the Inspector General of the U.S. Department of Health and Human Services. SOP 99-1 is included as Appendix D to this Guide.

Chapter 13

Financial Accounting and Reporting by Providers of Prepaid Health Care Services

Overview

13.01 This chapter provides guidance on applying GAAP to providers of prepaid health care services for the accounting and reporting of health care costs, contract losses (premium deficiencies), stop-loss insurance (reinsurance), and contract acquisition costs.

Accounting for Health Care Costs

13.02 Health care costs should be accrued as services are rendered, including estimates of the costs of services rendered but not yet reported. Furthermore, if a provider of prepaid health care services is obligated to render services to specific members beyond the premium period due to provisions in the contract or regulatory requirements, the costs of such services to be incurred also should be accrued currently. Costs that will be incurred after a contract is terminated, such as guaranteed salaries, rent, and depreciation, net of any anticipated revenues, should be accrued when it is determined that a contract with a sponsoring employer or other group will be terminated. FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, provides accounting and reporting guidance for certain contract termination costs associated with an exit or disposal activity.[1]

13.03 Amounts payable to hospitals, physicians, or other health care providers under risk-retention, bonus, or similar programs should be accrued during the contract period based on relevant factors, such as experience to date.

13.04 The basis for accruing health care costs and significant business and contractual arrangements with hospitals, physicians, or other associated entities should be disclosed in the notes to the financial statements.

Accounting for Loss Contracts

13.05 A prepaid health care provider enters into contracts to provide members with specified health care services for specified periods in return for fixed periodic premiums. The premium revenue is expected to cover health care costs and other costs over the terms of the contracts. Only in unusual circumstances would a provider be able to increase premiums on contracts in force to cover expected losses. A provider may be able to control or reduce future health care delivery costs to avoid anticipated losses, but the ability to avoid losses under existing contracts may be difficult to measure or to demonstrate. Associated entities such as hospitals, medical groups, and individual practice associations

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[1] This pronouncement is not applicable to governmental health care entities that do not apply paragraph 7 of GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting.* (See Chapter 1, footnote 1.)

(IPAs) may enter into similar contracts with prepaid health care providers in which they agree to deliver identified health care services to the providers' members for specified periods in return for fixed fees.

13.06 FASB Statement No. 5, *Accounting for Contingencies*, states that a loss should be accrued in financial statements when it is probable that a loss has been incurred and the amount of the loss can be reasonably estimated. Accordingly, losses should be recognized when it is probable that expected future health care costs and maintenance costs under a group of existing contracts will exceed anticipated future premiums and stop-loss insurance recoveries on those contracts. The estimated future health care costs and maintenance costs to be considered in determining whether a loss has been incurred should include fixed and variable, direct and allocable indirect costs. Contracts should be grouped in a manner consistent with the provider's method of establishing premium rates, for example, by community rating practices, geographical area, or statutory requirements, to determine whether a loss has been incurred.

Accounting for Stop-Loss Insurance

13.07 In stop-loss insurance, prepaid health care providers or associated entities transfer portions of their financial risks to other companies. A provider typically contracts to recover health care costs in excess of stated amounts during the contract periods.

13.08 Stop-loss insurance premiums should be included in reported health care costs. Stop-loss insurance recoveries should be reported as reductions of related health care costs. Receivables representing amounts recoverable from insurers should be reported as assets, reduced by appropriate valuation allowances. In addition, the nature, amounts, and effects of significant stop-loss insurance contracts should be disclosed.*

Accounting for Contract Acquisition Costs

13.09 Many prepaid health care providers incur costs that vary with, and are primarily related to, the marketing of subscriber contracts and member enrollment. These costs, sometimes referred to as acquisition costs, consist mainly of commissions paid to agents or brokers and incentive compensation based on new enrollments. Commissions and incentive compensation may be paid when the contracts are written, at later dates, or over the terms of the contracts as premiums are received. Some providers incur additional costs directly related to the acquisition of specific contracts, such as the costs of specialized brochures, marketing, and advertising. Providers also incur costs that are related to the acquisition of new members but that do not relate to specific contracts and are not considered acquisition costs. These costs include salaries of the marketing director and staff, general marketing brochures, and general advertising and promotion expenses.

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* In November 2003, the GASB issued GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries.* Among other matters, GASB Statement No. 42 clarifies and establishes accounting requirements for insurance recoveries. GASB Statement No. 42 is effective for financial statements for periods beginning after December 15, 2004. Earlier application is encouraged.

13.10 Although there is theoretical support for deferring certain acquisition costs, acquisition costs of providers of prepaid health care services—other than costs of advertising—should be expensed as incurred.[2] Advertising costs should be accounted for in conformity with the guidance in SOP 93-7, *Reporting on Advertising Costs*.[3]

[2] In accordance with existing practice, as mandated by SOP 89-5, *Financial Accounting and Reporting by Providers of Prepaid Health Care Services*. Although SOP 89-5 has been superseded with the issuance of this Audit and Accounting Guide, its provisions have been adopted in this chapter.

[3] This pronouncement is not applicable to governmental health care enterprises that do not apply paragraph 7 of GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*. (See Chapter 1, footnote 1.)

Chapter 14

Financial Accounting and Reporting by Continuing Care Retirement Communities

Overview

14.01 This chapter provides guidance on applying GAAP to continuing care retirement communities (CCRCs) for refundable and nonrefundable advance fees, for obligations to provide future services and the use of facilities to current residents, and for the costs of acquiring initial care contracts.[1]

14.02 The United States has over one thousand CCRCs. Most CCRCs are operated by not-for-profit organizations, and many are affiliated with religious organizations.

14.03 CCRC facilities may be independent or they may be affiliated with other health care facilities. They usually provide less intensive care than do hospitals. They generally supply required continuous nursing service or appropriate assistance to residents who have a wide range of medical conditions and needs.

14.04 Some states regulate CCRCs, although most states currently do not. There is, however, a growing trend toward regulation in this rapidly developing industry. States that do require some form of regulation specify that the CCRCs be certified by a state authority, such as a department of insurance or a department of social services. In addition, some states mandate that escrow or reserve funds be maintained for the protection of residents.

Types of Contracts

14.05 CCRCs use three basic types of contracts. They include all-inclusive (type A), modified (type B), and fee-for-service (type C) contracts.

Type A Contracts

14.06 An all-inclusive continuing-care contract includes residential facilities, meals, and other amenities. It also provides long-term nursing care for little or no increase in periodic fees, except to cover normal operating costs and inflation.

Type B Contracts

14.07 A modified continuing-care contract also includes residential facilities, meals, and other amenities. However, only a specified amount of long-term nursing care is provided for little or no increase in periodic fees, except to

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[1] The provisions of this chapter do not apply to governmental health care enterprises, unless the entity has elected to follow all FASB pronouncements under paragraph 7 of GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting.* (See Chapter 1, footnote 1.)

cover normal operating costs and inflation. After the specified amount of nursing care is used, residents pay either a discounted rate or the full per diem rates for required nursing care.

Type C Contracts

14.08 A fee-for-service continuing-care contract includes residential facilities, meals, and other amenities as well as emergency and infirmary nursing care. Access to long-term nursing care is guaranteed, but it may be required at full per diem rates.

Types of Living Accommodations

14.09 CCRCs offer different types of living accommodations to residents, such as single or shared apartment units or individual homes. They also provide a variety of amenities, including social, recreational, dining, and laundry services.

14.10 CCRCs may provide long-term nursing-care services, either at the same location or, by agreement, with another facility. Residents are transferred to or from a nursing center as medical care is required. As the health of a resident declines, he or she may be transferred permanently to a nursing center.

Fees and Payment Methods

14.11 Continuing-care contracts contain a number of different approaches to providing delivery of services. Contract provisions, for example, may stipulate the amount of the advance fee, whether periodic fees will be required, and, if so, whether they can be adjusted. In addition, contracts generally do the following: detail the future services that will be provided to residents; explain how a resident will be charged for services; describe the CCRC's refund policies and the formula for calculating the amount of the refund, which may be simple or complex; and describe the obligations of the CCRC and the resident if a contract is terminated or a residential unit is reoccupied.

14.12 A CCRC may require several different payment methods for services and the use of facilities. Paragraphs 14.13 through 14.19 discuss three of the most prevalent methods.

Advance Fee Only

14.13 Under this method, a resident pays an advance fee in return for future services and the use of facilities. Such services generally include CCRC housing-related services (for example, meals, laundry, housekeeping, and social services) and health care. These services usually are provided to the resident for the remainder of his or her life or until the contract is terminated. Additional periodic fees are not paid, regardless of how long a resident lives or if the resident requires more services than anticipated. Generally, the resident receives no ownership interest in the facility.

Advance Fee With Periodic Fees

14.14 Under this method, a resident pays an advance fee and periodic fees for services and the use of facilities. Such periodic fees may be fixed, or they may be subject to adjustment for increases in operating costs or inflation or for other economic reasons.

Periodic Fees Only

14.15 Under this method, a resident pays a fee at periodic intervals for services and the use of the facilities provided by the CCRC. Such fees may be either fixed or adjustable.

14.16 An advance fee may be met by transferring a resident's personal assets (which may include rights to future income) or by paying a lump sum of cash to the CCRC.

14.17 Advance fees received for future services may be refunded at the occurrence of some future event, such as death, withdrawal from the CCRC, termination of the contract, or reoccupancy of a residential unit. The amount of the refund generally is based on contractual provisions or statutory requirements.

14.18 Many continuing-care contracts are similar to annuity contracts. Under those contracts, the CCRC assumes the risks associated with (*a*) estimating the amount of the advance fee and other fees to be paid by a resident and (*b*) determining whether such fees will be sufficient to cover the cost of providing a resident's required services and the use of facilities. For some contracts, residents may share the future costs without limit.

14.19 The CCRC has an obligation to provide future services for the length of the contract or the life of the resident. In certain circumstances, this obligation continues regardless of whether advance fees or periodic fees are sufficient to meet the costs of providing services to a resident.

Accounting for Refundable Advance Fees

14.20 Payment of an advance fee generally is required before a resident acquires a right to reside in an apartment or residential unit for life. A portion of advance fees may be refundable by rescission within a legally set time period or if a certain future event occurs, such as the death or withdrawal of a resident or termination of the contract. Some refunds are paid only if a residential unit is reoccupied.

14.21 CCRC refund policies vary either by region or according to statutory requirements, but generally the amount of the refund is based on provisions specified in a contract. For example, some contracts require a refund of the advance fee, less a reasonable processing fee. Amounts refunded may be based on a fixed amount or percentage, an amount that declines to a fixed amount over time, an amount that declines to zero, or an amount based on the resale amount. Refunds may be contingent on vacating the unit, resale of the unit, or passage of a fixed period of time if the unit is not resold.

14.22 The estimated amount of advance fees that is expected to be refunded to current residents under the terms of the contracts should be accounted for and reported as a liability. The estimated amount should be based on the individual facility's own experience or, if records are not available, on the experience of comparable facilities. The remaining amount of advance fees should be accounted for as deferred revenue within the liability section of the balance sheet. Adjustments to the estimated liability should be accounted for as deferred revenue and amortized together with nonrefundable advance fees as discussed in paragraph 14.23. The gross amount of contractual refund obligations under existing contracts and the CCRC's refund policy should be disclosed in the notes to the financial statements. Amounts refunded should be disclosed in the statement of cash flows as a financing transaction.

14.23 The deferred revenue should be amortized to income over future periods based on the estimated life of the resident or on the contract term, if shorter. The period of amortization should be adjusted annually based on the actuarially determined, estimated, remaining life expectancy of each individual or on the joint and last survivor life expectancy of each pair of residents occupying the same unit. The straight-line method should be used to amortize deferred revenue except in certain circumstances when costs are expected to increase at a significantly higher rate than future revenues in the later years of residence. In those situations, deferred revenue may be amortized to income using a method that reflects the disproportionate ratio between the costs of the expected services and the expected revenues. The amortized amount should not exceed the amount available to the CCRC under state regulations, contract provisions, or management policy. Unamortized deferred revenue from nonrefundable advance fees should be recorded as revenue upon a resident's death or the termination of the contract. The method of amortization should be disclosed in the notes to the financial statements.

Accounting for Fees Refundable to Residents Only From Reoccupancy Proceeds of a Contract Holder's Unit

14.24 Some contracts between a CCRC and a resident stipulate that all or a portion of the advance fee may be refundable if the contract holder's unit is reoccupied by another person. The source of money for the payment is from the proceeds of the advance fees collected by the CCRC from the next resident of the reoccupied unit. The terms governing how the proceeds from the next resident are to be paid to the previous resident vary from contract to contract. In effect, the CCRC acts as if it were an agent for present and future residents.

14.25 The portion of the fees that will be paid to current residents or their designees, only to the extent of the proceeds of reoccupancy of a contract holder's unit, should be accounted for as deferred revenue, provided that legal and management policy and practice support the withholding of refunds under this condition. Similar amounts received from new residents in excess of the amount to be paid to previous residents or their designees also should be deferred. The deferred revenue should be amortized to income over future periods based on the remaining useful life of the facility. The basis and method of amortization should be consistent with the method for calculating depreciation and should be disclosed in the notes to the financial statements.

Accounting for Nonrefundable Advance Fees

14.26 Under provisions of continuing-care contracts entered into by a CCRC and residents, nonrefundable advance fees represent payment for future services and should be accounted for as deferred revenue. If a CCRC has sufficient historical experience and relevant statistical data about life expectancies, it should consider that information when determining the remaining life of residents. A CCRC with insufficient historical experience or reliable actuarial data may use relevant data of similar communities within that area, relevant national industry statistics, or other appropriate data. Nonrefundable advance fees should be amortized in the manner discussed in paragraph 14.23.

14.27 The application of the conclusions in paragraphs 14.25 and 14.26 is presented in Exhibit 14-1 at the end of this chapter.

Accounting for the Obligation to Provide Future Services and the Use of Facilities to Current Residents

14.28 A CCRC expects to provide services and the use of facilities to individuals over their remaining lives under continuing-care contract agreements. The nature and extent of such services depend on such variables as the individual's age, health, sex, and economic status upon entering the CCRC. Thus, the CCRC assumes a risk in estimating the cost of future services and the use of facilities. Although many CCRCs are allowed contractually to increase periodic fees, some contracts may restrict increases in periodic fees and require continuing services without additional compensation. If the advance fees and periodic fees charged are insufficient to meet the costs of providing future services and the use of facilities, the CCRC has a liability to provide future services and the use of facilities that is equal to the estimated cost of providing future services and the use of facilities (defined as amounts that are expected to be incurred to provide services and the use of facilities to individuals over their remaining lives under continuing care contracts, including resident-care, dietary, health care, facility, interest, depreciation, and amortization costs) in excess of the related anticipated revenues. The liability is based on actuarial assumptions (such as mortality and morbidity rates), on estimates of future costs and revenues, and on the specific CCRC's historical experience and statistical data.

14.29 The obligation to provide future services and the use of facilities to current residents should be calculated annually in order to determine whether a liability should be reported in the financial statements. The liability related to continuing-care contracts is the present value of future net cash flows, minus the balance of unamortized deferred revenue, plus depreciation of facilities to be charged related to the contracts, plus unamortized costs of acquiring the related initial continuing-care contracts, if applicable. The calculation should be made by grouping contracts by type, such as all contracts with a limit on annual increases in fees, contracts with unlimited fee increases, and so forth.

14.30 Cash inflows include revenue contractually committed to support the residents and inflows resulting from monthly fees including anticipated increases in accordance with contract terms. This includes third-party payments, contractually or statutorily committed investment income from services related to CCRC activities, contributions pledged by donors to support CCRC activities, and the volume of deferred nonrefundable advance fees. Cash outflows are composed of operating expenses, including interest expense and excluding selling, and general and administrative expenses. Anticipated cost increases affecting these operating expenses should be considered in determining cash outflows. The expected inflation rate as well as other factors should be considered in determining the discount rate. In calculating the liability, the specific CCRC's historical experience or statistical data relating to the residents' life spans should be used. The life spans used should be the same as those used to amortize deferred revenue (see paragraph 14.23). For a new CCRC, either relevant data of similar communities in the area or relevant national industry statistics may be used if they are deemed to be representative.

14.31 A CCRC should disclose in its notes to the financial statements (1) the carrying amount of the liability to provide future services and the use of facilities related to continuing-care contracts that is presented at present value in the financial statements (if not separately disclosed in the balance sheet) and (2) the interest rate used to discount that liability. Also, the FASB has

issued FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. This Concepts Statement provides useful discussion of general principles governing the use of present value, and of the objective of present value in accounting measurements. Statements of Financial Accounting Concepts are not sources of established accounting principles as described in SAS No. 69, *The Meaning of* Present Fairly in Conformity with Generally Accepted Accounting Principles, and, thus, do not amend, modify, or justify a change from generally accepted accounting principles currently in effect.

14.32 The application of the conclusions in paragraph 14.30 is presented in Exhibit 14-2 at the end of this chapter.

Accounting for the Costs of Acquiring Initial Continuing-Care Contracts

14.33 Advertising costs incurred in connection with acquiring initial continuing-care contracts should be accounted for in conformity with the guidance in SOP 93-7, *Reporting on Advertising Costs*. Start-up costs should be expensed as incurred in accordance with SOP 98-5, *Reporting on the Costs of Start-Up Activities*. However, costs of acquiring initial continuing-care contracts that are within the scope of FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, should be expensed or capitalized in accordance with that Statement. Capitalized costs should be amortized to expenses on a straight-line basis over the average expected remaining lives of the residents under the contract or the contract term, if shorter. The costs of acquiring continuing-care contracts after a CCRC is substantially occupied or one year following completion should be expensed when incurred.[2]

Financial Statements

14.34 A complete set of illustrative financial statements for a CCRC is included in Appendix A.

14.35 The notes to the financial statements for each year presented should include—

- A description of the CCRC and the nature of the related continuing-care contracts entered into by the CCRC.
- The statutory escrow or similar requirements.
- The refund policy of the CCRC and the general amount of refund obligation under the existing contracts.
- The interest rate used to discount the liability to provide future services.

Auditing

14.36 When auditing a CCRC, the independent auditor may need to consider the examples of specific auditing objectives, selected control activities, and auditing procedures that are presented in Exhibit 14-3 at the end of this chapter.

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[2] In accordance with existing practice, as mandated by SOP 90-8, *Financial Accounting and Reporting by Continuing Care Retirement Communities*. Although SOP 90-8 is superseded with the issuance of this Audit and Accounting Guide, its provisions have been adopted in this chapter.

Exhibit 14-1

Accounting for Refundable and Nonrefundable Advance Fees

Assumptions:

a. The unit is occupied for twenty years.

b. The facility has an estimated thirty-year life.

c. The resident is admitted on the first day of the year indicated and dies on the last day of year indicated.

d. The estimated remaining life expectancy is taken from an appropriate actuarial table.

e. The cost of providing future services is expected to be incurred equally over the remaining life.

Example:

Year Admitted	*Dies*	*Resident*	*Entry Age*	*Advance Fees* *Total*	*Advance Fees* *Nonrefundable 25%*	*Advance Fees* *Refundable 75%*	*Refunded to the Previous Occupant**
1	4	A	68	$100,000	$25,000	$ 75,000	—
5	8	B	82	120,000	30,000	90,000	$75,000
9	13	C	79	150,000	37,500	112,500	90,000
14	—	D	80	130,000	32,500	97,500	97,500

Amortization of Nonrefundable Advance Fees:

Resident A	*Unamortized Deferred Revenue*	*Estimated Remaining Life (in Years)*	*Income*
Year 1	$25,000	12.1 =	$ 2,066
2	22,934	11.5 =	1,994
3	20,940	11.1 =	1,886
4	19,054	10.6 =	1,798
Unamortized deferred revenue recognized upon the death of the resident			17,256
		Total	$25,000

* Per contact, the amount is limited to 75% of proceeds of reoccupancy up to amount originally paid by previous occupant.

Amortization of Advance Fees Refundable to Residents

$75,000/30 years = $2,500 per year for years 1 through 4

15,000/26 years = $577 additional or $3,077 per year for years 5 through 8

22,500/22 years = $1,023 additional or $4,100 per year for years 9 through next change in occupancy

Resident B	*Unamortized Deferred Revenue*	*Estimated Remaining Life (in Years)*	*Income*
Year 5	$30,000	6.1 =	$ 4,918
6	25,082	5.8 =	4,324
7	20,758	5.5 =	3,774
8	16,984	5.3 =	3,205
Unamortized deferred revenue recognized upon the death of the resident			13,779
		Total	$30,000

Resident C	*Unamortized Deferred Revenue*	*Estimated Remaining Life (in Years)*	*Income*
Year 9	$37,500	7.0 =	$ 5,357
10	32,143	6.7 =	4,797
11	27,346	6.4 =	4,273
12	23,073	6.1 =	3,783
13	19,290	5.8 =	3,324
Unamortized deferred revenue recognized upon the death of the resident			15,966
		Total	$37,500

Resident D	*Unamortized Deferred Revenue*	*Estimated Remaining Life (in Years)*	*Income*
Year 14	$32,500	6.7 =	$4,851
15	27,649	6.4 =	4,321
16	23,328	6.1 =	3,824
17	19,504	5.8 =	3,363
18	16,141	5.5 =	2,935
19	13,206	5.3 =	2,492
20	10,714	5.1 =	2,100

Amortization continues until the death of the resident.

Exhibit 14-2

Accounting for the Obligation to Provide Future Services and the Use of Facilities to Current Residents

Assumptions:

a. All residents pay a $ 50,000 fee, which is refundable less 2 percent per month for the first 36 months. After that period, none of the fee is refundable. The CCRC opened on 1/1/X4. (See Exhibit 14-1 for an illustration of how to compute refundable and deferred revenue.)

b. An additional periodic fee of $1,000 is payable monthly with a 5 percent increase annually.

c. The unamortized (deferred) costs of acquiring related initial contracts on 12/31/X6 are assumed to be $17,000.

d. The unamortized deferred revenue on 12/31/X6 is assumed to be $27,027.

Present value of net cash flow on 12/31/X6:

Cash inflows:

Resident	*Estimated Remaining Life (in Months) on 12/31/X6*	*Estimated Cash Inflows*			
		19X7	*19X8*	*19X9*	*20X0*
A	36	$12,000	$12,600	$13,230	—
B	22	12,000	10,500	—	—
C	27	12,000	12,600	3,308	—
D	38	12,000	12,600	13,230	$2,315
Estimated cash inflows		$48,000	$48,300	$29,768	$2,315

Cash outflows:

Resident	*Estimated Remaining Life (in Months) on 12/31/X6*	*Estimated Cash Outflows*			
		19X7	*19X8*	*19X9*	*20X0*
A	36	$10,000	$12,000	$15,000	—
B	22	15,000	11,000	—	—
C	27	14,000	17,000	5,000	—
D	38	8,000	12,000	14,000	$4,000
Estimated cash outflows		$47,000	$52,000	$34,000	$4,000

Recapitulation	*19X7*	*19X8*	*19X9*	*20X0*
Cash inflows	$ 48,000	$ 48,300	$ 29,768	$ 2,315
Cash outflows	(47,000)	(52,000)	(34,000)	(4,000)
	$ 1,000	$ (3,700)	$ (4,232)	$(1,685)
Present value of net cash flows discounted at 10 percent				$(7,137)

Depreciation of facilities to be charged to current residents:

Original cost of facility		$17,000,000
Cost of facility allocable to revenue-producing service areas		$(2,000,000)
Cost of facility to be allocated to residents (including common areas)		$15,000,000
Useful life	40 years	
Annual depreciation using straight-line method		$ 375,000
Number of residents expected to occupy the facility	200	
Annual depreciation per resident		$ 1,875
Monthly depreciation per resident		$ 156

Resident	*Estimated Remaining Life (in Months) on 12/31/X6*	*19X7*	*19X8*	*19X9*	*20X0*
A	36	$1,875	$1,875	$1,875	—
B	22	1,875	1,560	—	—
C	27	1,875	1,875	468	—
D	38	1,875	1,875	1,875	$ 312
Yearly estimated depreciation of facilities to be charged to current residents		$7,500	$7,185	$4,218	$ 312

Total estimated depreciation of the use of facilities to be charged to the current residents	$19,215

Liability for providing future services and the use of facilities to current residents:

Present value of future net cash outflows	$ 7,137
Minus:	
Unamortized deferred revenue on 12/31/X6	(27,027)
Plus:	
Depreciation to be charged to current residents	19,215
Unamortized costs of acquiring initial contracts—see assumption *c* above	17,000†
Liability for providing future services and the use of facilities to current residents on 12/31/X6	$16,325

† These numbers are for illustrative purposes only and no inference has been made as to the recoverability of the $17,000.

Exhibit 14-3

Auditing Considerations

Financial Statement Assertions	*Specific Auditing Objectives*	*Selected Control Activities*	*Auditing Procedures*
Continuing Care Retirement Communities			
Existence, completeness, and presentation and maturity	Liabilities relating to refundable fee arrangements are accounted for and reported properly.	Written documentation is prepared for refundable fee arrangements.	Review the refundable fee arrangements regarding stipulations for repayments and determine that such arrangements are classified and disclosed properly in the financial statements.
	Liabilities are accounted for and reported properly.	All liabilities are classified, described, and disclosed properly in the financial statements.	Compare the account balances with the prior periods' balance and the amortization schedules.
		Management monitors compliance with restrictive covenants.	Confirm any significant new obligations.
Deferred Revenue			
Completeness, rights and obligations, and presentation and disclosure	Deferred revenue and the obligation to provide future services to, and the use of facilities by, current residents of CCRCs are recognized and reported properly.	Procedures ensure that amounts received as advance fees are recognized in the proper period and that the obligation to provide future services and the use of facilities is reported.	Test the procedures related to the recognition of advance fees and determine that the obligation to provide future services and the use of facilities is properly reported.
Long-Term Obligations			
Existence, completeness, and	Liabilities relating to	Written documentation is	Review the refundable fee

Financial Statement Assertions	*Specific Auditing Objectives*	*Selected Control Activities*	*Auditing Procedures*
presentation and maturity	refundable fee arrangements are accounted for and reported properly.	prepared for refundable fee arrangements.	arrangements regarding stipulations for repayments and determine that such arrangements are classified and disclosed properly in the financial statements.

Appendix A

Illustrative Financial Statements

The following illustrative financial statements illustrate the applications of the reporting practices discussed in this Guide. Specific types of health care organizations have been selected to illustrate a wide diversity of reporting practices. It is not intended that these illustrations represent either the only types of disclosure nor the only statement formats that would be appropriate. For example, the reporting of revenue, expenses, gains, and losses vary depending on the relationship of the underlying transaction to the entity's operations. More or less detail should appear either in the financial statements or in the notes to the financial statements, depending on the circumstances.

Governmental health care entities are required to follow the accounting and reporting requirements of the GASB. GASB pronouncements may require governmental health care entities to present information beyond or different from that presented by not-for-profit and investor-owned entities. For example, GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*, requires governmental entities to make certain disclosures about the credit and market risks of their investments. GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, requires certain accounting for and disclosures about pension benefits provided to employees of governmental health care entities. GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*, requires governmental health care entities to present a statement of cash flows using a format that differs in some respects from that required by FASB Statement No. 95, *Statement of Cash Flows*, and that requires the reporting of cash flow information on both restricted and unrestricted funds. GASB Statement No. 12, *Disclosure of Information on Postemployment Benefits Other Than Pension Benefits by State and Local Governmental Employers*, requires certain disclosures about other postemployment benefits (OPEB) provided to employees of governmental health care entities. GASB Statement No. 12 also provides that governmental health care entities are not required to change their recognition and measurement of OPEB to comply with FASB Statement No. 106, *Accounting for Postretirement Benefits Other Than Pensions*, or FASB Statement No. 112, *Employer's Accounting for Postemployment Benefits*. GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, establishes new financial reporting requirements for state and local governments, and amends or supersedes various existing GASB and NCGA Statements and Interpretations.

Other GASB pronouncements may also have implications for governmental health care entities. For example, GASB Statement No. 13, *Accounting for Operating Leases with Scheduled Rent Increases* (paragraph 6.11), may affect the accounting for and financial reporting of certain lease transactions. Discussed elsewhere in this Audit and Accounting Guide are GASB Statement No. 7, *Advance Refundings Resulting in Defeasance of Debt* (paragraph 7.20), GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues* (paragraph 8.02), GASB Statement No. 14, *The Financial Reporting Entity* (paragraph 11.03), GASB Statement No. 16, *Accounting for Compensated Absences* (paragraph 7.03), GASB Statement No. 20,

Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting (Chapter 1, footnote 1), GASB Statement No. 23, *Accounting and Financial Reporting for Refundings of Debt Reported by Proprietary Activities* (paragraph 7.20), GASB Statement No. 28, *Accounting and Financial Reporting for Securities Lending Transactions* (paragraph 4.13), GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities* (Chapter 1, footnote 1), GASB Statement No. 30, *Risk Financing Omnibus* (paragraph 8.02), GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools* (paragraph 4.12), GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, as amended by GASB Statement No. 36, *Recipient Reporting for Certain Shared Nonexchange Revenues*, (paragraphs 5.19, 5.20, 7.05, 10.05, and 10.12), GASB Statement No. 39, *Determining Whether Certain Organizations Are Component Units* (paragraph 11.03), GASB Interpretation No. 3, *Financial Reporting for Reverse Repurchase Agreements* (paragraph 4.13), GASB Interpretation No. 4, *Accounting and Financial Reporting for Capitalization Contributions to Public Entity Risk Pools* (paragraph 8.02), and GASB Technical Bulletin 03-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets* (paragraphs 4.18 and 5.26).

These illustrative financial statements are not intended to include items that should be accounted for under the requirements of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, and do not reflect the requirements of FASB Statement No. 133. FASB Statement No. 133, among other matters, amends the disclosure requirements for securities in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (see paragraph 534 of FASB Statement No. 133). In reporting disclosures about investments in securities, investor-owned entities should comply primarily with the requirements of paragraphs 6, 17, 19, 20, 21, and 22 of FASB Statement No. 115, as amended. Other disclosure requirements for investments in securities may also be applicable. For example, Emerging Issues Task Force (EITF) Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, requires certain disclosures for investments that are in an unrealized loss position but for which other-than-temporary impairments have not been recognized. Practitioners should refer to FASB Statement No. 133, as amended, for guidance on reporting derivative instruments and hedging activities.

This appendix contains illustrative financial statements for the following types of health care organizations:

1. Not-for-profit hospital
2. Governmental hospital authority (includes illustrative management's discussion and analysis)
3. Nursing home
4. Continuing care retirement community (CCRC)
5. Home health agency
6. Health maintenance organization (HMO)
7. Ambulatory care organization

ILLUSTRATIVE FINANCIAL STATEMENTS FOR A NOT-FOR-PROFIT HOSPITAL

Sample Not-for-Profit Hospital
Balance Sheets
December 31, 20X7 and 20X6
(in thousands)

	20X7	*20X6*
Assets		
Current assets:		
Cash and cash equivalents	$ 4,758	$ 5,877
Short-term investments	15,836	10,740
Assets limited as to use	970	1,300
Patient accounts receivable, net of allowance for doubtful accounts of $2,500 in 20X7 and $2,400 in 20X6	15,100	14,194
Other current assets	2,670	2,856
Total current assets	39,334	34,967
Interest in net assets of Sample Hospital Foundation*	510	462
Assets limited as to use:		
Internally designated for capital acquisition	12,000	12,500
Held by trustee	6,949	7,341
	18,949	19,841
Less amount required to meet current obligations	(970)	(1,300)
	17,979	18,541

(continued)

* These illustrative financial statements include a presentation of an interest in the net assets of a financially interrelated foundation that is based on the particular fact pattern described in Note 11 to the illustrative financial statements and the following additional facts:

- Sample Not-for-Profit Hospital can influence the financial decisions of Sample Hospital Foundation to such an extent that it can determine the timing and amount of distributions from the Foundation. Thus, it is inappropriate for the Hospital to imply a time restriction on amounts held by the Foundation.
- Contributions to Foundation are restricted by donors for property acquisitions. Those restrictions have been met by the Hospital even though the net assets remain at the Foundation. Thus, the net assets related to the interest in the Foundation are classified as unrestricted in the Hospital's financial statements.
- The Hospital's policy is to report restricted revenues as unrestricted if the restriction is met in the same period as the revenues are recognized.

Because the change in the interest in net assets of the foundation results from contributions restricted to property acquisitions, this presentation shows the change in that interest reported separately from the performance indicator, in the spirit of the guidance in paragraph 10.20 for contributions restricted to property acquisitions. Readers should be aware that FASB Statement No. 136 is silent on this classification. The AICPA has released a group of Technical Practice Aids (TPAs) (6400.36 through 6400.42) that address recognition of the interests in the net assets of financially interrelated organizations and the classification of the changes in those interests. TPAs are nonauthoritative and are not sources of established accounting principles as described in SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles.

Sample Not-for-Profit Hospital
Balance Sheets
(continued)
December 31, 20X7 and 20X6
(in thousands)

	20X7	*20X6*
Long-term investments	4,680	4,680
Long-term investments restricted for capital acquisition	320	520
Property and equipment, net	51,038	50,492
Other assets	1,185	908
Total assets	$115,046	$110,570
Liabilities and Net Assets		
Current liabilities:		
Current portion of long-term debt	$ 1,470	$ 1,750
Accounts payable and accrued expenses	5,818	5,382
Estimated third-party payor settlements	2,143	1,942
Other current liabilities	1,969	2,114
Total current liabilities	11,400	11,188
Long-term debt, net of current portion	23,144	24,014
Other liabilities	3,953	3,166
Total liabilities	38,497	38,368
Net assets:		
Unrestricted	70,846	66,199
Temporarily restricted	2,115	2,470
Permanently restricted	3,588	3,533
Total net assets	76,549	72,202
Total liabilities and net assets	$115,046	$110,570

See accompanying notes to financial statements.

FORMAT A

Sample Not-for-Profit Hospital
Statements of Operations
Years Ended December 31, 20X7 and 20X6
(in thousands)

	20X7	*20X6*
Unrestricted revenues, gains and other support:		
Net patient service revenue	$85,156	$78,942
Premium revenue	11,150	10,950
Other revenue	2,601	5,212
Net assets released from restrictions used for operations	300	
Total revenues, gains and other support	99,207	95,104
Expenses:		
Operating expenses	88,521	80,585
Depreciation and amortization	4,782	4,280
Interest	1,752	1,825
Provision for bad debts	1,000	1,300
Other	2,000	1,300
Total expenses	98,055	89,290
Operating income	1,152	5,814
Other income:		
Investment income	3,900	3,025
Other expense:		
Loss from extinguishment of debt	(500)	
Excess of revenues over expenses	4,552	8,839
Change in net unrealized gains and losses on other than trading securities	300	375
Net assets released from restrictions used for purchase of property and equipment	200	
Change in interest in net assets of Sample Hospital Foundation*	283	536
Transfers to parent	(688)	(3,051)
Increase in unrestricted net assets	$ 4,647	$ 6,699

See accompanying notes to financial statements.

* These illustrative financial statements include a presentation of an interest in the net assets of a financially interrelated foundation that is based on the particular fact pattern described in Note 11 to the illustrative financial statements and the following additional facts:

- Sample Not-for-Profit Hospital can influence the financial decisions of Sample Hospital Foundation to such an extent that it can determine the timing and amount of distributions from the Foundation. Thus, it is inappropriate for the Hospital to imply a time restriction on amounts held by the Foundation.
- Contributions to Foundation are restricted by donors for property acquisitions. Those restrictions have been met by the Hospital even though the net assets remain at the Foundation. Thus, the net assets related to the interest in the Foundation are classified as unrestricted in the Hospital's financial statements.
- The Hospital's policy is to report restricted revenues as unrestricted if the restriction is met in the same period as the revenues are recognized.

Because the change in the interest in net assets of the foundation results from contributions restricted to property acquisitions, this presentation shows the change in that interest reported separately from the performance indicator, in the spirit of the guidance in paragraph 10.20 for contributions restricted to property acquisitions. Readers should be aware that FASB Statement No. 136 is silent on this classification. The AICPA has released a group of Technical Practice Aids (TPAs) (6400.36 through 6400.42) that address recognition of the interests in the net assets of financially interrelated organizations and the classification of the changes in those interests. TPAs are nonauthoritative and are not sources of established accounting principles as described in SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles.

FORMAT B

Sample Not-for-Profit Hospital
Statements of Operations
Years Ended December 31, 20X7 and 20X6
(in thousands)

	20X7	*20X6*
Unrestricted revenues, gains and other support:		
Net patient service revenue	$ 85,156	$78,942
Premium revenue	11,150	10,950
Other, primarily investment income	6,501	8,237
Net assets released from restrictions used for operations	300	
Total revenues, gains and other support	103,107	98,129
Expenses:		
Salaries and benefits	53,900	49,938
Medical supplies and drugs	26,532	22,121
Insurance	8,089	8,526
Depreciation and amortization	4,782	4,280
Interest	1,752	1,825
Allowance for bad debts	1,000	1,300
Loss from extinguishment of debt	(500)	
Other	2,000	1,300
Total expenses	98,555	89,290
Excess of revenues, gains, and other support over expenses	4,552	8,839
Change in net unrealized gains and losses on other than trading securities	300	375
Net assets released from restrictions used for purchase of property and equipment	200	
Change in interest in net assets of Sample Hospital Foundation*	283	536
Transfers to parent	(688)	(3,051)
Increase in unrestricted net assets	$ 4,647	$ 6,699

See accompanying notes to financial statements.

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* These illustrative financial statements include a presentation of an interest in the net assets of a financially interrelated foundation that is based on the particular fact pattern described in Note 11 to the illustrative financial statements and the following additional facts:

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Because the change in the interest in net assets of the foundation results from contributions restricted to property acquisitions, this presentation shows the change in that interest reported separately from the performance indicator, in the spirit of the guidance in paragraph 10.20 for contributions restricted to property acquisitions. Readers should be aware that FASB Statement No. 136 is silent on this classification. The AICPA has released a group of Technical Practice Aids (TPAs) (6400.36 through 6400.42) that address recognition of the interests in the net assets of financially interrelated organizations and the classification of the changes in those interests. TPAs are nonauthoritative and are not sources of established accounting principles as described in SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles.

Sample Not-for-Profit Hospital
Statements of Changes in Net Assets
Years Ended December 31, 20X7 and 20X6
(in thousands)

	20X7	*20X6*
Unrestricted net assets:		
Excess of revenues over expenses	$ 4,552	$ 8,839
Net unrealized gains on investments, other than trading securities	300	375
Change in interest in net assets of Sample Hospital Foundation*	283	536
Transfers to parent	(688)	(3,051)
Net assets released from restrictions used for purchase of property and equipment	200	
Increase in unrestricted net assets	4,647	6,699
Temporarily restricted net assets:		
Contributions for charity care	140	996
Net realized and unrealized gains on investments	5	8
Net assets released from restrictions	(500)	
Increase (decrease) in temporarily restricted net assets	(355)	1,004
Permanently restricted net assets:		
Contributions for endowment funds	50	411
Net realized and unrealized gains on investments	5	2
Increase in permanently restricted net assets	55	413
Increase in net assets	4,347	8,116
Net assets, beginning of year	72,202	64,086
Net assets, end of year	$76,549	$72,202

See accompanying notes to financial statements.

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* These illustrative financial statements include a presentation of an interest in the net assets of a financially interrelated foundation that is based on the particular fact pattern described in Note 11 to the illustrative financial statements and the following additional facts:

- Sample Not-for-Profit Hospital can influence the financial decisions of Sample Hospital Foundation to such an extent that it can determine the timing and amount of distributions from the Foundation. Thus, it is inappropriate for the Hospital to imply a time restriction on amounts held by the Foundation.
- Contributions to Foundation are restricted by donors for property acquisitions. Those restrictions have been met by the Hospital even though the net assets remain at the Foundation. Thus, the net assets related to the interest in the Foundation are classified as unrestricted in the Hospital's financial statements.
- The Hospital's policy is to report restricted revenues as unrestricted if the restriction is met in the same period as the revenues are recognized.

Because the change in the interest in net assets of the foundation results from contributions restricted to property acquisitions, this presentation shows the change in that interest reported separately from the performance indicator, in the spirit of the guidance in paragraph 10.20 for contributions restricted to property acquisitions. Readers should be aware that FASB Statement No. 136 is silent on this classification. The AICPA has released a group of Technical Practice Aids (TPAs) (6400.36 through 6400.42) that address recognition of the interests in the net assets of financially interrelated organizations and the classification of the changes in those interests. TPAs are nonauthoritative and are not sources of established accounting principles as described in SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles.

Sample Not-for-Profit Hospital
Statements of Cash Flows (Indirect Method)
Years Ended December 31, 20X7 and 20X6
(in thousands)

	20X7	*20X6*
Cash flows from operating activities:		
Change in net assets	$ 4,347	$ 8,116
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Loss from extinguishment of debt	500	
Depreciation and amortization	4,782	4,280
Net realized and unrealized gains on investments, other than trading	(450)	(575)
Undistributed portion of change in interest in net assets of Sample Hospital Foundation	(48)	(51)
Transfers to parent	688	3,051
Allowance for bad debts	1,000	1,300
Restricted contributions and investment income received	(290)	(413)
(Increase) decrease in:		
Patient accounts receivable	(1,906)	(2,036)
Trading securities	215	
Other current assets	186	(2,481)
Other assets	(277)	(190)
Increase (decrease) in:		
Accounts payable and accrued expenses	436	679
Estimated third-party payor settlements	201	305
Other current liabilities	(145)	(257)
Other liabilities	787	(128)
Net cash provided by operating activities	10,026	11,600
Cash flows from investing activities:		
Purchase of investments	(3,769)	(2,150)
Capital expenditures	(4,728)	(5,860)
Net cash used in investing activities	(8,497)	(8,010)
Cash flows from financing activities:		
Transfers to parent	(688)	(3,051)
Proceeds from restricted contributions and restricted investment income	290	413
Payments on long-term debt	(24,700)	(804)
Payments on capital lease obligations	(150)	(100)
Proceeds from issuance of long-term debt	22,600	500
Net cash used in financing activities	(2,648)	(3,042)
Net (decrease) increase in cash and cash equivalents	(1,119)	548
Cash and cash equivalents, beginning of year	5,877	5,329
Cash and cash equivalents, end of year	$ 4,758	$ 5,877

Supplemental Disclosures of Cash Flow Information:

The Hospital entered into capital lease obligations in the amount of $600,000 for new equipment in 20X7.

Cash paid for interest (net of amount capitalized) in 20X7 and 20X6 was $1,780,000 and $1,856,000, respectively.

See accompanying notes to financial statements.

Sample Not-for-Profit Hospital
Notes to Financial Statements
December 31, 20X7 and 20X6

1. Description of Organization and Summary of Significant Accounting Policies[1]

Organization. The Sample Not-for-Profit Hospital (the Hospital), located in Tulsa, Oklahoma, is a not-for-profit acute care hospital. The Hospital provides inpatient, outpatient and emergency care services for residents of northeastern Oklahoma. Admitting physicians are primarily practitioners in the local area. The Hospital was incorporated in Oklahoma in 20X1 and is affiliated with the Sample Health System.

Use of estimates. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and cash equivalents. Cash and cash equivalents include certain investments in highly liquid debt instruments with original maturities of three months or less.

The Hospital routinely invests its surplus operating funds in money market mutual funds. These funds generally invest in highly liquid U.S. government and agency obligations.

Investments. Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value in the balance sheet. Investment income or loss (including realized gains and losses on investments, interest and dividends) is included in the excess of revenues over expenses unless the income or loss is restricted by donor or law. Unrealized gains and losses on investments are excluded from the excess of revenues over expenses unless the investments are trading securities.

Assets limited as to use. Assets limited as to use primarily include assets held by trustees under indenture agreements and designated assets set aside by the Board of Trustees for future capital improvements, over which the Board retains control and may at its discretion subsequently use for other purposes. Amounts required to meet current liabilities of the Hospital have been reclassified in the balance sheet at December 31, 20X7 and 20X6.

Property and equipment. Property and equipment acquisitions are recorded at cost. Depreciation is provided over the estimated useful life of each class of depreciable asset and is computed using the straight-line method. Equipment under capital lease obligations is amortized on the straight-line method over the shorter period of the lease term or the estimated useful life of the equipment. Such amortization is included in depreciation and amortization in the financial statements. Interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets.

Gifts of long-lived assets such as land, buildings, or equipment are reported as unrestricted support, and are excluded from the excess of revenues over expenses, unless explicit donor stipulations specify how the donated assets

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[1] Paragraph 13 of SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*, provides guidance on disclosures that should be included in the summary of significant accounting policies, including accounting policies for loans, trade receivables, and doubtful accounts.

must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

Temporarily and permanently restricted net assets. Temporarily restricted net assets are those whose use by the Hospital has been limited by donors to a specific time period or purpose. Permanently restricted net assets have been restricted by donors to be maintained by the Hospital in perpetuity.

Excess of revenues over expenses. The statement of operations includes excess of *revenues over expenses.* Changes in unrestricted net assets which are excluded from excess of revenues over expenses, consistent with industry practice, include unrealized gains and losses on investments other than trading securities, permanent transfers of assets to and from affiliates for other than goods and services, and contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purposes of acquiring such assets).

Net patient service revenue. The Hospital has agreements with third-party payors that provide for payments to the Hospital at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and per diem payments. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined.

Premium revenue. The Hospital has agreements with various Health Maintenance Organizations (HMOs) to provide medical services to subscribing participants. Under these agreements, the Hospital receives monthly capitation payments based on the number of each HMO's participants, regardless of services actually performed by the Hospital. In addition, the HMOs make fee-for-service payments to the Hospital for certain covered services based upon discounted fee schedules.

Charity care. The Hospital provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Because the Hospital does not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue.

Donor-restricted gifts. Unconditional promises to give cash and other assets to the Hospital are reported at fair value at the date the promise is received. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gift is received. The gifts are reported as either temporarily or permanently restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the statement of operations as net assets released from restrictions. Donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the accompanying financial statements.

Estimated malpractice costs. The provision for estimated medical malpractice claims includes estimates of the ultimate costs for both reported claims and claims incurred but not reported.

Income taxes. The Hospital is a not-for-profit corporation and has been recognized as tax-exempt pursuant to Sec. 501(c)(3) of the Internal Revenue Code.

2. Net Patient Service Revenue

The Hospital has agreements with third-party payors that provide for payments to the Hospital at amounts different from its established rates. A summary of the payment arrangements with major third-party payors follows:

- *Medicare.* Inpatient acute care services and outpatient services rendered to Medicare program beneficiaries are paid at prospectively determined rates. These rates vary according to a patient classification system that is based on clinical, diagnostic, and other factors. Inpatient nonacute services and defined capital and medical education costs related to Medicare beneficiaries are paid based on a cost reimbursement methodology. The Hospital is reimbursed for cost reimbursable items at a tentative rate with final settlement determined after submission of annual cost reports by the Hospital and audits thereof by the Medicare fiscal intermediary. Beginning in 20X3, the Hospital claimed Medicare payments based on an interpretation of certain "disproportionate share" rules. The intermediary disagreed and declined to pay the excess reimbursement claimed under that interpretation. Through 1996, the Hospital has not included the claimed excess in net patient revenues pending resolution of the matter. In 20X7, the intermediary accepted the claims and paid the outstanding claims, including $950,000 applicable to 20X6 and $300,000 applicable to 20X5 and prior, which has been included in 20X7 net revenues.
- *Medicaid.* Inpatient and outpatient services rendered to Medicaid program beneficiaries are reimbursed under a cost reimbursement methodology. The Hospital is reimbursed at a tentative rate with final settlement determined after submission of annual cost reports by the Hospital and audits thereof by the Medicaid fiscal intermediary.

Revenue from the Medicare and Medicaid programs accounted for approximately XX percent and XX percent, respectively, of the Hospital's net patient revenue for the year ended 20X7, and XX percent and XX percent, respectively, of the Hospital's net patient revenue, for the year ended 20X6. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. The 20X6 net patient service revenue increased approximately $XXX due to removal of allowances previously estimated that are no longer necessary as a result of final settlements and years that are no longer subject to audits, reviews, and investigations. The 20X7 net patient service revenue decreased approximately $XXX due to prior-year retroactive adjustments in excess of amounts previously estimated.

The Hospital also has entered into payment agreements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations. The basis for payment to the Hospital under these agreements includes prospectively determined rates per discharge, discounts from established charges, and prospectively determined daily rates.

3. Investments

Assets Limited as to Use

The composition of assets limited as to use at December 31, 20X7 and 20X6, is set forth in the following table. Investments are stated at fair value.

	20X7	20X6
Internally designated for capital acquisition:		
Cash	$ 545,000	$ 350,000
U.S. Treasury obligations	11,435,000	12,115,000
Interest receivable	20,000	35,000
	12,000,000	12,500,000
Held by trustee under indenture agreement:		
Cash and short-term investments	352,000	260,000
U.S. Treasury obligation	6,505,000	7,007,000
Interest receivable	92,000	74,000
	6,949,000	7,341,000
	$18,949,000	$19,841,000

Other Investments

Other investments, stated at fair value, at December 31, 20X7 and 20X6, include:

	20X7	20X6
Trading:		
U.S. Corporate Bonds	$ 1,260,000	$ 1,475,000
Other:		
U.S. Treasury obligations	$19,266,000	$14,233,000
Interest receivable	310,000	232,000
	20,836,000	15,940,000
Less:		
Long-term investments	4,680,000	4,680,000
Long-term investments restricted for capital acquisitions	320,000	520,000
Short-term investments	$15,836,000	$10,740,000

Investment income and gains for assets limited as to use, cash equivalents, and other investments are comprised of the following for the years ending December 31, 20X7 and 20X6:

	20X7	20X6
Income:		
Interest income	$3,585,000	$2,725,000
Realized gains on sales of securities	150,000	200,000
Unrealized gains on trading securities	165,000	100,000
	$3,900,000	$3,025,000
Other Changes in Unrestricted Net Assets:		
Unrealized gains on other than trading securities	$ 300,000	$ 375,000

4. Property and Equipment

A summary of property and equipment at December 31, 20X7 and 20X6, follows:

	20X7	20X6
Land	$ 3,000,000	$ 3,000,000
Land improvements	472,000	472,000
Buildings and improvements	46,852,000	46,636,000
Equipment	29,190,000	26,260,000
Equipment under capital lease obligations	2,851,000	2,752,000
	82,365,000	79,120,000
Less accumulated depreciation and amortization	34,928,000	30,661,000
	47,437,000	48,459,000
Construction in progress	3,601,000	2,033,000
Property and equipment, net	$51,038,000	$50,492,000

Depreciation expense for the years ended December 31, 20X7 and 20X6 amounted to approximately $4,782,000 and $4,280,000. Accumulated amortization for equipment under capital lease obligations was $689,000 and $453,000 at December 31, 20X7 and 20X6, respectively. Construction contracts of approximately $7,885,000 exist for the remodeling of Hospital facilities. At December 31, 20X7, the remaining commitment on these contracts approximated $4,625,000.

5. Long-Term Debt

A summary of long-term debt and capital lease obligations at December 31, 20X7 and 20X6, follows:

	20X7	20X6
7.25 percent 20X7 Tax-Exempt Revenue Bonds, principal maturing in varying annual amounts, due November 1, 20XX, collateralized by a pledge of the Hospital's gross receipts	$21,479,000	
8.50 percent 20X2 Tax-Exempt Revenue Bonds, principal maturing in varying annual amounts, due June 1, 20XX		$22,016,000
7.75 percent mortgage loan, principal maturing in varying annual amounts, due January 20XX, collateralized by a mortgage on certain property and equipment	2,010,000	2,127,000
7.75 percent note payable, payable in monthly installments of $12,000, including interest, due March 20XX, unsecured	125,000	671,000
Capital lease obligations, at varying rates of imputed interest from 6.8 percent to 9.3 percent collateralized by leased equipment	1,000,000	950,000
	24,614,000	25,764,000
Less current portion	1,470,000	1,750,000
	$23,144,000	$24,014,000

Under the terms of the 20X7 and 20X2 revenue bond indentures, the Hospital is required to maintain certain deposits with a trustee. Such deposits are included with assets limited as to use. The revenue note indenture also places limits on the incurrence of additional borrowings and requires that the Hospital satisfy certain measures of financial performance as long as the notes are outstanding.

Scheduled principal repayments on long-term debt and payments on capital lease obligations are as follows:

Year Ending December 31,	*Long-Term Debt*	*Capital Leases Obligations*
20X8	$ 970,000	$ 550,000
20X9	912,000	260,000
20Y0	983,000	260,000
20Y1	1,060,000	45,000
20Y2	1,143,000	—
Thereafter	18,546,000	—
	$23,614,000	1,115,000
Less amount representing interest under capital leases obligations		115,000
		$1,000,000

A summary of interest cost and investment income on borrowed funds held by the trustee under the 20X7 and 20X2 revenue bond indentures during the years ended December 31, 20X7 and 20X6, follows:

	20X7	*20X6*
Interest cost:		
Capitalized	$ 740,000	$ 700,000
Charged to operations	1,752,000	1,825,000
Total	$2,492,000	$2,525,000
Investment income:		
Capitalized	$ 505,000	$ 663,000
Credited to other revenue	330,000	386,000
Total	$ 835,000	$1,049,000

6. Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are available for the following purposes or periods at December 31, 20X7 and 20X6:

	20X7	*20X6*
Health care services		
Purchase of equipment	$ 320,000	$ 520,000
Indigent care	840,000	950,000
Health education	350,000	400,000
For periods after December 31, 20X9	605,000	600,000
	$2,115,000	$2,470,000

Permanently restricted net assets at December 31, 20X7 and 20X6, are restricted to:

	20X7	20X6
Investments to be held in perpetuity, the income from which is expendable to support health care services (reported as operating income)	$2,973,000	$2,923,000
Endowment requiring income to be added to original gift until fund value is $1,500,000	615,000	610,000
	$3,588,000	$3,533,000

During 20X7, net assets were released from donor restrictions by incurring expenses satisfying the restricted purposes of indigent care and health care education in the amounts of $250,000 and $50,000, respectively.

7. Medical Malpractice Claims

The Hospital purchases professional and general liability insurance to cover medical malpractice claims. There are known claims and incidents that may result in the assertion of additional claims, as well as claims from unknown incidents that may be asserted arising from services provided to patients. The Hospital has employed independent actuaries to estimate the ultimate costs, if any, of the settlement of such claims. Accrued malpractice losses have been discounted at 7 percent and in management's opinion provide an adequate reserve for loss contingencies.

On March 15, 20X7, a patient filed a suit against the Hospital for malpractice during care received as an inpatient. The Hospital believes it has meritorious defenses against the suit; however, the ultimate resolution of the matter could result in a loss. The patient has claimed $16 million in actual damages. Under state law, punitive damages are determined at trial. The Hospital maintains insurance coverage for malpractice claims. The coverage does not include punitive damages awards. Trial is scheduled to occur within the next year.

8. Pension and Other Postretirement Benefit Plans[2,†]

[*The following paragraph is encouraged but not required.*]

The Hospital has a defined benefit pension plan covering substantially all of its employees. The plan benefits are based on years of service and the employees'

[2] The disclosures for pensions and other postretirement benefits in this note to the illustrative financial statements have been modified to reflect the requirements of FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits* (revised 2003). FASB Statement No. 132 (revised 2003), is effective for fiscal years ending after December 15, 2003, with certain exceptions. Interim-period disclosures are effective for interim periods beginning after December 15, 2003. The provisions of FASB Statement No. 132 remain in effect until the provisions of FASB Statement No. 132 (revised 2003), are adopted. This note to the financial statements illustrates the financial statement disclosures about pension and postretirement benefit plans for a public entity. Readers should refer to FASB Statement No. 132 (revised), when considering disclosure requirements for nonpublic entities.

[†] Readers may also need to consider the accounting and disclosure requirements of FASB Staff Position (FSP) No. 106-1, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*, and FSP No. 106-2, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*, when an employer provides postretirement prescription drug coverage. FSP No. 106-2, which supersedes FSP No. 106-1, is effective, with exception for certain nonpublic entities, for the first interim or annual period beginning after June 15, 2004. For a nonpublic entity, as defined in FASB Statement No. 87, *Employers' Accounting for Pensions*, that sponsors one or more defined benefit postretirement health care plans that provide prescription drug coverage but of which no plan has more than 100 participants, FSP No. 106-2 is effective for fiscal years beginning after December 15, 2004. Earlier application is encouraged.

compensation during the last five years of covered employment. Contributions are intended to provide not only for benefits attributed to service to date but also for those expected to be earned in the future.

The Hospital also sponsors two defined benefit postretirement plans that cover both salaried and nonsalaried employees. One plan provides medical and dental benefits, and the other provides for the payment of life insurance premiums. The postretirement health care plan is contributory, with retiree contributions adjusted annually; the life insurance plan is noncontributory. The accounting for the health care plan anticipates future cost-sharing changes to the written plan that are consistent with the Hospital's expressed intent to increase retiree contributions each year to 50 percent of the excess of the expected general inflation rate over 6 percent. Beginning in 20X7, the Hospital adopted a funding policy for its postretirement health care plan similar to its funding policy for its life insurance plan—an amount equal to a level percentage of the employees' salaries is contributed to the plan annually. For 20X7, that percentage was 4.25, and the aggregate contribution for both plans was $34,000. The Hospital uses a December 31 measurement date for its plans.

The following table sets forth the changes in benefit obligations, changes in plan assets and components of net periodic benefit cost for both the pension plan and the other postretirement benefit plans:

	Pension Benefits		*Other Benefits*	
	20X7	*20X6*	*20X7*	*20X6*
Change in benefit obligation:				
Benefit obligation at beginning of year	$ 9,710	$ 9,700	$ 585	$ 500
Service cost	905	770	14	15
Interest cost	700	650	50	44
Plan participants' contributions			34	34
Actuarial gain	(20)		(7)	
Benefits paid	(375)	(1,410)	(66)	(8)
Benefit obligation at end of year	10,920	9,710	610	585
Change in plan assets:				
Fair value of plan assets at beginning of year	9,800	9,610	89	40
Actual return on plan assets	759	810	4	4
Employer contribution	866	790	39	19
Plan participants' contributions			34	34
Benefits paid	(375)	(1,410)	(66)	(8)
Fair value of plan assets at end of year	11,050	9,800	100	89
Funded status	130	90	(510)	(496)
Unrecognized net actuarial gain	(30)	(40)	(30)	(40)
Unrecognized prior service cost	50	55	16	19
Unrecognized transition obligation			445	470
Unrecognized transition asset	(15)	(20)		
Prepaid (accrued) benefit cost	$ 135	$ 85	$ (79)	$ (47)

The accumulated benefit obligation for the defined benefit pension plan was $XXX and $XXX at December 31, 20X7, and 20X6, respectively.

	Pension Benefits		*Other Benefits*	
	20X7	*20X6*	*20X7*	*20X6*
Components of net periodic benefit cost:				
Service cost	$ 905	$ 770	$14	$15
Interest cost	700	650	50	44
Expected return on plan assets	(784)	(769)	(6)	(3)
Amortization of prior service cost	5	7	3	2
Recognized net actuarial (gain)	(5)	(2)	(15)	(1)
Amortization of transition obligation			25	25
Amortization of transition asset	(5)	(1)		
Net periodic benefit cost	$ 816	$ 655	$71	$82

Additional Information

Assumptions

Weighted-average assumptions used to determine benefit obligations at December 31				
Discount rate	7.00%	7.00%	7.00%	7.00%
Rate of compensation increase	6.00%	6.00%		
Weighted-average assumptions used to determine net periodic benefit cost for years ended December 31				
Discount rate	7.00%	7.00%	7.00%	7.00%
Expected long-term return on plan assets	8.00%	8.00%	6.60%	6.60%
Rate of compensation increase	6.00%	6.00%		

(Entity specific narrative description of the basis used to determine the overall expected long-term rate of return on assets, as described in paragraph 5(d)(3) of FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits* (revised 2003), would be included here.)

Assumed health care cost trend rates at December 31		
Health care cost trend rate assumed for next year	7%	7%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	5%	5%
Year that the rate reaches the ultimate trend rate	20Y2	20Y2

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A one-percentage-point change in assumed health care cost trend rates would have the following effects:

	1-Percentage-Point Increase	*1-Percentage-Point Decrease*
Effect on total of service and interest cost	$13	$(11)
Effect on postretirement benefit obligation	73	(67)

Plan Assets

The composition of plan assets at December 31, 20X7, and 20X6, is as follows:

	Pension Benefits		*Other Benefits*	
	20X7	*20X6*	*20X7*	*20X6*
Asset Category	XX%	XX%	XX%	XX%
Equity securities	XX	XX	XX	XX
Debt securities	XX	XX	XX	XX
Real estate	XX	XX	XX	XX
Other	XX	XX	XX	XX
Total	100%	100%	100%	100%

(Entity specific narrative description of investment policies and strategies for plan assets, including weighted-average target asset allocations [if used as part of those policies and strategies] as described in paragraph 5(d)(2) of FASB Statement No. 132 (revised), would be included here.)

Cash Flows

Contributions

The Hospital expects to contribute $XXX to its pension plan and $XXX to its other postretirement benefit plan in 20X8.

Estimated Future Benefit Payments

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid:

	Pension Benefits	*Other Benefits*
20X8	$XXX	$XXX
20X9	XXX	XXX
20Y0	XXX	XXX
20Y1	XXX	XXX
20Y2	XXX	XXX
Years 20Y3–20Y7	XXX	XXX

9. Concentrations of Credit Risk

The Hospital grants credit without collateral to its patients, most of whom are local residents and are insured under third-party payor agreements. The mix of receivables from patients and third-party payors at December 31, 20X7 and 20X6, was as follows:

	20X7	20X6
Medicare	51%	53%
Medicaid	17	14
Blue Cross	18	17
Other third-party payors	7	9
Patients	7	7
	100%	100%

10. Commitments and Contingencies

Operating leases. The Hospital leases various equipment and facilities under operating leases expiring at various dates through April 20Y2. Total rental expense in 20X7 and 20X6 for all operating leases was approximately $859,000 and $770,000, respectively.

The following is a schedule by year of future minimum lease payments under operating leases as of December 31, 20X7, that have initial or remaining lease terms in excess of one year.

Year Ending December 31,	*Amount*
20X8	$517,000
20X9	506,000
20Y0	459,000
20Y1	375,000
20Y2	343,000

Litigation. The Hospital is involved in litigation and regulatory investigations arising in the course of business. After consultation with legal counsel, management estimates that these matters will be resolved without material adverse effect on the Hospital's future financial position or results from operations.

Allowance for doubtful accounts. Beginning in 20X5, the Hospital has provided care under an agreement with Associated HMO. The HMO currently owes the Hospital $950,000, substantially all of which is overdue. The Hospital has notified the HMO that further services under the contract cannot be provided without payment on the outstanding balance. The HMO has assured the Hospital that additional funds are being obtained in order to pay the overdue balance and continue service under the agreement, however, if the HMO is unable to make payments, additional allowances for bad debts would need to be accrued.

11. Related Party Transactions

During the years ended December 31, 20X7 and 20X6, the Hospital contributed capital to Sample Health System, an affiliate with some board members in common with the Hospital, in the amounts of $688,000 and $3,051,000, respectively.

The Sample Hospital Foundation (the Foundation), which is controlled by Sample Health System, was established to solicit contributions from the general public solely for the funding of capital acquisitions by the Hospital. Funds are distributed to the Hospital as determined by the Foundation's Board of Directors. A summary of the foundation's assets, liabilities, net assets, results of operations, and changes in net assets follows. The Hospital's interest in the net assets of the Foundation is reported as a non-current asset in the balance sheets.

	At December 31,	
	20X7	20X6
Assets, principally cash and cash equivalents	$521,000	$472,000
Liabilities	11,000	10,000
Unrestricted net assets	510,000	462,000
Total liabilities and net assets	$521,000	$472,000
Support and revenue	$269,000	$535,000
Expenses		
Distributions to Sample Hospital for property acquisitions	235,000	485,000
Other	13,000	16,000
Total expenses	248,000	501,000
Excess of support and revenue over expenses	21,000	34,000
Other changes in net assets	27,000	17,000
Unrestricted net assets, beginning of year	462,000	411,000
Unrestricted net assets, end of year	$510,000	$462,000

Liabilities include $10,000 payable at the end of each year to Sample Hospital. These amounts were paid after the end of each year.

12. Functional Expenses

The Hospital provides general health care services to residents within its geographic location. Expenses related to providing these services are as follows (in thousands):

	At December 31,	
	20X7	20X6
Health care services	$86,000	$78,647
General and administrative	12,055	10,643
	$98,055	$89,290

13. Fair Value of Financial Instruments

The following methods and assumptions were used by the Hospital in estimating the fair value of its financial instruments:

Cash and cash equivalents: The carrying amount reported in the balance sheet for cash and cash equivalents approximates its fair value.

Investments: Fair values, which are the amounts reported in the balance sheet, are based on quoted market prices, if available, or estimated using quoted market prices for similar securities.

Assets limited as to use: These assets consist primarily of cash and short-term investments and interest receivable. The carrying amount reported in the balance sheet is fair value.

Accounts payable and accrued expenses: The carrying amount reported in the balance sheet for accounts payable and accrued expenses approximates its fair value.

Estimated third-party payor settlements: The carrying amount reported in the balance sheet for estimated third-party payor settlements approximates its fair value.

Long-term debt: Fair values of the Hospital's revenue notes are based on current traded value. The fair value of the Hospital's remaining long-term debt is estimated using discounted cash flow analyses, based on the Hospital's current incremental borrowing rates for similar types of borrowing arrangements.

The carrying amounts and fair values of the Hospital's financial instruments at December 31, 20X7 and 20X6, are as follows (In thousands):

	20X7		*20X6*	
	Carrying Amount	*Fair Value*	*Carrying Amount*	*Fair Value*
Cash and cash equivalents	$ 4,758	$ 4,758	$ 5,877	$ 5,877
Short-term investments	15,836	15,836	10,740	10,740
Assets limited as to use	18,949	18,949	19,841	19,841
Long-term investments	4,680	4,680	4,680	4,680
Long-term investments restricted for capital acquisition	320	320	520	520
Accounts payable and accrued expenses	5,818	5,818	5,382	5,382
Estimated third-party payor settlements	2,143	2,143	1,942	1,942
Long-term debt	24,614	23,980	25,764	24,918

14. Promises to Contribute

At December 31, 20X7, the Hospital had received $1,500,000 of conditional promises to contribute to the building of a new facility for outpatient services. These contributions will be recorded as temporarily restricted support when received. The Hospital had no material outstanding unconditional promises of support at December 31, 20X7.

15. Charity Care

The amount of charges foregone for services and supplies furnished under the Hospital's charity care policy aggregated approximately $4,500,000 and $4,100,000 in 20X7 and 20X6, respectively.

16. Subsequent Event

On February 9, 20X8, the Hospital signed a contract in the amount of $1,050,000 for the purchase of certain real estate.

Illustrative Management's Discussion and Analysis and Financial Statements

Sample Governmental Hospital Authority
A Component Unit of Feeling County, State of Union
Management's Discussion and Analysis

Our discussion and analysis of Sample Hospital Authority's (Authority's) financial performance provides an overview of the Authority's financial activities for the fiscal years ended December 31, 20X7 and 20X6. Please read it in conjunction with the Authority's financial statements, which begin on page XXX. Unless otherwise indicated, amounts are in thousands.

Financial Highlights

- The Authority's net assets increased in each of the past two years with a $4,225 or 6.6 percent increase in 20X7 and a $9,460 or 17.4 percent increase in 20X6.
- The Authority reported increased operating losses in both 20X7 ($24,403) and 20X6 ($13,365). Losses in 20X7 increased by $11,038 or 82.6 percent over the loss reported in 20X6. Operating losses in 20X6 increased by $4,020 or 43.0 percent.
- Nonoperating revenues increased by $7,890 or 39.6 percent in 20X7 compared to 20X6. Nonoperating revenues also increased in 20X6 by $1,139 or 6 percent compared to 20X5.

Using This Annual Report

The Authority's financial statements consist of three statements—a Balance Sheet; a Statement of Revenues, Expenses, and Changes in Net Assets; and a Statement of Cash Flows. These financial statements and related notes provide information about the activities of the Authority, including resources held by the Authority but restricted for specific purposes by contributors, grantors, or enabling legislation.

The Balance Sheet and Statement of Revenues, Expenses, and Changes in Net Assets

Our analysis of the Authority finances begins on page XXX. One of the most important questions asked about the Authority's finances is, "Is the Authority as a whole better or worse off as a result of the year's activities?" The Balance Sheet and the Statement of Revenues, Expenses, and Changes in Net Assets report information about the Authority's resources and its activities in a way that helps answer this question. These statements include all restricted and unrestricted assets and all liabilities using the accrual basis of accounting. All of the current year's revenues and expenses are taken into account regardless of when cash is received or paid.

These two statements report the Authority's net assets and changes in them. You can think of the Authority's net assets—the difference between assets and liabilities—as one way to measure the Authority's financial health, or financial position. Over time, increases or decreases in the Authority's net assets are one indicator of whether its financial health is improving or deteriorating. You will need to consider other nonfinancial factors, however, such as changes in the Authority's patient base and measures of the quality of service it provides to the community, as well as local economic factors to assess the overall health of the Authority.

The Statement of Cash Flows

The final required statement is the Statement of Cash Flows. The statement reports cash receipts, cash payments, and net changes in cash resulting from operations, investing, and financing activities. It provides answers to such questions as "Where did cash come from?" "What was cash used for?" and "What was the change in cash balance during the reporting period?"

The Authority's Net Assets

The Authority's net assets are the difference between its assets and liabilities reported in the Balance Sheet on page X. The Authority's net assets increased in each of the past two years by $4,225 (6.6 percent) in 20X7 and $9,460 (17.4 percent) in 20X6, as you can see from **Table 1**.

Table 1: Assets, Liabilities, and Net Assets

	20X7	*20X6*	*20X5*
Assets:			
Current assets	$32,382	$30,135	$26,070
Capital assets, net	43,382	42,918	42,445
Other noncurrent assets	25,118	23,494	19,767
Total assets	**100,882**	**96,547**	**88,282**
Liabilities:			
Long-term liabilities	23,033	23,102	24,349
Other liabilities	9,690	9,511	9,459
Total liabilities	**32,723**	**32,613**	**33,808**
Net assets:			
Invested in capital assets, net of related debt	22,460	21,018	18,649
Restricted for debt service	1,945	2,005	2,035
Restricted expendable net assets	1,845	2,100	2,075
Restricted nonexpendable net assets	3,003	2,919	2,652
Unrestricted	38,906	35,892	29,063
Total net assets	**$68,159**	**$63,934**	**$54,474**

A significant component of the change in the Authority's assets is the increase in patient accounts receivable. Although operating revenues decreased in 20X7 by $3,445 (5.7 percent), patient accounts receivable, net of estimated uncollectible amounts, increased by $3,107 or 18.6 percent in 20X7. In addition,

patient service revenue decreased by $2,105 in 20X6 compared to 20X5, but receivables increased by $2,114 or 14.5 percent. In both cases, the increase in accounts receivable is primarily the result of overall slowdowns by health insurers in making payments in attempting to cut costs by managing their cash flows.

Operating Results and Changes in The Authority's Net Assets

In 20X7, the Authority's net assets increased by $4,225 or 6.6 percent, as shown in Table 2. This increase is made up of very different components. And it represents a decline of 55.3 percent compared with the increase in net assets for 20X6 of $9,460.

Table 2: Operating Results and Changes in Net Assets

	20X7	*20X6*	*20X5*
Operating Revenues:			
Net patient service revenues	$43,305	$43,736	$45,841
Premium revenues	9,876	13,058	12,976
Other operating revenues	3,416	3,248	2,910
Total operating revenues	56,597	60,042	61,727
Operating Expenses:			
Salaries and benefits	46,845	43,235	40,640
Medical supplies and drugs	12,746	7,986	6,788
Depreciation and amortization	4,065	3,638	3,508
Other operating expenses	17,344	18,548	20,136
Total operating expenses	81,000	73,407	71,072
Operating loss	(24,403)	(13,365)	(9,345)
Nonoperating Revenues and Expenses			
Property taxes	23,895	15,309	14,875
Investment income	5,653	5,304	5,108
Noncapital grants and contributions	170	853	510
Other nonoperating revenues and expenses, net	(1,914)	(1,552)	(1,718)
Total nonoperating revenues (expenses)	27,804	19,914	18,775
Excess of revenues over expenses before capital grants, contributions, and additions to permanent endowments	**3,401**	**6,549**	**9,430**
Grants, Contributions, and Endowments			
Capital grants and contributions	824	2,560	1,980
Additions to permanent endowments		351	—
Increase in net assets	$ 4,225	$ 9,460	$11,410
Net assets end of year	$68,159	$63,934	$ 4,474

Operating Losses

The first component of the overall change in the Authority's net assets is its operating income (loss)—generally, the difference between net patient service and Premium revenues and the expenses incurred to perform those services. In each of the past two years, the Authority has reported an operating loss. This is consistent with the Authority's entire operating history. The Authority's hospital operations were begun in 19XX as a municipal hospital, when it was agreed that a portion of its costs would be subsidized by property tax revenues, making the facility more affordable for the County's lower income residents. However, in each of the past two years, operating losses have increased. Losses in 20X7 increased by $11,038 or 82.6 percent higher than the loss reported in 20X6. Operating losses in 20X6 increased by $4,020 or 43.0 percent.

The primary components of these increased operating losses are:

- A decrease in premium revenue of $3,182 or 24.4 percent in 20X7. (Premium revenues in 20X6 were roughly the same as in the previous year.)
- Increases in salary and benefit costs for the hospital's employees ($3,610 or 8.4 percent in 20X7 and $2,595 or 6.4 percent in 20X6).
- Increases in medical supply and drug costs of $4,760 or 59.6 percent in 20X7 and of $1,198 or 17.6 percent in 20X6.
- An increase in the level of uncompensated care provided. These are services provided for which there is no expectation of payment.

Premium revenues from contracts with health maintenance organizations decreased in 20X7 primarily because of changes in the fixed amount per individual per month (capitation rate) paid by the Acme Health Maintenance Group. Acme is the HMO for the County's largest employer, the XYZ Motor Company. The Authority, (with the assistance of the County), negotiated a new 4-year contract with Acme in 20X6. Those negotiations resulted in a 15 percent reduction in capitation rates in 20X7. Under the contract, capitation rates increase by 3 percent each year for the next three years. At the same time, the Authority (with the County's approval) agreed to increase its property tax levy by 10 percent, as discussed below.

Employee salary and benefits costs increased in 20X6 and again in 20X7 based on rates established in labor contracts negotiated in 20X5 and 20X6. Current labor contracts for all of the Authority's unionized employees extend until 20Y1.

The rate of healthcare inflation has a direct effect on the cost of services provided by the Authority. A component of the Authority's costs are expenses for medical supplies and prescription drugs. In 20X5, medical supplies and prescription drug costs totaled $6.8 million. In 20X6, they totaled $8.0 million or 10.7 percent of total expenses and an increase of 17.6 percent over 20X5. And, in 20X7, medical supplies and prescription drug costs totaled $12.7 million, representing 15.6 percent of total expenses and an increase of 59.6 percent over 20X6. Some of the major factors contributing to the increased medical supply and drug costs include the introduction of new drugs that cannot be obtained in generic form, and changes in therapeutic mix. In addition, in 20X7, the company that the Authority used as its major wholesale drug supplier filed for bankruptcy. The Authority negotiated new contracts with other suppliers at substantially higher costs. At its August 20X7 meeting, the Authority's Board of Trustees authorized management to explore other supplier options.

The Authority sometimes provides care for patients who have little or no health insurance or other means of repayment. As discussed, this service to the community is consistent with the goals established for the Authority when it was established in 19XX. The level of services provided to these patients increased by $1,200 in 20X6 compared to 20X5. In 20X7, the costs of uncompensated care increased by $255. Because there is no expectation of repayment, charity care is not reported as patient service revenues of the Authority.

Nonoperating Revenues and Expenses

Nonoperating revenues consist primarily of property taxes levied by the Authority and interest revenue and investment earnings. During its negotiations with Acme and XYZ, discussed earlier, the Authority agreed—with the County's approval—to increase its property tax levy to County residents by 10 percent. County voters approved this increase in November 20X6. In addition, a 35 percent increase in the sales of new homes in the County in 20X6 and 20X5 as well as additions of new commercial and manufacturing facilities resulted in an increase in the County's grand list. The grand list is calculated as of July 1 each year and used as the basis for tax levies on January 1. As a result of both of these factors, nonoperating tax revenues increased by $8,586 or 56.1 percent in 20X7 compared to a $434 (2.9 percent) increase in 20X6.

Grants, Contributions, and Endowments

The Authority receives both capital and operating grants from various state and federal agencies for specific programs. These are discussed in detail in Note 2 to the financial statements. Capital and operating grants received in 20X7 from the State of Union declined due to fiscal/budgetary issues at the state from $3,085 in 20X6 ($2,300 capital and $785 operating) to $800 in 20X7 ($650 capital and $150 operating). Although $1,640 in grants have been budgeted by the state for the Authority in 20X8, it is not clear whether monies to fund these grants will be appropriated.

The Authority received $351 in permanent endowments in 20X6 from the AIA Foundation. Earnings from investing the principal of this endowment must be used to support expenditures for Program A research. This is in contrast to an increase in state funding of $580 in 20X6 compared to 20X5. The Authority has received other permanent endowments in the past. Restrictions established by these endowments are detailed in Note 2 to the financial statements.

The Authority's Cash Flows

Changes in the Authority's cash flows are consistent with changes in operating losses and nonoperating revenues and expenses, discussed earlier, with one exception. Cash flows used by operating activities increased slightly more than operating losses in both 20X7 and 20X6 due to increases in the Authority's patient accounts receivable, discussed earlier.

Capital Asset and Debt Administration

Capital Assets

At the end of 20X7, the Authority had $43.3 million invested in capital assets, net of accumulated depreciation, as detailed in Note 7 to the financial statements. In 20X7, the Authority purchased new equipment costing $4,529. Of this, $510 was acquired through capital leases. Nearly the same amount—$4,111—was spent to acquire new equipment in 20X6. Both of these amounts

are less than 20X5, when the Authority spent $7,308 for new equipment. The Authority has recently found it more economical to lease much of its equipment. This allows the Authority to avoid some of the costs of obsolescence caused by technological changes.

In August 20X5, the Authority's Board of Trustees approved a resolution setting aside $15 million of its unrestricted net assets for future expansion of the hospital and possible addition of a cancer care wing. The Board of Trustees held a special meeting in September 20X7 to reconsider the feasibility of the project and held initial meetings with several local architectural firms in January 20X8. No decisions have been reached as of the date of this annual report.

Debt

At year-end, the Authority had $20.9 in revenue notes, mortgage loans, and capital lease obligations outstanding as detailed in Note 8 to the financial statements. Except for capital leases of $510 initiated in 20X7, the Authority issued no new debt in 20X7 or 20X6. The Authority's formal debt issuances—revenue notes—cannot be issued without approval of the Feeling County Board of Commissioners. The amount of debt issued is subject to limitations that apply to the County and its component units as a whole. There have been no changes in the Authority's debt ratings in the past two years.

Other Economic Factors

The County's largest employer, the XYZ Motor Company, has a number of operating plants throughout the country. In late 20X5, XYZ announced that it would close its plant in New City, Ohio and move the majority of that plant's operations (including up to 2,000 full-time employees) to its Feeling County plant. Work on that move began in May 20X6.

Contacting The Authority's Financial Management

This financial report is designed to provide our patients, suppliers, taxpayers, and creditors with a general overview of the Authority's finances and to show the Authority's accountability for the money it receives. If you have questions about this report or need additional financial information, contact the Authority Controller's Office, at Sample Hospital Authority, 92 Third Street, Anytown, UN 01000.

ILLUSTRATIVE FINANCIAL STATEMENTS FOR A GOVERNMENTAL HOSPITAL AUTHORITY

Sample Governmental Hospital Authority
A Component Unit of Feeling County, State of Union
Balance Sheets[A]
December 31, 20X7 and 20X6
(in thousands)

	20X7	*20X6*
Assets		
Current assets:		
Cash and cash equivalents	$ 7,136	$ 7,557
Short-term investments	3,142	3,423
Patient accounts receivable, net of estimated uncollectibles of $2,125 (20X7) and $2,040 (20X6)	19,834	16,727
Supplies and other current assets	2,270	2,428
Total current assets	32,382	30,135
Noncurrent cash and investments:		
Internally designated for capital acquisitions	15,000	15,000
Other long-term investments	2,605	1,327
Held by trustee for debt service	1,945	2,005
Restricted by contributors and grantors for capital acquisitions and research	1,124	1,078
Principal of permanent endowments	3,003	2,919
Delinquent property taxes	385	229
Capital Assets:		
Land	3,590	3,590
Depreciable capital assets, net of accumulated depreciation	39,792	39,328
Total capital assets, net of accumulated depreciation	43,382	42,918
Other assets	1,056	936
Total assets	$100,882	$96,547

(continued)

[A] As discussed in paragraph 1.17 in this Guide, either a balance sheet or a statement of net assets format may be used.

	20X7	20X6
Liabilities and Net Assets		
Current liabilities:		
Current maturities of long-term debt	$ 1,250	$ 1,488
Accounts payable and accrued expenses	4,945	4,575
Estimated third-party payor settlements	1,822	1,651
Other current liabilities	1,673	1,797
Total current liabilities	9,690	9,511
Long-term debt, net of current maturities	19,672	20,412
Other long-term liabilities	3,361	2,690
Total liabilities	32,723	32,613
Net Assets:[B]		
Invested in capital assets net of related debt	22,460	21,018
Restricted:		
For debt service	1,945	2,005
Expendable for capital acquisitions	733	628
Expendable for research	781	899
Expendable for specific operating activities	331	573
Nonexpendable permanent endowments	3,003	2,919
Unrestricted	38,906	35,892
Total net assets	68,159	63,934
Total liabilities and net assets	$100,882	$96,547

See accompanying notes to financial statements.

[B] As discussed in paragraph 1.18 in this Guide, either "net assets" or "equity" may be used as the label for the difference between assets and liabilities.

Sample Governmental Hospital Authority
A Component Unit of Feeling County, State of Union
Statements of Revenues, Expenses, and Changes in Net Assets[C]
Years Ended December 31, 20X7 and 20X6
(in thousands)

	20X7	*20X6*
Operating revenues:		
Net patient service revenue (net of provision for bad debts of $859 in 20X7 and $938 in 20X6)	$43,305	$43,736
Premium revenue	9,876	13,058
Other	3,416	3,248
Total operating revenues	56,597	60,042
Operating expenses:		
Salaries and benefits	46,845	43,235
Medical supplies and drugs	12,746	7,986
Insurance	7,030	7,382
Other supplies	10,314	11,166
Depreciation and amortization	4,065	3,638
Total operating expenses	81,000	74,407
Operating loss	(24,403)	(13,365)
Nonoperating revenues (expenses):		
Property taxes	23,895	15,309
Investment income	5,653	5,304
Interest expense	(1,489)	(1,552)
Noncapital grants and contributions	170	853
Other	(425)	—
Total nonoperating revenues (expenses)	27,804	19,914
Excess of revenues over expenses before capital grants, contributions, and additions to permanent endowments	3,401	6,549
Capital grants and contributions	824	2,560
Additions to permanent endowments	—	351
Increase in net assets	4,225	9,460
Net assets beginning of the year	63,934	54,474
Net assets end of the year	$68,159	$63,934

See accompanying notes to financial statements.

[C] As discussed in paragraph 1.20 of this Guide, GASB Statement No. 34, paragraph 101, requires proprietary funds and special purpose governments engaged only in business-type activities to present an operating statement that uses an "all-inclusive" format, presenting all changes in both restricted and unrestricted net assets and presenting a final total, "Increase (decrease) in net assets/equity." As discussed in paragraph 1.18 of this Guide, governmental healthcare entities may use either the term "net assets" or "equity" as a label for the difference between assets and liabilities.

Sample Governmental Hospital Authority
A Component Unit of Feeling County, State of Union
Statements of Cash Flows
Years Ended December 31, 20X7 and 20X6
(in thousands)

	20X7	*20X6*
Cash flows from operating activities:		
Receipts from and on behalf of patients	$50,074	$54,680
Payments to suppliers and contractors	(30,029)	(26,634)
Payments to employees	(46,955)	(43,460)
Other receipts and payments, net	4,591	3,597
Net cash provided by operating activities	(22,319)	(11,817)
Cash flows from noncapital financing activities:		
Property taxes	20,739	12,224
Noncapital grants and contributions	170	853
Contributions to permanent endowments	—	351
Other	(425)	—
Net cash provided by noncapital financing activities	20,484	13,428
Cash flows from capital and related financing activities:		
Capital grants and contributions	824	2,560
Property taxes restricted to capital acquisitions	3,000	3,000
Principal paid on long-term debt	(1,488)	(1,896)
Interest paid on long-term debt	(1,489)	(1,552)
Purchase of capital assets	(4,019)	(4,111)
Net cash used by capital and related financing activities	(3,172)	(1,999)
Cash flows from investing activities:		
Interest and dividends on investments	2,737	2,124
Purchases of investments	(1,045)	(289)
Proceeds from sale of investments	2,327	683
Net cash provided by investing activities	4,019	2,518
Net increase (decrease) in cash and cash equivalents	(988)	2,130

(continued)

	20X7	20X6
Cash and cash equivalents, beginning of year	9,101	6,971
Cash and cash equivalents, end of year	$ 8,113	$ 9,101
Reconciliation of cash and cash equivalents to the statement of net assets:		
Cash and cash equivalents in current assets	7,136	7,557
Restricted cash and cash equivalents	977	1,544
Total cash and cash equivalents	$ 8,113	$ 9,101
Reconciliation of operating income (loss) to net cash provided (used) by operating activities:		
Operating loss	($24,403)	($13,365)
Adjustments to reconcile operating income to net cash flows used in operating activities:		
Depreciation and amortization	4,065	3,638
Provision for bad debts	859	938
Changes in:		
Patient accounts receivable	(3,966)	(2,909)
Supplies and other current assets	158	100
Other assets	(120)	—
Accounts payable, accrued expenses, and other current liabilities	246	(225)
Estimated third-party payor settlements	171	(235)
Other liabilities related to operating activities	671	241
Net cash used in operating activities	($22,319)	($11,817)

Noncash Investing, Capital, and Financing Activities:

The Authority entered into capital lease obligations of $510,000 for new equipment in 20X7.

The Authority held investments at December 31, 20X7 with a fair value of $XXX. During 20X7, the net increase in the fair value of these investments was $XXX.

See accompanying notes to financial statements.

Sample Governmental Hospital Authority
A Component Unit of Feeling County, State of Union
Notes to Financial Statements[D]
December 31, 20X7 and 20X6
(in thousands)

1. Description of Reporting Entity and Summary of Significant Accounting Policies

Reporting entity. The Sample Hospital Authority (the Authority) is a public corporation. It was created on January 1, 19XX, by the Board of County Commissioners of Feeling County, State of Union, to operate, control, and manage all matters concerning the County's health care functions. The Board of County Commissioners appoints the Board of Trustee members of the Authority, and the Authority may not issue debt or levy taxes without the county's approval. For this reason, the Authority is considered to be a component unit of Feeling County and is included as a discretely presented component unit in the basic financial statements of the County.

Use of estimates. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Enterprise fund accounting. The Authority uses enterprise fund accounting. Revenues and expenses are recognized on the accrual basis using the economic resources measurement focus. Based on Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, as amended, the Authority has elected to apply the provisions of all relevant pronouncements of the Financial Accounting Standards Board (FASB), including those issued after November 30, 1989, that do not conflict with or contradict GASB pronouncements.

Cash and cash equivalents. Cash and cash equivalents include investments in highly liquid debt instruments with an original maturity of three months or less.

Capital assets. The Authority's capital assets are reported at historical cost. Contributed capital assets are reported at their estimated fair value at the time of their donation. All capital assets other than land are depreciated or amortized (in the case of capital leases) using the straight-line method of depreciation using these asset lives:

Land improvements	15 to 20 years
Buildings and building improvements	20 to 40 years
Equipment, computers, and furniture	3 to 7 years

Costs of borrowing. Except for capital assets acquired through gifts, contributions, or capital grants, interest cost on borrowed funds during the period of

[D] The notes to the financial statements in these illustrative financial statements generally include only disclosures unique to a governmental hospital. The disclosures regarding the accounting policies for the use of estimates and cost of borrowing in note 1; and charity care in note 5 are not unique to a governmental hospital. Also, the notes to the financial statements include disclosures that are not required.

construction of capital assets is capitalized as a component of the cost of acquiring those assets. None of the Authority's interest cost was capitalized in either 20X7 or 20X6.

Property taxes. The Authority received approximately 29 percent in 20X7 and 19 percent in 20X6 of its financial support from property taxes. These funds were used as follows:

	20X7	*20X6*
Used to support operations	$20,895	$12,309
Levied for debt service	3,000	3,000

Property taxes are levied by the County on the Authority's behalf on January 1 and are intended to finance the Authority's activities of the same calendar year. Amounts levied are based on assessed property values as of the preceding July 1.

Property taxes are considered delinquent on the day following each payment due date.

Grants and contributions. From time to time, the Authority receives grants from Feeling County and the State of Union as well as contributions from individuals and private organizations. Revenues from grants and contributions (including contributions of capital assets) are recognized when all eligibility requirements, including time requirements are met. Grants and contributions may be restricted for either specific operating purposes or for capital purposes. Amounts that are unrestricted or that are restricted to a specific operating purpose are reported as nonoperating revenues. Amounts restricted to capital acquisitions are reported after nonoperating revenues and expenses.

Endowments. Endowments are provided to the Authority on a voluntary basis by individuals and private organizations. *Permanent* endowments require that the principal or corpus of the endowment be retained in perpetuity. If a donor has not provided specific instructions, Union state law permits the Authority's Board of Trustees to authorize for expenditure the net appreciation of the investments of endowment funds, as discussed in Note 2.

Restricted resources. When the Authority has both restricted and unrestricted resources available to finance a particular program, it is the Authority's policy to use restricted resources before unrestricted resources.

Net assets. Net assets of the Authority are classified in four components. *Net assets invested in capital assets net of related debt* consist of capital assets net of accumulated depreciation and reduced by the current balances of any outstanding borrowings used to finance the purchase or construction of those assets. *Restricted expendable net assets* are noncapital net assets that must be used for a particular purpose, as specified by creditors, grantors, or contributors external to the Authority, including amounts deposited with trustees as required by revenue bond indentures, discussed in Note 8. *Restricted nonexpendable net assets* equal the principal portion of permanent endowments. *Unrestricted net assets* are remaining net assets that do not meet the definition of *invested in capital assets net of related debt* or *restricted.*

Operating revenues and expenses. The Authority's statement of revenues, expenses and changes in net assets distinguishes between operating and nonoperating revenues and expenses. Operating revenues result from exchange transactions associated with providing health care services—the Authority's

principal activity. Nonexchange revenues, including taxes, grants, and contributions received for purposes other than capital asset acquisition, are reported as nonoperating revenues. Operating expenses are all expenses incurred to provide health care services, other than financing costs.

Compensated absences. The Authority's employees earn vacation days at varying rates depending on years of service. Vacation time does not accumulate. Generally, any days not used at year-end expire. Employees also earn sick leave benefits based on varying rates depending on years of service. Employees may accumulate sick leave up to a specified maximum. Employees are not paid for accumulated sick leave if they leave before retirement. However, employees who retire from the Authority may convert accumulated sick leave to termination payments at varying rates, depending on the employee's contract. The estimated amount of sick leave payable as termination payments is reported as a noncurrent liability in both 20X7 and 20X6.

Risk management. The Authority is exposed to various risks of loss from torts; theft of, damage to, and destruction of assets; business interruption; errors and omissions; employee injuries and illnesses; natural disasters; medical malpractice; and employee health, dental, and accident benefits. Commercial insurance coverage is purchased for claims arising from such matters. Settled claims have not exceeded this commercial coverage in any of the three preceding years.

Investments in debt and equity securities. Investments in debt and equity securities are reported at fair value except for short-term highly liquid investments that have a remaining maturity at the time they are purchased of one year or less. These investments are carried at amortized cost. Interest, dividends, and gains and losses, both realized and unrealized, on investments in debt and equity securities are included in nonoperating revenue when earned.

2. Endowments and Restricted Net Assets

Restricted, expendable net assets are available for the following purposes:

	20X7	*20X6*
Program A activities:		
Purchase of equipment	$ 404	$ 321
Research	553	683
General	46	63
Program B activities:		
Purchase of equipment	235	235
Research	184	151
General	79	110
Program C activities:		
General	206	400
Buildings and equipment	94	72
Research	44	65
Total expendable, restricted net assets	$1,845	$2,100

Unless the contributor provides specific instructions, Union state law permits the Authority Board of Trustees to authorize for expenditure the net appreciation (realized and unrealized) of the investments in its endowments. When

administering its power to spend net appreciation, the Board of Trustees is required to consider the Authority's "long- and short-term needs, present and anticipated financial requirements, expected total return on its investments, price-level trends, and general economic conditions." Any net appreciation that is spent is required to be spent for the purposes designated by the contributor.

The Board of Trustees chooses to spend only a portion of the investment income (including changes in the value of investments) each year. Under the policy established by the Board, 5 percent of the average market value of endowment investments at the end of the previous three years has been authorized for expenditure. The Authority retains the remaining amount, if any, to be used in future years when the amount computed using the spending policy exceeds investment income. At December 31, 20X7 and 20X6, net appreciation of $864 and $953, respectively, is available to be spent, of which $402 and $682, respectively, is reported as restricted expendable net assets, and the balance is in unrestricted net assets.

Restricted nonexpendable net assets as of December 31, 20X7 and 20X6, represent the principal amounts of permanent endowments, restricted to investment in perpetuity. Investment earnings from the Authority's permanent endowments are expendable to support these programs as established by the contributor:

	20X7	*20X6*
Program A activities	$ 158	$ 158
Program B activities	176	176
Program C activities	423	423
Any activities of the Authority	854	854
	1,611	1,611
Endowment requiring income to be added to original gift until the fund's value is $2,125	1,392	1,308
Total restricted nonexpendable net assets	3,003	2,919

3. Designated Net Assets

Of the $40,851 and $37,897 of unrestricted net assets reported in 20X7 and 20X6, respectively, $15,000 has been designated by the Authority's Board of Trustees for capital acquisitions. Designated funds remain under the control of the Board of Trustees, which may at its discretion later use the funds for other purposes.

4. Deposits and Investments[‡]

State law requires collateralization of all deposits with federal depository insurance and other acceptable collateral in specific amounts. The Authority's bylaws require that all bank balances be insured or collateralized by U.S. government securities held by the pledging financial institution's trust department in the name of the Authority.

[‡] GASB Statement No. 40, *Deposit and Investment Risk Disclosures*, an amendment of GASB Statement No. 3, *Deposits with Financial Institutions, Investments (Including Repurchase Agreements), and Reverse Repurchase Agreements*, establishes and modifies disclosure requirements for deposit risks and investment risks. The provisions of GASB Statement No. 40 are effective for financial statements for periods beginning after June 15, 2004. Earlier application is encouraged. Conforming changes to reflect the issuance of GASB Statement No. 40 will be made in a future edition of this Guide.

At December 31, 20X7 and 20X6, the Authority had bank balances as follows:

	20X7	*20X6*
Insured (FDIC)	$3,687	$5,677
Collateralized by securities held by the pledging financial institution's trust department in the Authority's name	1,153	300
Uninsured, uncollateralized or collateralized by securities held by the pledging institution or by its trust department or agent in other than the Authority's name	—	—
Total	$4,840	$5,977
Carrying amount	$5,021	$6,539

Statutes authorize the Authority to invest in obligations of the U.S. Treasury, agencies, and instrumentalities, commercial paper rated A-1 by Standard & Poor's Corporation or P-1 by Moody's Commercial Paper Record, and bankers' acceptances. However, the Authority's bylaws require that investments be made only in U.S. government obligations held by the Authority's third-party agent.

The Authority's investments generally are reported at fair value, as discussed in Note 1. At December 31, 20X7 and 20X6, the Authority's investments consisted of the following, all of which were held in the Authority's name by a custodial bank that is an agent of the Authority:

	20X7	*20X6*
U.S. Treasury Obligations	$21,774	$20,039
U.S. Government Agency Securities	7,160	6,731
	$28,934	$26,770

The carrying amounts of deposits and investments shown above are included in the Authority's balance sheets as follows:

	20X7	*20X6*
Carrying amount		
Deposits	$ 5,021	$ 6,539
Investments	28,934	26,770
	$33,955	$33,309
Included in the following balance sheet captions		
Cash and cash equivalents	$ 7,136	$ 7,557
Short-term investments	3,142	3,423
Noncurrent cash and investments:		
Other long-term investments	2,605	1,327
Restricted by contributors and grantors for capital acquisitions and research	1,124	1,078
Internally designated for capital acquisitions	15,000	15,000
Held by trustee for debt service	1,945	2,005
Principal of permanent endowments	3,003	2,919
	$33,955	$33,309

5. Charity Care

Charges excluded from revenue under the Authority's charity care policy were $7,100 and $6,845 for 20X7 and 20X6, respectively.

6. Accounts Receivable and Payable

Patient accounts receivable and accounts payable (including accrued expenses) reported as current assets and liabilities by the Authority at December 31, 20X7 and 20X6 consisted of these amounts:

Patient Accounts Receivable	*20X7*	*20X6*
Receivable from patients and their insurance carriers	$13,976	$11,868
Receivable from Medicare	4,286	3,002
Receivable from Medicaid	3,697	3,897
Total patient accounts receivable	21,959	18,767
Less allowance for uncollectibles amounts	2,125	2,040
Patient accounts receivable, net	$19,834	$16,727

Accounts Payable and Accrued Expenses	*20X7*	*20X6*
Payable to employees (including payroll taxes)	$2,437	$1,970
Payable to suppliers	2,481	2,591
Other	27	14
Total accounts payable and accrued expenses	$4,945	$4,575

7. Capital Assets

Capital asset additions, retirements, and balances for the years ended December 31, 20X7 and 20X6 were as follows:

	Balance December 31, 20X6	*Additions*	*Retirements*	*Balance December 31, 20X7*
Land[E]	$ 3,590	—	—	$ 3,590
Land improvements	645	17	—	662
Buildings and improvements	29,265	965	(810)	29,420
Equipment	30,375	3,547	(1,860)	32,062
Totals at historical cost	$63,875	$4,529	($2,670)	$65,734
Less accumulated depreciation for:				
Land improvements	(291)	(65)	—	(356)
Buildings and improvements	(5,352)	(582)	810	(5,124)
Equipment	(15,314)	(3,418)	1,860	(16,872)
Total accumulated depreciation	(20,957)	(4,065)	2,670	(22,352)
Capital assets, net	$42,918	$ 464	$ 0	$43,382

[E] When present, construction-in-progress should be reported in a separate line in this schedule. (See the GASB staff document *Comprehensive Implementation Guide—2003*, item 7.353). See paragraph 1.11 in this Guide regarding references to GASB staff Implementation Guides. Also, GASB Statement No. 34, paragraph 20, requires non-depreciable capital assets to be shown separately on the face of the balance sheet when these balances are significant.

	Balance December 31, 20X5	*Additions*	*Retire-ments*	*Balance December 31, 20X6*
Land	$ 3,590	—	—	$ 3,590
Land improvements	608	112	(75)	645
Buildings and improvements	29,187	78	—	29,265
Equipment	26,710	3,921	(256)	30,375
Totals at historical cost	$60,095	$4,111	($331)	$63,875
Less accumulated depreciation for:				
Land improvements	(309)	(57)	75	(291)
Buildings and improvements	(4,826)	(526)	—	(5,352)
Equipment	(12,515)	(3,055)	256	(15,314)
Total accumulated depreciation	(17,650)	(3,638)	331	(20,957)
Capital assets, net	$42,445	$ 473	$ 0	$42,918

8. Long-Term Debt and Other Noncurrent Liabilities

A schedule of changes in the Authority's noncurrent liabilities for 20X7 and 20X6 follows:

	Balance December 31, 20X6	*Additions*	*Reductions*	*Balance December 31, 20X7*	*Amounts Due Within One Year*
Bonds and Notes Payable:					
Revenue notes	$18,714	—	($457)	$18,257	$620
Mortgage loan	1,808	—	(99)	1,709	99
Note payable	570	—	(464)	106	106
Total long-term debt	21,092	—	(1,020)	20,072	825
Capital lease obligations	808	510	(468)	850	425
Other Liabilities:					
Compensated absences	2,625	662	(6)	3,281	—
Net pension obligation	65	15	—	80	See Note 9
Total other liabilities	2,690	677	(6)	3,361	—
Total noncurrent liabilities	$24,590	$1,187	($1,494)	$24,283	$1,250

	Balance December 31, 20X5	Additions	Reductions	Balance December 31, 20X6	Amounts Due Within One Year
Bonds and Notes Payable:					
Revenue notes	19,568	—	(854)	18,714	457
Mortgage loan	1,907	—	(99)	1,808	99
Note payable	1,045	—	(475)	570	464
Total long-term debt	22,520	—	(1,428)	21,092	1,020
Capital lease obligations	1,276	—	(468)	808	468
Other Liabilities:					
Compensated absences	2,400	236	(11)	2,625	—
Net pension obligation	49	16	—	65	See Note 9
Total other liabilities	2,449	252	(11)	2,690	—
Total noncurrent liabilities	$26,245	$ 252	($1,907)	$24,590	$1,488

Long-term debt. The terms and due dates of the Authority's long-term debt, including capital lease obligations, at December 31, 20X7 and 20X6, follow:

- 7.25 percent Revenue Notes, due November 1, 20Z7, collateralized by a pledge of the Authority's gross receipts. Thus all operating and nonoperating revenues of the authority are similarly pledged.
- 9.25 percent mortgage loan, due January 20Y4, collateralized by a mortgage on property and equipment with a depreciated cost of $1,530 at December 31, 20X7
- 9.75 percent note payable, due March 20X8, unsecured
- Capital lease obligations, at varying rates of imputed interest from 9.8 percent to 12.3 percent collateralized by leased equipment with cost of $1,275 at December 31, 20X7

Under the terms of the Revenue Note Indenture, the Authority is required to maintain certain deposits with a trustee. Such deposits are included with restricted cash and investments in the balance sheet. The Revenue Note Indenture also places limits on the incurrence of additional borrowings and requires that the Authority satisfy certain measures of financial performance as long as the notes are outstanding.

Scheduled principal and interest repayments on long-term debt and payments on capital lease obligations are as follows:

	Long-term Debt		Capital Lease Obligations	
Year Ending December 31:	Principal	Interest	Principal	Interest
20X8	$ 825	$ 553	$425	$58
20X9	775	487	213	27
20Y0	836	465	212	13
20Y1	900	448		
20Y2	972	432		
20Y3 to 20Y7	5,764	1,769		
20Y8 to 20Z2	4,824	1,492		
20Z3 to 20Z7	5,176	1,116		
Total	$20,072	$6,762	$850	$98

9. Commitments under Noncancelable Operating Leases

The Authority is committed under various noncancelable operating leases, all of which are for equipment and computers. These expire in various years through 20Y9. Future minimum operating lease payments are as follows:

Year ending December 31:	
20X8	$3,109
20X9	2,898
20Y0	2,795
20Y1	2,780
20Y2	2,575
20Y3–20Y7	4,215
20Y8–20Y9	1,065
Total	$19,437

10. Pension Plan[F]

Plan description. Sample Hospital Pension Plan (SHPP) provides retirement and disability benefits, annual cost-of-living adjustments, and death benefits to plan members and beneficiaries. SHPP is affiliated with County Employees Pension Plan (CEPP), an agent multiple-employer pension plan administered by the Union Retirement System. Article 39 of the Regulations of the State of Union assigns the authority to establish and amend the benefit provisions of the plans that participate in CEPP to the respective employer entities; for CEPP, that authority rests with the County of Feeling, Union. The Union Retirement System issues a publicly available financial report that includes financial statements and required supplementary information for SHPP. That report may be obtained by writing to Union Retirement System, State Government Lane, Anytown, Union 01000 or by calling 1-800-555-PLAN.

Funding policy. The contribution requirements of plan members and the Authority are established and may be amended by the CEPP Board of Trustees. Plan members are required to contribute 7.8 percent of their annual covered salary. The Authority is required to contribute at an actuarially determined rate; the current rate for both 20X7 and 20X6 is 11.9 percent of annual covered payroll.

Annual pension cost and net pension obligation. The Authority's annual pension cost and net pension obligation to SHPP for 20X7 and 20X6 were as follows:

	20X7	*20X6*
Annual required contribution	$26	$23
Interest on net pension obligation	3	2
Adjustment to annual required contribution	(3)	(2)
Annual pension cost	26	23
Contributions made	(11)	(7)
Increase (decrease) in net pension obligation	15	16
Net pension obligation, beginning of year	65	49
Net pension obligation, end of year	$80	$65

[F] The preparer of the financial statements should consider the need for required supplementary information (RSI) as required by GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, paragraph 22.

The annual required contribution for the current year was determined as part of the December 31, 20X6, actuarial valuation using the entry age actuarial cost method. The actuarial assumptions included (*a*) 7.5 percent investment rate of return (net of administrative expenses) and (*b*) projected salary increases ranging from 5.5 percent to 9.5 percent per year. Both (*a*) and (*b*) included an inflation component of 5.5 percent. The actuarial assumptions also include a 2 percent per year cost-of-living adjustment. The actuarial value of assets was determined using techniques that smooth the effects of short-term volatility in the market value of investments over a four-year period. The same actuarial assumptions were used to determine the actuarial required contributions for 20X6. The unfunded actuarial accrued liability is being amortized as a level percentage of projected payroll on an open basis. The remaining amortization period at December 31, 20X6, was 23 years.

Three-Year Trend Information

Fiscal Year Ending	*Annual Pension Cost (APC)*	*Percentage of APC Contributed*	*Net Pension Obligation*
12/31/X5	$20	94%	$49
12/31/X6	23	30	65
12/31/X7	26	42	80

11. Postretirement Plan[11]

In addition to the pension benefits described above, the Authority provides postretirement health care benefits, in accordance with the Authority's bylaws, to all employees who retire from the Authority on or after attaining age 60 with at least 15 years of service. Currently 250 retirees (245 in 20X6) meet these eligibility requirements. The Authority reimburses 75 percent of the amount of validated claims for medical, dental, and hospitalization costs incurred by pre-Medicare retirees and their dependents. The Authority also reimburses a fixed amount of $25 per month for a Medicare supplement for each retiree eligible for Medicare. Expenses for postretirement health care benefits are recognized as retirees report claims and include a provision for estimated claims incurred but not yet reported to the Authority. Expenses of $764 were recognized for postretirement health care in 20X7; expenses recognized in 20X6 were $636. Approximately $64 of the $128 increase in expenses over the previous year was caused by the addition of dental benefits, effective July 1, 20X7.

NOTE—Although not presented in these sample illustrative financial statements, other disclosures required by GASB pronouncements may be applicable, including the following:

- Short-term debt (GASB Statement No. 38, paragraph 12)
- Interfund balances and transfers (GASB Statement No. 38, paragraph 14, when a governmental health care entity reports multiple enterprise

[11] The GASB published a revised exposure draft of a proposed statement, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, that addresses how state and local governments should account for and report their costs and obligations related to postemployment health care and other non-pension benefits provided to retirees. A final pronouncement, GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postretirement Benefits Other than Pensions*, was issued in the third quarter of 2004. Conforming changes to reflect the issuance of GASB Statement No. 45 will be made in a future edition of this Guide.

funds or is reported as an enterprise fund of a general purpose government. See Appendix F, footnote 5.)

- Segment information (GASB Statement No. 34. paragraphs 122 and 123, as amended by GASB Statement No. 37, paragraph 17)
- Violations of finance-related legal or contractual provisions (GASB Statement No. 38, paragraph 9)
- Risk financing (Requirements for disclosures about claims and judgments and risk financing by governmental health care entities that retain a portion of risk for claims and judgments (including malpractice claims and judgments) are provided in GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, as amended). Additionally, GASB Statement No. 34, paragraph 119 requires disclosure of certain information about the long-term portion of accrued claims and judgments, if applicable.

Other required disclosures, which may be applicable, and that would be similar to the disclosures contained in the notes to the sample illustrative financial statements for a not-for-profit hospital, are not repeated here. They include the following:

- Off-Balance Sheet Risk and Concentration of Credit Risk
- Fair Value of Financial Instruments
- Commitments and Contingencies
- Subsequent Events
- Net patient service revenue
- Related party transactions
- Description of Reporting Entity and Summary of Significant Accounting Policies—*Supplies, Net Patient Service Revenue, Charity Care, Premium Revenue*

ILLUSTRATIVE FINANCIAL STATEMENTS FOR A NURSING HOME

Sample For-Profit Nursing Home, Inc.
Balance Sheets
December 31, 20X5 and 20X4

	20X5	*20X4*
Assets		
Current assets:		
Cash and cash equivalents	$ 95,000	$ 129,000
Investments	150,000	
Assets limited as to use	50,000	50,000
Patient accounts receivable, net of allowance for doubtful accounts of $6,700 in 20X5 and $5,300 in 20X4	162,000	152,000
Estimated third-party payor settlements	71,000	62,000
Interest receivable	7,000	
Supplies	47,000	43,000
Prepaid expenses	3,000	2,000
Deferred tax asset	12,000	14,000
Total current assets	597,000	452,000
Assets limited as to use, net of amount required for current liabilities	173,000	150,000
Property and equipment:		
Land	205,000	205,000
Land improvements	37,000	32,000
Buildings	1,399,000	1,399,000
Furniture, fixtures, and equipment	228,000	189,000
	1,869,000	1,825,000
Less accumulated depreciation	210,000	141,000
Property and equipment, net	1,659,000	1,684,000
Other assets	150,000	127,000
Total assets	$2,579,000	$2,413,000

(continued)

Sample For-Profit Nursing Home, Inc.
Balance Sheets
(continued)
December 31, 20X5 and 20X4

	20X5	*20X4*
Liabilities and Shareholders' Equity		
Current liabilities:		
Current maturities of long-term debt	$ 50,000	$ 50,000
Accounts payable	78,000	52,000
Accrued expenses	175,000	188,000
Deposits from patients	50,000	45,000
Other current liabilities	74,000	15,000
Total current liabilities	427,000	350,000
Deferred tax liability	6,000	14,000
Long-term debt, net of current maturities	1,700,000	1,750,000
Shareholders' equity:		
Common stock, $20 par value; authorized 5,000 shares; issued and outstanding 3,500 shares	70,000	70,000
Retained earnings	376,000	229,000
Total shareholders' equity	446,000	299,000
Total liabilities and shareholders' equity	$2,579,000	$2,413,000

See accompanying notes to financial statements.

Sample For-Profit Nursing Home, Inc.
Statements of Income and Retained Earnings
Years Ended December 31, 20X5 and 20X4

	20X5	*20X4*
Revenue:		
Net patient service revenue	$2,163,000	$1,949,000
Other revenue	67,000	22,000
Interest on investments held by trustee	13,000	7,000
Total revenue	2,243,000	1,978,000
Expenses:		
Salaries and benefits	969,000	919,000
Medical supplies and drugs	511,000	499,000
Insurance and other	216,000	176,000
Provision for bad debts	92,000	83,000
Depreciation	69,000	57,000
Interest	164,000	172,000
Total expenses	2,021,000	1,906,000
Operating income	222,000	72,000
Nonoperating income:		
Other interest income	5,000	
Income before provision for income taxes	227,000	72,000
Provision for income taxes	80,000	29,000
Net income	147,000	43,000
Retained earnings, beginning of year	229,000	186,000
Retained earnings, end of year	$ 376,000	$ 229,000

See accompanying notes to financial statements.

Sample For-Profit Nursing Home, Inc.
Statements of Cash Flows
Years Ended December 31, 20X5 and 20X4

	20X5	*20X4*
Cash flows from operating activities:		
Cash received from residents and third-party payors	$2,019,000	$1,796,000
Cash received from others	67,000	22,000
Cash paid to employees and suppliers	(1,679,000)	(1,495,000)
Interest and dividends received	10,000	10,000
Interest paid	(160,000)	(170,000)
Taxes paid	(29,000)	(30,000)
Deposits received from patients	35,000	15,000
Deposits refunded to patients	(30,000)	(20,000)
Net cash provided by operating activities	233,000	128,000
Cash flows from investing activities:		
Purchase of investments	(150,000)	
Proceeds from sale of property		2,000
Capital expenditures	(44,000)	(79,000)
Purchase of assets limited as to use	(23,000)	
Net cash used in investing activities	(217,000)	(77,000)
Cash flows from financing activities:		
Repayment of long-term debt	(50,000)	(50,000)
Net cash used in financing activities	(50,000)	(50,000)
Net increase (decrease) in cash and cash equivalents	(34,000)	1,000
Cash and cash equivalents, beginning of year	129,000	128,000
Cash and cash equivalents, end of year	$ 95,000	$ 129,000

(continued)

Sample For-Profit Nursing Home, Inc.
Statements of Cash Flows
(continued)
Years Ended December 31, 20X5 and 20X4

	20X5	*20X4*
Reconciliation of net income to net cash provided by operating activities:		
Net income	$147,000	$43,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	69,000	57,000
Provision for bad debts	92,000	83,000
Loss on sale of property	—	11,000
Change in deferred income taxes	(6,000)	(14,000)
(Increase) decrease in:		
Patient accounts receivable	(102,000)	(41,000)
Other current assets	(21,000)	(15,000)
Estimated third-party payor settlements	(9,000)	(10,000)
Interest receivable	(7,000)	(3,000)
Other assets	(7,000)	(10,000)
Increase (decrease) in:		
Accounts payable and accrued expenses	13,000	43,000
Deposits from patients	5,000	(5,000)
Other current liabilities	59,000	(11,000)
Net cash provided by operating activities	$233,000	$128,000

See accompanying notes to financial statements.

Sample For-Profit Nursing Home, Inc.
Notes to Financial Statements
December 31, 20X5 and 20X4

1. Description of Organization and Summary of Significant Accounting Policies[3]

Organization. The Sample Nursing Home, Inc. (the Company) was incorporated in New State in 20X1 and operates a 128-bed nursing home in Abacus, New State. A summary of the Company's significant accounting policies follows:

Use of estimates. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and cash equivalents. Cash and cash equivalents include investments in highly liquid debt instruments with an original maturity of three months or less, excluding amounts whose use is limited by note indenture.

Investments. Investments in debt instruments, including assets limited as to use, are classified as held-to-maturity because the Company has the positive intent and ability to hold the securities until maturity. Held-to-maturity securities are carried at cost adjusted for amortization of premiums and accretion of discounts.

Assets limited as to use. Assets deposited with a trustee under terms of the note indenture and assets set aside by the Board of Directors for capital improvements are classified as assets limited as to use. Amounts required to meet current liabilities have been reclassified in the balance sheet.

Property and equipment. Property and equipment are recorded at cost. Depreciation is calculated on the straight-line method over the estimated useful lives of depreciable assets.

Bond issuance costs. Costs incurred in issuing the Series 20X1 bonds are being amortized based on the effective interest method.

Net patient service revenue. Net patient service revenue is reported at the estimated net realizable amounts from residents, third-party payors, and others for service rendered.

Revenue under third-party payor agreements is subject to audit and retroactive adjustment. Provisions for estimated third-party payor settlements are provided in the period the related services are rendered. Differences between the estimated amounts accrued and interim and final settlements are reported in operations in the year of settlement.

Income taxes. The provisions for income taxes are based on amounts estimated to be currently payable and those deferred because of temporary differences between the financial statement and tax bases of assets and liabilities. These differences consist principally of bad debts and depreciation.

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[3] Paragraph 13 of SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*, provides guidance on disclosures that should be included in the summary of significant accounting policies, including accounting policies for loans, trade receivables, and doubtful accounts.

2. Assets Limited as to Use

Assets limited as to use include:

Assets held by trustee under the Series 20X1 note indenture agreement at December 31, 20X5 and 20X4.

	20X5	*20X4*
U.S. Government obligations	$150,000	$130,000
Cash	24,000	21,000
Accrued interest income	2,000	2,000
	176,000	153,000
Internally designated by the Board of Directors for capital improvements		
Certificate of deposit	$ 45,000	$ 45,000
Accrued interest	2,000	2,000
	47,000	47,000
	$223,000	$200,000

3. Investments#

4. Long-Term Debt

Long-term debt at December 31, 20X5 and 20X4, was as follows:

	20X5	*20X4*
9.5 percent bonds payable to the City of Abacus, maturing $50,000 annually through November 1, 20YY, with a final maturity of $1 million on November 1, 20YY	$1,750,000	$1,800,000
Less current maturities	50,000	50,000
	$1,700,000	$1,750,000

The notes are collateralized by a first-mortgage lien on all property and equipment of the Company and a security interest in all of its receipts. The note indenture requires the maintenance of certain deposits with a trustee, which are included in assets limited as to use.

Future maturities of long-term debt as of December 31, 20X5, follow:

Year Ending December 31,	*Amount*
20X6	$ 50,000
20X7	50,000
20X8	50,000
20X9	50,000
20Y0	50,000
Thereafter	1,500,000
Total	$1,750,000

In reporting disclosures about investments in securities, entities should comply primarily with the requirements of paragraphs 6, 17, 19, 20, 21, and 22 of FASB Statement No. 115, as amended. Other disclosure requirements may also be applicable.

5. Income Taxes

The provisions for income taxes are as follows:

	20X5	*20X4*
Current:		
Federal	$72,000	$15,000
State	2,000	
Total current	74,000	15,000
Deferred:		
Federal	6,000	13,000
State		1,000
Total deferred	6,000	14,000
Total provision for income taxes	$80,000	$29,000

Deferred income taxes are provided for the temporary differences between the financial reporting basis and the tax basis of the Company's assets and liabilities.

For the years ended December 31, 20X5 and 20X4, the effective tax rate approximated the statutory rate of 34 percent and 40 percent, respectively.

The net current and noncurrent components of deferred income taxes recognized in the balance sheet at December 31, 20X5 and 20X4, follows:

	20X5	*20X4*
Net current assets	$12,000	$14,000
Net noncurrent liabilities	6,000	14,000
	$ 6,000	$ 0

Management has determined that no valuation allowance related to deferred tax assets is necessary at December 31, 20X5 and 20X4, respectively.

6. Concentration in State Medicaid Program

The Company has 100 of its 128 beds designated for care of patients under the state's Medicaid program. The current funding of that program is 90 days behind filed claims. The current state budget has no provision for reducing that lag and, while the proposed budget for 20X6 includes additional funding, there is no assurance that the final budget will include the needed additional funds.

7. Third Party Rate Adjustments and Revenue

Revenue from the Medicaid program accounted for approximately XX percent for the year ended 20X5, and XX percent for the year ended 20X4, of the Company's net patient revenue. Laws and regulations governing the Medicaid program are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. The 20X5 net patient service revenue increased approximately $XXX due to removal of allowances previously estimated that are no longer necessary as a result of final settlements and years that are no longer subject to audits, reviews, and investigations. The 20X4 net patient service revenue decreased approximately $XXX due to prior-year retroactive adjustments in excess of amounts previously estimated.

8. Risks and Uncertainties Disclosures**

9. Pension Plan**

10. Postretirement Benefits**

11. Fair Values of Financial Instruments**

12. Concentrations of Credit Risk**

** The disclosures contained in these notes would be similar to the disclosures contained in the notes to the financial statements for not-for-profit hospital and, therefore, are not repeated here.

ILLUSTRATIVE FINANCIAL STATEMENTS FOR A CONTINUING CARE RETIREMENT COMMUNITY

Sample Not-for-Profit Continuing Care Retirement Community
Balance Sheets
December 31, 20X5 and 20X4

	20X5	*20X4*
Assets		
Current assets:		
Cash	$ 375,000	$ 330,000
Assets limited as to use	265,000	170,000
Accounts receivable, net of allowance for doubtful accounts of $4,000 in 20X5 and $5,000 in 20X4	187,000	197,000
Supplies	40,000	21,000
Prepaid expenses	115,000	73,000
Total current assets	982,000	791,000
Assets limited as to use, net of amount required for current liabilities	1,865,000	1,583,000
Property and equipment, net	14,893,000	15,280,000
Deferred financing costs, net of accumulated amortization of $28,000 in 20X5 and $21,000 in 20X4	83,000	90,000
Total assets	$17,823,000	$17,744,000
Liabilities and Net Assets		
Liabilities:		
Current maturities of long-term debt	$ 90,000	$ 77,000
Accounts payable	180,000	174,000
Accrued expenses	161,000	178,000
Deposits on unoccupied units	22,000	40,000
Total current liabilities	453,000	469,000
Long-term debt, less current maturities	8,871,000	8,935,000
Refundable fees	59,000	144,000
Estimated obligation to provide future services, in excess of amounts received or to be received	88,000	100,000
Deferred revenue from advance fees	6,304,000	6,585,000
Total liabilities	15,775,000	16,233,000
Net assets:		
Unrestricted	1,286,000	833,000
Temporarily restricted	311,000	294,000
Permanently restricted	451,000	384,000
Total net assets	2,048,000	1,511,000
Total liabilities and net assets	$17,823,000	$17,744,000

See accompanying notes to financial statements.

Sample Not-for-Profit Continuing Care Retirement Community
Statements of Operations
Years Ended December 31, 20X5 and 20X4

	20X5	*20X4*
Revenue, gains, and other support:		
Resident services, including amortization of advance fees of $935,000 in 20X5 and $915,000 in 20X4	$3,946,000	$3,152,000
Patient revenue from nonresidents	249,000	275,000
Change in obligation to provide future services	12,000	(82,000)
Contributions	54,000	39,000
Net assets released from restrictions used for operations	24,000	50,000
Investment income	29,000	30,000
Other	75,000	68,000
Total revenue, gains, and other support	4,389,000	3,532,000
Expenses:		
Salaries and benefits	1,708,000	1,250,000
Medical supplies and drugs	543,000	742,000
Insurance	291,000	311,000
Depreciation	452,000	447,000
Interest	967,000	955,000
Total expenses	3,961,000	3,705,000
Operating income (loss)	428,000	(173,000)
Net assets released from restriction—purchase of equipment	25,000	45,000
Increase (decrease) in unrestricted net assets	$ 453,000	$ (128,000)

See accompanying notes to financial statements.

Sample Not-for-Profit Continuing Care Retirement Community
Statements of Changes in Net Assets
Years Ended December 31, 20X5 and 20X4

	20X5	*20X4*
Unrestricted net assets:		
Operating income (loss)	$ 428,000	$ (173,000)
Net assets released from restriction—purchase of equipment	25,000	45,000
Increase (decrease) in unrestricted net assets	453,000	(128,000)
Temporarily restricted net assets:		
Contributions	40,000	15,000
Net assets released from restrictions used for operations	(24,000)	(50,000)
Net assets released from restriction—purchase of equipment	(25,000)	(45,000)
Investment income	26,000	15,000
Increase (decrease) in temporarily restricted net assets	17,000	(65,000)
Permanently restricted net assets:		
Contributions	67,000	52,000
Increase in permanently restricted net assets	67,000	52,000
Increase (decrease) in net assets	537,000	(141,000)
Net assets, beginning of year	1,511,000	1,652,000
Net assets, end of year	$2,048,000	$1,511,000

See accompanying notes to financial statements.

Sample Not-for-Profit Continuing Care Retirement Community
Statements of Cash Flows
Years Ended December 31, 20X5 and 20X4

	20X5	*20X4*
Cash flows from operating activities:		
Cash received from residents and third-party payors	$ 3,252,000	$ 2,341,000
Advance fees received	654,000	857,000
Other receipts from operations	75,000	68,000
Investment income received	68,000	53,000
Contributions received	51,000	44,000
Cash paid to employees and suppliers	(2,576,000)	(2,040,000)
Interest paid	(950,000)	(945,000)
Net cash provided by operating activities	574,000	378,000
Cash flows from investing activities:		
Purchase of property and equipment	(65,000)	(250,000)
Purchase of assets limited as to use	(377,000)	229,000
Net cash used in investing activities	(442,000)	(21,000)
Cash flows from financing activities:		
Permanently restricted funds received	67,000	52,000
Refunds of deposits and refundable fees	(103,000)	(52,000)
Proceeds from issuance of long-term debt	26,000	
Principal payments of long-term debt	(77,000)	(307,000)
Net cash used in financing activities	(87,000)	(307,000)
Net increase in cash	45,000	50,000
Cash, beginning of year	330,000	280,000
Cash, end of year	$ 375,000	$ 330,000

(continued)

Sample Not-for-Profit Continuing Care Retirement Community
Statements of Cash Flows
(continued)
Years Ended December 31, 20X5 and 20X4

	20X5	*20X4*
Reconciliation of change in net assets to net cash provided by operating activities:		
Change in net assets	$ 537,000	$(141,000)
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Advance fees received	654,000	857,000
Restricted net assets received	(67,000)	(52,000)
Amortization of advance fees	(935,000)	(915,000)
Loss (gain) on obligation to provide future services	(12,000)	82,000
Depreciation	452,000	447,000
Amortization of deferred financing costs	7,000	34,000
Provision for bad debts	3,000	3,000
(Increase) decrease in:		
Accounts receivable	7,000	(33,000)
Other assets	(61,000)	(4,000)
Increase (decrease) in:		
Accounts payable and accrued expenses	(11,000)	100,000
Net cash provided by operating activities	$ 574,000	$ 378,000

See accompanying notes to financial statements.

Sample Not-for-Profit Continuing Care Retirement Community Notes to Financial Statements[4] December 31, 20X5 and 20X4

1. Description of Organization and Summary of Significant Accounting Policies[††, 5]

Organization. The Sample Continuing Care Retirement Community (the CCRC) is a nonprofit organization that principally provides housing, health care, and other related services to residents through the operation of a retirement facility containing 249 apartments and a 78-bed health care facility located in Evergreen Park, Illinois. The CCRC was incorporated in Illinois in 20X1. A summary of significant accounting policies follows.

Use of estimates. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Investments. Investments, which consist of U.S. Treasury obligations, are measured at fair value in the balance sheet. Investment income (including realized gains and losses on investments, interest, and dividends) is included in operating income (loss) unless restricted by donor or law. Unrealized gains and losses on investments, if any, are excluded from operating income (loss).

Deferred financing costs. Deferred financing costs are amortized using the effective interest method over the term of the related financing agreement.

Advance fees. Fees paid by a resident upon entering into a continuing care contract, net of the portion thereof that is refundable to the resident, are recorded as deferred revenue and are amortized to income using the straight-line method over the estimated remaining life expectancy of the resident.

Obligation to provide future services. The CCRC annually calculates the present value of the net cost of future services and the use of facilities to be provided to current residents and compares that amount with the balance of deferred revenue from advance fees. If the present value of the net cost of future services and the use of facilities exceeds the deferred revenue from advance fees, a liability is recorded (obligation to provide future services and use of facilities) with the corresponding charge to income. The obligation is discounted at 9 percent, based on the expected long-term rate of return on government obligations.

Donor restrictions. The CCRC reports gifts of cash and other assets as restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires (that is, when a stipulated time restriction ends or a purpose restriction is accomplished), temporarily restricted net assets are

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[4] SOP 00-1 provides auditors with guidance regarding uncertainties in health care revenue recognition and includes a sample disclosure in paragraph 37 of the SOP for material differences between an original estimate and subsequent revisions regarding third-party payments. SOP 00-1 is included in Appendix E to this Guide.

[††] Does not include all disclosures common to all health care entities.

[5] Paragraph 13 of SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*, provides guidance on disclosures that should be included in the summary of significant accounting policies, including accounting policies for loans, trade receivables, and doubtful accounts.

reclassified as unrestricted net assets and reported in the statement of operations as net assets released from restrictions. Donor-restricted contributions whose restrictions are met within the same year as received are reflected as unrestricted contributions in the accompanying financial statements.

The CCRC reports gifts of property and equipment (or other long-lived assets) as unrestricted support unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, the CCRC reports expirations of donor restrictions when the donated or acquired long-lived assets are placed in service.

Income taxes. The CCRC has been recognized by the Internal Revenue Service as a not-for-profit corporation as described in Sec. 501(c)(3) of the Internal Revenue Code (IRC) and is exempt from federal income taxes pursuant to Sec. 501(a) of the IRC.

Property and equipment. Property and equipment are stated at cost. Donated property is recorded at its estimated fair value at the date of receipt. Depreciation is computed on the straight-line method based on the following estimated useful lives:

Land improvements	20 years
Buildings and improvements	40 years
Furniture and equipment	5–15 years

Operating income (loss). The statement of operations includes *operating income (loss)*. Changes in unrestricted net assets which are excluded from operating income (loss), consistent with industry practice, include unrealized gains and losses on investments other than trading securities, permanent transfers of assets to and from affiliates for other than goods and services, and contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purposes of acquiring such assets).

2. Property and Equipment

A summary of property and equipment at December 31, 20X5 and 20X4, follows:

	20X5	*20X4*
Land	$ 557,000	$ 557,000
Land improvements	205,000	203,000
Buildings and improvements	14,573,000	14,564,000
Furniture and equipment	752,000	698,000
	16,087,000	16,022,000
Less: accumulated depreciation	(1,194,000)	(742,000)
	$14,893,000	$15,280,000

3. Temporarily Restricted Net Assets

Temporarily restricted net assets are available for the following purposes:

	20X5	*20X4*
Purchase of equipment	$169,000	$152,000
Charity care	142,000	142,000
	$311,000	$294,000

Net assets were released from donor restrictions by incurring expenses satisfying the restricted purposes or by occurrence of other events specified by donors:

	20X5	*20X4*
Charity care	$24,000	$50,000
Purchase of equipment	$25,000	$45,000

4. Permanently Restricted Net Assets

Permanently restricted net assets are restricted to investment in perpetuity, the income from which is expendable to support:

	20X5	*20X4*
Charity care	$168,000	$168,000
Community activities	283,000	216,000
	$451,000	$384,000

5. Long-Term Debt

Long-term debt at December 31, 20X5 and 20X4, is as follows:

	20X5	*20X4*
10.75 percent mortgage note payable	$8,901,000	$8,965,000
Notes payable to bank—unsecured	34,000	14,000
Other	26,000	33,000
	8,961,000	9,012,000
Less current maturities	90,000	77,000
	$8,871,000	$8,935,000

The mortgage note is payable in consecutive monthly installments of principal and interest of $85,425 to May 20XX. The note is collateralized by a first mortgage on property and equipment with a depreciated cost at December 31, 20X5, of $14,893,000 and by a pledge of all operating revenue.

As required by the mortgage note agreement, the CCRC established an initial debt service reserve fund of $1,000,000 at April 15, 20X3. All resident fees received thereafter, net of resident fee refunds and debt service payments not to exceed $300,000 annually in the first four years and $200,000 annually thereafter, are to be added to the debt service reserve fund until the total sum of $2,050,000 is accumulated. Since June 1, 20X4, the CCRC has been required to deliver to the trustee $5,500 per month to establish maintenance reserves until the aggregate of such payments equals a residential unit reserve and a health care center reserve of $240,000 and $90,000, respectively. At December 31, 20X5 and 20X4, the trustee held investments aggregating $2,130,000 and $1,753,000, respectively. Such amount has been classified as assets limited as to use.

Scheduled annual principal maturities of long-term debt for the next five years are as follows:

Year Ending December 31,	*Amount*
20X6	$ 90,000
20X7	90,000
20X8	95,000
20X9	105,000
20Y0	105,000

6. Classification of Expenses

	20X5	*20X4*
Program activities	3,368,000	3,135,000
General and administrative	593,000	570,000
	$3,961,000	$3,705,000

7. Assets Limited as to Use[#]

8. Risks and Uncertainties Disclosures[#]

9. Pension Plan[#]

10. Postretirement Benefits[#]

11. Fair Values of Financial Instruments[#]

12. Concentrations of Credit Risk[#]

13. Investments[#]

[#] The disclosures contained in these notes would be similar to the disclosures contained in the notes to the financial statements for the not-for-profit hospital and, therefore, are not repeated here.

ILLUSTRATIVE FINANCIAL STATEMENTS FOR A HOME HEALTH AGENCY

Sample Not-for-Profit Home Health Agency
Balance Sheets
December 31, 20X5 and 20X4

	20X5	*20X4*
Assets		
Current assets:		
Cash and cash equivalents	$ 74,000	$ 41,000
Investments	147,000	137,000
Accounts receivable, net of allowance for doubtful accounts of $61,000 in 20X5 and $30,000 in 20X4	752,000	476,000
Other receivables	27,000	22,000
Total current assets	1,000,000	676,000
Investments	100,000	100,000
Equipment:		
Medical and office equipment	56,000	39,000
Vehicles	50,000	37,000
	106,000	76,000
Less accumulated depreciation	(45,000)	(24,000)
Equipment, net	61,000	52,000
Deferred finance charges, net of accumulated amortization of $15,000 in 20X5 and $10,000 in 20X4	20,000	25,000
Total assets	$1,181,000	$853,000
Liabilities and Net Assets		
Current liabilities:		
Current maturities of long-term debt	$ 13,000	$ 13,000
Accounts payable	40,000	21,000
Accrued payroll and vacation costs	496,000	352,000
Estimated third-party payor settlements	28,000	31,000
Advances from third-party payors	70,000	66,000
Total current liabilities	647,000	483,000
Long-term debt, less current maturities	105,000	118,000
Total liabilities	752,000	601,000
Net assets:		
Unrestricted	330,000	167,000
Temporarily restricted	9,000	5,000
Permanently restricted	90,000	80,000
Total net assets	429,000	252,000
Total liabilities and net assets	$1,181,000	$853,000

See accompanying notes to financial statements.

FORMAT A

Sample Not-for-Profit Home Health Agency
Statements of Operations
Years Ended December 31, 20X5 and 20X4

	20X5	*20X4*
Revenue, gains, and other support:		
Net patient service revenue	$4,042,000	$2,687,000
Contributions	5,000	22,000
Net assets released from restrictions	5,000	—
Investment income	13,000	6,000
Other revenue	27,000	32,000
Total revenue, gains, and other support	4,092,000	2,747,000
Expenses:		
Salaries and benefits	2,714,000	1,835,000
Medical supplies and drugs	1,042,000	675,000
Insurance and other	90,000	83,000
Provision for bad debts	46,000	21,000
Depreciation	21,000	15,000
Interest	16,000	19,000
Total expenses	3,929,000	2,648,000
Excess of revenue over expenses and change in unrestricted net assets	$ 163,000	$ 99,000

See accompanying notes to financial statements.

FORMAT B

Sample Not-for-Profit Home Health Agency
Statements of Operations
Years Ended December 31, 20X5 and 20X4

	20X5	*20X4*
Revenue, gains, and other support:		
Net patient service revenue	$4,042,000	$2,687,000
Contributions	5,000	22,000
Net assets released from restrictions	5,000	—
Other revenue	27,000	32,000
Total revenue, gains, and other support	4,079,000	2,741,000
Expenses:		
Salaries and benefits	2,714,000	1,835,000
Medical supplies and drugs	1,042,000	675,000
Insurance and other	90,000	83,000
Provision for bad debts	46,000	21,000
Depreciation	21,000	15,000
Interest	16,000	19,000
Total expenses	3,929,000	2,648,000
Operating income	150,000	93,000
Other income:		
Investment income	13,000	6,000
Excess of revenue over expenses and change in unrestricted net assets	$ 163,000	$ 99,000

See accompanying notes to financial statements.

Sample Not-for-Profit Home Health Agency
Statements of Changes in Net Assets
Years Ended December 31, 20X5 and 20X4

	20X5	*20X4*
Unrestricted net assets:		
Excess of revenue over expenses	$163,000	$ 99,000
Increase in unrestricted net assets	163,000	99,000
Temporarily restricted net assets:		
Contributions	9,000	5,000
Net assets released from restrictions	(5,000)	—
Increase in temporarily restricted net assets	4,000	5,000
Permanently restricted net assets:		
Contributions	10,000	6,000
Increase in permanently restricted net assets	10,000	6,000
Increase in net assets	177,000	110,000
Net assets, beginning of year	252,000	142,000
Net assets, end of year	$429,000	$252,000

See accompanying notes to financial statements.

Sample Not-for-Profit Home Health Agency
Statements of Cash Flows
Years Ended December 31, 20X5 and 20X4

	20X5	*20X4*
Cash flows from operating activities:		
Cash received from patients and third-party payors	$3,721,000	$2,542,000
Other receipts from operations	22,000	32,000
Cash paid to employees and suppliers	(3,679,000)	(2,541,000)
Interest paid	(11,000)	(14,000)
Nonoperating revenue	23,000	22,000
Net cash provided by operating activities	76,000	41,000
Cash flows from investing activities:		
Purchase of equipment	(30,000)	(19,000)
Purchase of investments	(10,000)	(15,000)
Net cash used in investing activities	(40,000)	(34,000)
Cash flows from financing activities:		
Proceeds from contributions restricted for:		
Endowment	10,000	6,000
Other financing activities:		
Payment of long-term debt	(13,000)	—
Net cash provided by (used in) financing activities	(3,000)	6,000
Net increase in cash and cash equivalents	33,000	13,000
Cash and cash equivalents, beginning of year	41,000	28,000
Cash and cash equivalents, end of year	$ 74,000	$ 41,000

(continued)

Sample Not-for-Profit Home Health Agency
Statements of Cash Flows
(continued)
Years Ended December 31, 20X5 and 20X4

	20X5	*20X4*
Reconciliation of change in net assets to net cash provided by operating activities:		
Change in net assets	$177,000	$110,000
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Increase in permanently restricted net assets	(10,000)	(6,000)
Provision for bad debts	46,000	21,000
Depreciation	21,000	15,000
Amortization of deferred financing charges	5,000	5,000
(Increase) decrease in:		
Accounts receivable	(322,000)	(150,000)
Other receivables	(5,000)	4,000
Increase (decrease) in:		
Accounts payable, accrued payroll, and vacation costs	163,000	38,000
Estimated third-party payor settlements	1,000	4,000
Net cash provided by operating activities	$ 76,000	$ 41,000

See accompanying notes to financial statements.

Sample Not-for-Profit Home Health Agency
Notes to Financial Statements
Years Ended December 31, 20X5 and 20X4

1. Description of Organization and Summary of Significant Accounting Policies[6]

Organization. The Sample Home Health Agency (the Agency) was incorporated in 20X0 in New State as a not-for-profit corporation. The Agency provides health and supportive services to individuals at their homes, primarily in the New State area.

Use of estimates. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and cash equivalents. Cash and cash equivalents include investments in highly liquid debt instruments with an original maturity of three months or less.

Investments. Investments, which consist of U.S. Treasury obligations, are measured at fair value in the balance sheet. Investment income (including realized gains and losses on investments, interest and dividends) is included in excess of revenues over expenses unless restricted by donor or law. Unrealized gains and losses on investments, if any, are excluded from excess of revenues over expenses.

Equipment. Equipment is recorded at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets.

Deferred financing costs. Deferred financing costs are being amortized using the effective interest method over the term of the related financing agreement.

Donor restrictions. The Agency reports gifts of cash and other assets as restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the statement of operations as net assets released from restrictions. When long-lived assets are placed in service, thus satisfying purpose restrictions, the amount is included as a change in net assets, restricted and unrestricted. Donor-restricted contributions whose restrictions are met within the same year as received are reflected as unrestricted contributions in the accompanying financial statements.

The Agency reports gifts of equipment (or other long-lived assets) as unrestricted support unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, the Agency reports expirations of donor restrictions when the donated or acquired long-lived assets are placed in service.

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[6] Paragraph 13 of SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*, provides guidance on disclosures that should be included in the summary of significant accounting policies, including accounting policies for loans, trade receivables, and doubtful accounts.

Net patient service revenue. Net patient service revenue represents the estimated net realizable amounts from patients, third-party payors, and others for services rendered.

Charity care. The Agency has a policy of providing charity care to patients who are unable to pay. Such patients are identified based on financial information obtained from the patient and subsequent analysis. Since the Agency does not expect payment, estimated charges for charity care are not included in revenue.

Income taxes. The Agency has been recognized by the Internal Revenue Service as a not-for-profit corporation as described in Sec. 501(c)(3) of the Internal Revenue Code (IRC) and is exempt from federal income taxes on related income pursuant to Sec. 501(a) of the IRC.

Excess of revenue over expenses. The statement of operations includes excess of *revenue over expenses*. Changes in unrestricted net assets which are excluded from excess of *revenue over expenses*, consistent with industry practice, include unrealized gains and losses on investments other than trading securities, permanent transfers of assets to and from affiliates for other than goods and services, and contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purposes of acquiring such assets).

2. Temporarily Restricted Net Assets

Temporarily restricted net assets are available for the following purposes:

	20X5	*20X4*
Charity care	$ —	$5,000
Purchase of equipment	9,000	—
	$9,000	$5,000

Net assets were released from donor restrictions by incurring expenses satisfying the restricted purposes or by occurrence of other events specified by donors:

	20X5	*20X4*
Charity care expenditures	$5,000	$ —

3. Permanently Restricted Net Assets

Permanently restricted net assets are restricted in perpetuity, the income from which is expendable to support:

	20X5	*20X4*
Program A activities	$10,000	$ —
Any activities of the Agency	80,000	80,000
	$90,000	$80,000

4. Third-Party Rate Adjustments and Revenue

Approximately 38 percent in 20X5 and 37 percent in 20X4 of net patient service revenue was derived under federal and state third-party reimbursement programs. These revenues are based, in part, on cost reimbursement principles and are subject to audit and retroactive adjustment by the respective third-party fiscal intermediaries. Laws and regulations governing these programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. The 20X5 net patient service revenue increased approximately $XXX due to removal of allowances previously estimated

that are no longer necessary as a result of final settlements and years that are no longer subject to audits, reviews, and investigations. The 20X4 net patient service revenue decreased approximately $XXX due to prior-year retroactive adjustments in excess of amounts previously estimated.

5. Internally-Designated Assets

The Board of Directors has designated investments aggregating $100,000 to be used for future major capital improvements. Those assets are classified in the balance sheet as long-term investments.

6. Long-Term Debt

Long-term debt at December 31, 20X5 and 20X4, is as follows:

	20X5	*20X4*
Note payable to bank, interest at 15 percent, payable in monthly installments of $2,200 per month, including interest, collateralized by equipment with a depreciated cost of $42,000	$118,000	$131,000
Less current maturities	13,000	13,000
	$105,000	$118,000

Scheduled maturities of long-term debt at December 31, 20X5, are as follows:

Year Ending December 31,	*Amount*
20X6	$ 13,000
20X7	13,000
20X8	13,000
20X9	13,000
20Y0	13,000
Thereafter	53,000
Total	$118,000

7. Classification of Expenses

		Program			
	Total	*A*	*B*	*C*	*General and Administrative*
Expenses incurred for the year ended December 31, 20X5, were for:					
Salaries and benefits	$2,714,000	$1,363,000	$699,000	$363,000	$289,000
Medical supplies and drugs	1,042,000	511,000	246,000	285,000	
Insurance and other	90,000	58,000			32,000
Provision for bad debts	46,000	16,000	30,000		
Depreciation	21,000	5,000			16,000
Interest	16,000	10,000	3,000		3,000
Total expenses	$3,929,000	$1,963,000	$978,000	$648,000	$340,000

	Total	Program			General and Administrative
		A	B	C	
Expenses incurred for the year ended December 31, 20X4, were for:					
Salaries and benefits	*$1,835,000*	*$ 915,000*	*$463,000*	*$216,000*	*$241,000*
Medical supplies and drugs	675,000	335,000	211,000	129,000	
Insurance and other	83,000	64,000			19,000
Provision for bad debts	21,000	21,000			
Depreciation	15,000	6,000			9,000
Interest	19,000	12,000	5,000		2,000
Total expenses	$2,648,000	$1,353,000	$679,000	$345,000	$271,000

(The preparer of the financial statements may wish to include a brief description of the types of programs.)

8. Charity Care

Charity care represented approximately 3 percent and 4 percent of visits in 20X5 and 20X4, respectively.

9. Risks and Uncertainties Disclosures[||||]

10. Pension Plan[||||]

11. Postretirement Benefits[||||]

12. Fair Value of Financial Statements[||||]

13. Concentrations of Credit Risk[||||]

14. Investments[||||]

[||||] The disclosures contained in these notes would be similar to the disclosures contained in the notes to the financial statements for the not-for-profit hospital and, therefore, are not repeated here.

ILLUSTRATIVE FINANCIAL STATEMENTS FOR A HEALTH MAINTENANCE ORGANIZATION

Sample Not-for-Profit Health Maintenance Organization
Balance Sheets
June 30, 20X5 and 20X4

	20X5	*20X4*
Assets		
Current assets:		
Cash and cash equivalents	$2,937,000	$1,021,000
Premiums receivable, net of allowance for doubtful accounts of $36,000 in 20X5 and $42,000 in 20X4	358,000	407,000
Other receivables	263,000	261,000
Supplies	190,000	184,000
Prepaid expenses	197,000	99,000
Total current assets	3,945,000	1,972,000
Property and equipment, net	5,756,000	5,626,000
State guaranty fund deposit	150,000	150,000
Debt issuance costs, net of accumulated amortization of $42,000 in 20X5 and $39,000 in 20X4	18,000	21,000
Total assets	$9,869,000	$7,769,000
Liabilities and Net Assets		
Current liabilities:		
Unsecured 12 percent note payable to a bank	$ —	$ 44,000
Current maturities of long-term debt	241,000	109,000
Accounts payable—medical services	2,245,000	1,471,000
Other accounts payable and accrued expenses	829,000	661,000
Unearned premium revenue	141,000	202,000
Total current liabilities	3,456,000	2,487,000
Long-term debt, less current maturities	4,295,000	2,382,000
Total liabilities	7,751,000	4,869,000
Net assets—unrestricted	2,118,000	2,900,000
Total liabilities and net assets	$9,869,000	$7,769,000

See accompanying notes to financial statements.

Sample Not-for-Profit Health Maintenance Organization
Statements of Operations and Changes in Net Assets
Years Ended June 30, 20X5 and 20X4

	20X5	*20X4*
Revenue:		
Premiums earned	$27,682,000	$22,500,000
Coinsurance	689,000	500,000
Interest and other income	242,000	100,000
Total revenue	28,613,000	23,100,000
Expenses:		
Salaries and benefits	16,154,000	13,328,000
Medical supplies and drugs	8,507,000	5,988,000
Insurance	3,963,000	2,463,000
Provision for bad debts	19,000	20,000
Depreciation	367,000	336,000
Interest	385,000	375,000
Total expenses	29,395,000	22,510,000
Operating income (loss)	(782,000)	590,000
Net assets, beginning of year	2,900,000	2,310,000
Net assets, end of year	$ 2,118,000	$ 2,900,000

See accompanying notes to financial statements.

Sample Not-for-Profit Health Maintenance Organization
Statements of Cash Flows
Years Ended June 30, 20X5 and 20X4

	20X5	*20X4*
Cash flows from operating activities:		
Cash received from premiums, stop-loss insurance recoveries, and coinsurance	$28,969,000	$24,410,000
Cash paid to employees and to providers of health care services	(28,405,000)	(22,818,000)
Interest and other income received	230,000	90,000
Interest paid	(382,000)	(372,000)
Net cash provided by operating activities	412,000	1,310,000
Cash flows from investing activities:		
Capital expenditures	(497,000)	(121,000)
Net cash used in investing activities	(497,000)	(121,000)
Cash flows from financing activities:		
Proceeds from long-term debt	2,300,000	—
Principal payments on long-term debt	(255,000)	(1,000,000)
Principal payments on note payable	(44,000)	—
Net cash provided by (used in) financing activities	2,001,000	(1,000,000)
Net increase in cash and cash equivalents	1,916,000	189,000
Cash and cash equivalents, beginning of year	1,021,000	832,000
Cash and cash equivalents, end of year	$ 2,937,000	$ 1,021,000

(continued)

Sample Not-for-Profit Health Maintenance Organization
Statements of Cash Flows
(continued)
Years Ended June 30, 20X5 and 20X4

	20X5	*20X4*
Reconciliation of change in net assets to net cash provided by operating activities:		
Change in net assets	$(782,000)	$ 590,000
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	370,000	339,000
Provision for bad debts	19,000	20,000
(Increase) decrease in:		
Premiums receivables	30,000	64,000
Other current assets	230,000	(93,000)
Increase (decrease) in:		
Accounts payable—medical services	774,000	335,000
Other accounts payable and accrued expenses	(168,000)	(60,000)
Unearned premium revenue	(61,000)	115,000
Net cash provided by operating activities	$ 412,000	$1,310,000

See accompanying notes to financial statements.

Sample Not-for-Profit Health Maintenance Organization
Notes to Financial Statements[7]
June 30, 20X5 and 20X4

1. Organization

The Sample Health Maintenance Organization (the HMO) was incorporated in 20X0 in New State as a not-for-profit corporation for the purpose of providing comprehensive health care services on a prepaid basis and for the purpose of establishing and operating organized health maintenance and health care delivery systems.

The HMO has been determined to be a qualified health maintenance organization under Title XIII of the Public Health Service Act.

2. Summary of Significant Accounting Policies[8]

Use of estimates. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and cash equivalents. Cash and cash equivalents include investments in highly liquid debt instruments with an original maturity of three months or less.

Supplies. Inventories of drugs and other supplies are stated at the lower of cost (first-in, first-out) or market.

Property and equipment. Property and equipment are recorded at cost. Maintenance and repairs are charged to expense, and betterments are capitalized. Property and equipment costing approximately $700,000 was financed by health maintenance organization initial development grants received in 20X1 and 20X2 from the U.S. Department of Health and Human Services (HHS). This property will be owned by the HMO as long as the equipment and facilities are used for projects related to the objectives of the Public Health Service Act.

Depreciation is computed using the straight-line method over the estimated useful lives of the related assets as follows:

Building	40 years
Improvements	20–25 years
Data processing and laboratory equipment and automobiles	3–7 years
Medical equipment	10 years
Office equipment	5–10 years

Amortization of debt issuance costs. Debt issuance costs are deferred and amortized using the effective interest method over the term of the related debt.

Health care service cost recognition. The HMO contracts with various health care providers for the provision of certain medical care services to its members.

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[7] SOP 00-1 provides auditors with guidance regarding uncertainties in health care revenue recognition and includes a sample disclosure in paragraph 37 of the SOP for material differences between an original estimate and subsequent revisions regarding third-party payments. SOP 00-1 is included in Appendix E to this Guide.

[8] Paragraph 13 of SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*, provides guidance on disclosures that should be included in the summary of significant accounting policies, including accounting policies for loans, trade receivables, and doubtful accounts.

The HMO compensates these providers on a capitation basis. As part of a cost control incentive program, the HMO retains up to 20 percent of the capitation as a risk-sharing fund. In the event of hospital utilization in excess of budget, those providers bear the risk to the extent of 15 percent of the capitation fee. Operating expenses include all amounts incurred by the HMO under the aforementioned contracts.

The cost of other health care services provided or contracted for is accrued in the period in which it is provided to a member based in part on estimates, including an accrual for medical services provided but not reported to the HMO.

Premiums revenue. Membership contracts are on a yearly basis subject to cancellation by the employer group or the HMO upon 30 days written notice. Premiums are due monthly and are recognized as revenue during the period in which the HMO is obligated to provide services to members.

Reinsurance (stop-loss insurance). Reinsurance premiums are reported as health care costs, and reinsurance recoveries are reported as a reduction of related health care costs.

Federal income tax. The HMO is exempt from federal income taxes under Sec. 501(c)(4) of the Internal Revenue Code; accordingly, no provision for federal income taxes has been made in the accompanying financial statements.

3. Property and Equipment

Property and equipment at June 30, 20X5 and 20X4, consists of the following:

	20X5	*20X4*
Land	$ 300,000	$ 300,000
Buildings and improvements	5,473,000	5,459,000
Furniture and equipment	1,786,000	1,303,000
	7,559,000	7,062,000
Less accumulated depreciation	(1,803,000)	(1,436,000)
	$5,756,000	$5,626,000

4. Long-Term Debt

Long-term debt is collateralized by assets with a depreciated cost of $4,943,000. A summary of long-term debt at June 30, 20X5 and 20X4, follows.

	20X5	*20X4*
HHS loan, interest at 7.5 percent, payable in monthly installments of $50,000, including interest	$2,020,000	$ 111,000
HHS loan, interest at 9.25 percent, payable in monthly installments of $10,000, including interest	1,658,000	1,694,000
Secured equipment loans, payable in monthly installments of $15,000, including interest	858,000	686,000
	4,536,000	2,491,000
Less current maturities	241,000	109,000
	$4,295,000	$2,382,000

Scheduled principal payments on long-term debt are as follows:

Year Ending December 31,	*Amount*
20X6	$ 241,000
20X7	259,000
20X8	280,000
20X9	800,000
20Y0	2,956,000
	$4,536,000

5. State Guarantee Fund Deposit

In August 20X4 the state in which the HMO is domiciled enacted legislation specifically governing HMOs. Under this legislation, the corporation is required to maintain a deposit of $150,000 with the director of the division of insurance of the state.

6. Employee Retirement Plan

The HMO has a contributory defined contribution retirement plan covering substantially all employees. Expense determined in accordance with the plan formula (4 percent to 10 percent of eligible covered compensation) was $354,000 and $275,000 for the years ended June 30, 20X5 and 20X4, respectively.

7. Stop-Loss Insurance

The HMO entered into a stop-loss insurance agreement with an insurance company to limit its losses on individual claims. Under the terms of this agreement, the insurance company will reimburse the HMO approximately 25 percent of the cost of each member's annual hospital services, in excess of a $1,000 deductible, up to a lifetime limitation of $500,000 per member. In the event the HMO ceases operations, (*a*) plan benefits will continue for members who are confined in an acute care hospital on the date of insolvency until their discharge, and (*b*) plan benefits will continue for any other member until the end of the contract period for which premiums have been paid.

Stop-loss insurance premiums of approximately $700,000 and $500,000 are included in insurance expense (Note 9) in 20X5 and 20X4, respectively. Approximately $600,000 and $400,000 in stop-loss insurance recoveries are deducted from insurance expense in 20X5 and 20X4, respectively.

Included in other receivables is approximately $50,000 recoverable from insurers.

8. Malpractice Claims

Malpractice claims have been asserted against the HMO by various claimants. The claims are in various stages of processing, and some may ultimately be brought to trial. In the opinion of counsel, the outcome of these actions will not have a significant effect on the financial position or the operating income of the HMO. Incidents occurring through June 30, 20X5, may result in the assertion of additional claims. Other claims may be asserted arising from past services provided. Management believes that these claims, if asserted, would be settled within the limits of insurance coverage.

9. Classification of Expenses

	20X5	*20X4*
Program activities	26,921,000	20,909,000
General and administrative	2,474,000	1,601,000
	$29,395,000	$22,510,000

10. Risks and Uncertainties Disclosures[##]

11. Pension Plan[##]

12. Postretirement Benefits[##]

13. Fair Value of Financial Instruments[##]

14. Concentrations of Credit Risk[##]

[##] The disclosures contained in these notes would be similar to the disclosures contained in the notes to the financial statements for the not-for-profit hospital and, therefore, are not repeated here.

ILLUSTRATIVE FINANCIAL STATEMENTS FOR AN AMBULATORY CARE ORGANIZATION

Sample Not-for-Profit Ambulatory Care, Inc.
Balance Sheets
December 31, 20X5 and 20X4

	20X5	*20X4*
Assets		
Current assets:		
Cash	$ 65,000	$ 76,000
Patient accounts receivable, net of allowance for doubtful accounts of $15,000 in 20X5 and $5,000 in 20X4	290,000	278,000
Estimated retroactive adjustments—third-party payors	19,000	32,000
Accounts receivable—other	13,000	8,000
Supplies	21,000	18,000
Prepaid expenses and deposits	5,000	9,000
Total current assets	413,000	421,000
Property and equipment, at cost:		
Land	100,000	100,000
Land improvements	322,000	322,000
Buildings	682,000	682,000
Equipment	1,390,000	1,389,000
	2,494,000	2,493,000
Less accumulated depreciation	217,000	100,000
Property and equipment, net	2,277,000	2,393,000
Other assets:		
Advances receivable	14,000	5,000
Total assets	$2,704,000	$2,819,000
Liabilities and Net Assets		
Current liabilities:		
Notes payable	$ 138,000	$ 144,000
Accounts payable	42,000	77,000
Accrued payroll, benefits, and taxes	33,000	22,000
Estimated retroactive adjustments—third-party payors	30,000	24,000
Financing advance from third-party payors	—	1,000
Total current liabilities	243,000	268,000
Guarantee liability	10,000	10,000
Total liabilities	253,000	278,000
Net assets—unrestricted	2,451,000	2,541,000
Total liabilities and net assets	$2,704,000	$2,819,000

See accompanying notes to financial statements.

Sample Not-for-Profit Ambulatory Care, Inc.
Statements of Operations and Changes in Net Assets
Years Ended December 31, 20X5 and 20X4

	20X5	*20X4*
Revenue and gains:		
Net patient service revenue	$ 860,000	$ 357,000
Other	29,000	15,000
Total revenue and gains	889,000	372,000
Expenses:		
Salaries and benefits	485,000	243,000
Medical supplies and drugs	189,000	66,000
Insurance	154,000	98,000
Provision for bad debts	14,000	4,000
Depreciation	117,000	100,000
Interest	20,000	18,000
Total expenses	979,000	529,000
Operating loss	(90,000)	(157,000)
Net assets, beginning of year	2,541,000	2,698,000
Net assets, end of year	$2,451,000	$2,541,000

See accompanying notes to financial statements.

Sample Not-for-Profit Ambulatory Care, Inc.
Statements of Cash Flows
Years Ended December 31, 20X5 and 20X4

	20X5	*20X4*
Cash flows from operating activities:		
Cash received from patients and third-party payors	$866,000	$368,000
Cash received from others	21,000	6,000
Interest received	3,000	11,000
Interest paid	(15,000)	(16,000)
Cash paid to employees and suppliers	(870,000)	(432,000)
Net cash provided by (used in) operating activities	5,000	(63,000)
Cash flows from investing activities:		
Purchase of equipment	(1,000)	(4,000)
Advances made to XYZ Affiliate	(9,000)	(5,000)
Net cash used in investing activities	(10,000)	(9,000)
Cash flows from financing activities:		
Proceeds from notes payable	—	144,000
Payments on notes payable	(6,000)	—
Net cash provided by (used in) financing activities	(6,000)	144,000
Net increase (decrease) in cash	(11,000)	72,000
Cash, beginning of year	76,000	4,000
Cash, end of year	$ 65,000	$ 76,000

(continued)

Sample Not-for-Profit Ambulatory Care, Inc.
Statements of Cash Flows
(continued)
Years Ended December 31, 20X5 and 20X4

	20X5	*20X4*
Reconciliation of change in net assets to net cash provided by (used in) operating activities:		
Change in net assets	$ (90,000)	$(157,000)
Adjustments to reconcile change in net assets to net cash provided by (used in) operating activities:		
Depreciation	117,000	100,000
Provision for bad debts	14,000	4,000
(Increase) decrease in:		
Patient accounts receivable	(12,000)	(19,000)
Other current assets	1,000	(2,000)
Increase (decrease) in:		
Accounts payable and accrued payroll, benefits, and taxes	(24,000)	10,000
Other current liabilities	(1,000)	1,000
Net cash provided by (used in) operating activities	$ 5,000	$ (63,000)

See accompanying notes to financial statements.

Sample Not-for-Profit Ambulatory Care, Inc.
Notes to Financial Statements
December 31, 20X5 and 20X4

1. Description of Organization and Summary of Significant Accounting Policies[9]

Organization. Ambulatory Care, Inc. was incorporated on September 7, 20X3, in New State, to operate an ambulatory care health facility to treat or prevent injury and disease, to provide funds or to expend funds to further the treatment or prevention of injury or disease, and to develop and participate in activities designed to promote the general health of the community.

Three area hospitals—ABC Hospital and Health Center, DEF Hospital, and GHI Hospital—entered into a members' agreement to develop this ambulatory care center. In accordance with this agreement, each hospital contributed capital of $947,000 to Ambulatory Care, Inc. Ambulatory Care, Inc. began operations in October 20X3.

Use of estimates. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Supplies. Supplies are stated at the lower of cost (first-in, first-out) or net realizable value.

Depreciation. Depreciation of property and equipment is computed on the straight-line method over the estimated lives of depreciable assets.

Third-party contractual adjustments. Retroactively calculated third-party contractual adjustments are accrued on an estimated basis in the period the related services are rendered. Net patient service revenue is adjusted as required in subsequent periods based on final settlements.

Net patient service revenue. Patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered.

Charity care. Ambulatory Care, Inc. has a policy of providing charity care to patients who are unable to pay. Such patients are identified and related charges are estimated, based on financial information obtained from the patient and subsequent analysis. Since management does not expect payment for charity care, the estimated charges are excluded from revenue.

Income taxes. Ambulatory Care, Inc. has been recognized by the Internal Revenue Service as a not-for-profit corporation as described in Sec. 501(c)(3) of the Internal Revenue Code (IRC) and is exempt from federal income taxes on related income pursuant to Sec. 501(a) of the IRC.

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[9] Paragraph 13 of SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*, provides guidance on disclosures that should be included in the summary of significant accounting policies, including accounting policies for loans, trade receivables, and doubtful accounts.

2. Advances Receivable

In May 20X4, Ambulatory Care, Inc. entered into a five-year agreement with XYZ Affiliates (XYZ). Under this agreement, XYZ is to provide emergency medical services as well as charge and bill each patient treated at Ambulatory Care, Inc. Ambulatory Care, Inc. has guaranteed that XYZ will collect at least $18,000 per month during the term of this agreement. In any month in which XYZ does not collect the minimum guarantee, Ambulatory Care, Inc. advances funds to XYZ to cover the deficiency. Such advances are to be repaid to the extent XYZ's net cash collections exceed the minimum guarantee amount. Management estimates that the advances will be fully recovered in 20X8.

3. Related-Party Transactions

During 20X3, Ambulatory Care, Inc. entered into a contract with one of the member hospitals (the managing hospital) for the management of the business and affairs of Ambulatory Care, Inc. Under this agreement, Ambulatory Care, Inc. pays $4,000 per month to the managing hospital. The agreement with the managing hospital was to remain in effect through December 31, 20X5, but has been extended on a month-to-month basis.

In addition, during 20X4 each hospital loaned $48,000 to Ambulatory Care, Inc. in the form of promissory notes at an interest rate of prime rate plus 1 percent (effective rates of 10 percent and 9 percent in 20X5 and 20X4, respectively). Of the total $144,000 liability, $48,000 is payable on demand after November 28, 20X5, to one member hospital, with the remaining portion ($96,000) payable on demand after December 8, 20X5, to the other two member hospitals. During 20X5, Ambulatory Care, Inc. paid $2,000 to each member hospital, thereby reducing the obligation to $138,000.

4. Revenue From Contracting Agencies

Ambulatory Care, Inc. participates as a provider of health care services to Blue Cross, Medicare, and County Indigent Plan patients. Reimbursement for covered services is based on tentative payment rates. Final reimbursement is determined after submission of annual cost reports and audits thereof by the fiscal intermediaries. Provisions for estimated reimbursement adjustments are reported in the financial statements in the period that the services are rendered.

Revenue from the Medicare program accounted for approximately XX percent for the year ended 20X5, and XX percent for the year ended 20X4, of Ambulatory Care, Inc.'s net patient revenue. Laws and regulations governing the Medicare program are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. The 20X5 net patient service revenue increased approximately $XXX due to removal of allowances previously estimated that are no longer necessary as a result of final settlements and years that are no longer subject to audits, reviews, and investigations. The 20X4 net patient service revenue decreased approximately $XXX due to prior-year retroactive adjustments in excess of amounts previously estimated.

5. Charity Care

Ambulatory Care, Inc. has a policy of providing charity care to indigent patients in emergency situations. These services, which are excluded from revenues, amounted to $27,000 and $13,000 in 20X5 and 20X4, respectively, when measured at Ambulatory Care, Inc.'s established rates.

6. Classification of Expenses

	Total	Program A	Program B	Program C	General and Administrative
Expenses incurred for the year ended December 31, 20X5, were for:					
Salaries and benefits	$485,000	$216,000	$102,000	$121,000	$46,000
Medical supplies and drugs	189,000	98,000	43,000	48,000	—
Insurance	154,000	79,000	45,000	14,000	16,000
Provision for bad debts	14,000	9,000	—	5,000	—
Depreciation	117,000	100,000	—	17,000	—
Interest	20,000	9,000	—	—	11,000
Total expenses	$979,000	$511,000	$190,000	$205,000	$73,000

	Total	Program A	Program B	Program C	General and Administrative
Expenses incurred for the year ended December 31, 20X4, were for:					
Salaries and benefits	$243,000	$111,000	$46,000	$ 57,000	$29,000
Medical supplies and drugs	66,000	31,000	15,000	20,000	—
Insurance	98,000	45,000	19,000	26,000	8,000
Provision for bad debts	4,000	—	4,000	—	—
Depreciation	100,000	56,000	—	44,000	—
Interest	18,000	7,000	—	—	11,000
Total expenses	$529,000	$250,000	$84,000	$147,000	$48,000

(The preparer of the financial statements may wish to include a brief description of the types of programs.)

7. Risks and Uncertainties Disclosures***

8. Pension Plan***

9. Postretirement Benefits***

10. Fair Value of Financial Instruments***

11. Concentrations of Credit Risk***

*** The disclosures contained in these notes would be similar to the disclosures contained in the notes to the financial statements for the not-for-profit hospital and, therefore, are not repeated here.

Appendix B

Background Information and Basis for Conclusions

1. This appendix provides background information and discusses the comments received on the April 14, 1995 exposure draft that preceded this Audit and Accounting Guide (Guide)— Proposed Audit and Accounting Guide *Health Care Organizations* and the basis for key conclusions in this Guide.

Background Information

2. In 1989, the AICPA Health Care Committee ("the Committee") completed a total rewrite of the Guide. Since then, conforming changes have been made to update the Guide for newly issued technical pronouncements. In June 1993, the FASB issued FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made* ("Contributions"), and FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations* ("Display"). These Statements provide broad standards and introduce new concepts for which there is no detailed implementation guidance. FASB Statement No. 117 permits the AICPA to provide more specific reporting guidance. Specifically, paragraph 3 of FASB Statement No. 117 states:

> "Within the parameters of the Statement, the AICPA or another appropriate body, following the process described in AICPA Statement of Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report*, may provide more specific reporting guidance for certain not-for-profit organizations."

The Guide provides this guidance as it relates to providers of health care services.

3. In April 1995, the Committee released an exposure draft of a proposed Audit and Accounting Guide *Health Care Organizations* (ED) for public comment. The committees received 40 comment letters on the ED. The committees redeliberated the issues based on the comments received. This appendix discusses the key issues in the ED and comments received on those issues, as well as the basis for AcSEC's conclusions on those and certain other issues.

Basis for Conclusions

Contributions and Display

4. FASB Statements No. 116 and No. 117 allow more flexibility in financial reporting than currently exists within the health care industry. The most prominent flexibility relates to the elimination of the requirements to present a classified balance sheet and income statement as compared to the statement of activities.

5. FASB Statements No. 116 and No. 117 apply to all not-for-profit enterprises, regardless of whether or not the entity is a business enterprise. The majority of tax-exempt health care organizations, however, operate as business enterprises (i.e., are essentially self-sustaining from fees charged for goods and services). The Committee believes that the uniformity and usefulness of financial reporting for business enterprise organizations would be enhanced if the implementation guidance for FASB Statements No. 116 and No. 117 were consistent with the objectives of business enterprise financial reporting. The Committee points to the provisions in FASB Concept Statement No. 4, paragraph 8, which clearly supports the use of business enterprise financial reporting objectives for those organizations:

> "Some organizations have no ownership interest but are essentially self-sustaining from fees they charge for goods and services. Examples are those private nonprofit hospitals...that may receive relatively small amounts of contributions and grants, but finance their capital needs largely from the proceeds of debt issues and their operating needs largely from service charges rather than from private philanthropy or governmental grants. As a result, assessments of amounts, timing, and uncertainty of cash flows become the dominate interest of their creditors and other resource providers and profitability becomes an important indicator of performance. Consequently, the objectives of Concepts Statement 1 may be more appropriate for those organizations."

6. Based on the theoretical support provided in FASB Concepts Statement No. 4, as well as the FASB allowance for more specific guidance (see paragraph 2 of this appendix), Chapter 1 of the Guide defines four types of operating structures that are found within the industry: (1) not-for-profit business-oriented organizations, (2) investor-owned health care enterprises, (3) governmental health care organizations, and (4) not-for-profit, nonbusiness-oriented organizations. This Guide provides specific reporting guidance for not-for-profit business-oriented organizations, investor-owned enterprises and governmental entities. (Not-for-profit nonbusiness organizations follow guidance for not-for-profit entities provided in the Audit and Accounting Guide *Not-for-Profit Organizations*.) The Guide recommends that these entities provide a classified balance sheet and a statement of operations. The Guide also encourages natural class reporting on the face of the financial statements, with disclosure of functional details in the footnotes.

7. A number of respondents to the ED were concerned that because the exposure draft of the Guide did not require an entity to distinguish between operating activities and nonoperating activities that such distinctions were no longer permissible. In response to these concerns, the Guide was clarified to incorporate paragraph 23 of FASB Statement No. 117. This paragraph specifically allows additional classifications within a statement of operations. Like FASB Statement No. 117, however, the Guide neither requires nor precludes such classifications.

Assets Whose Use is Limited

8. Several comments were received on the ED requesting specific guidance to allow internally designated funds to be disclosed on the face of the financial statements. In response to these comments, the Committee clarified the Guide to require cash and claims to cash that meet one of the following criteria to be reported separately and excluded from current assets:

a. restricted as to withdrawal or use for other than current operations,

b. designated for expenditure in the acquisition or construction of noncurrent assets,

c. required to be segregated for the liquidation of long-term debts, or

d. required by a donor-imposed restriction that limits their use to long-term purposes.

Consistent with comments received from a rating agency, the Guide requires internally designated funds to be reported separately from externally designated funds either in the notes to or on the face of the financial statements. The Committee believes this separation is beneficial due to the degree of control an organization maintains over internally designated funds.

Investments

9. Chapter 4, as presented in the Exposure Draft, was re-drafted to conform with the provisions of FASB Statement No. 124, *Certain Investments Held by Not-For-Profit Organizations*. This Standard requires fair value accounting for marketable equity and debt securities. The majority of respondents to the ED favored an income recognition approach similar to FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. They believe such an approach is essential because it would foster greater consistency among not-for-profit and for-profit entities. Accordingly, an approach similar to FASB Statement No. 115 (i.e., the differentiation of trading securities vs. available-for-sale securities) was incorporated into the Guide. (The FASB specifically prohibited the use of a held-to-maturity category by not-for-profit organizations.)

Accounting for Donor-Imposed Restricted Contributions on Long-Lived Assets

10. The majority of comments received on accounting for donor-imposed restrictions on contributions of long-lived assets concurred with the Health Care Committee's conclusion that the expiration of donor imposed restrictions on long-lived assets should be recognized when the asset is placed in service (rather than as depreciated as permitted by FASB Statement No. 116). Other respondents disagreed with the Health Care Committee's position for various reasons. After considering each comment on the issue, the Committee concluded that it would maintain the position set forth in the ED. The Committee believes this approach is easier to implement, it provides for uniformity in reporting within the industry and, because the donations are excluded from operating results, an appropriate matching of revenues and expenses occurs.

Use of a Performance Indicator

11. The Guide stresses the importance of the performance indicator and, in an effort to ensure consistency within the industry, provides specific guidance on what the performance indicator should represent. This guidance is consistent with performance criteria historically used in the health care industry, to the extent allowed under the provisions of FASB Statement No. 117. Specifically, the Guide states that health care organizations should report the results of their operations separately from—

a. Transactions with owners acting in that capacity.

b. Equity transfers involving other entities that control the reporting entity, are controlled by the reporting entity, or are under common control with the reporting entity.

c. Receipt of restricted contributions, including temporary restrictions (such as time or purpose) or permanent restrictions.

d. Contributions of (and assets released from donor restrictions related to) long-lived assets.

e. Unrealized gains and losses on investments not restricted by donors or by law, except for those investments classified as trading securities.

f. Investment returns restricted by donors or by law.

g. Other items that are required by GAAP to be reported separately (such as extraordinary items, the effect of discontinued operations, or the cumulative effect of accounting changes).[1]

12. In its deliberations, the FASB discussed the use of the word *net income* to describe the performance indicator of not-for-profit health care organizations. The Board concluded that the term *net income* is an inappropriate term to describe the performance indicator of a not-for-profit organization and that descriptive terms such as *revenues over expenses, revenues and gains over expenses and losses, earned income* or *performance earnings* would be more appropriate. Accordingly, this Guide requires the use of such descriptive terms instead of *net income* to describe the performance indicator of not-for-profit organizations.

Definition of a Governmental Entity

13. Subsequent to the release of the ED, the FASB and the GASB agreed on the definition of a governmental entity. Paragraph 1.02 of the Guide incorporates that definition.

Effective Date

14. Several comment letters were received expressing concern about the effective date of the Guide. In response to these comments, the Committee revised the effective date to fiscal years beginning after June 15, 1996, with earlier application permitted.

Status of Audit and Accounting Guides in the GAAP Hierarchy

15. In several instances the Guide provides more specific reporting requirements than FASB Statements No. 116 and No. 117 (see paragraphs 4 through 6, 8, 10, and 11). In the deliberation of the Guide, the question has arisen regarding the status of the Guide in the GAAP hierarchy, given the fact that AICPA Audit and Accounting Guides are "Level B" GAAP while FASB Statements are "Level A". In discussing the issue the Committee and the Accounting Standards Executive Committee referred to paragraph 49 of FASB Statement No. 117, which states that the AICPA:

> "may provide more specific reporting guidance for certain not-for profit organizations. SAS 69 requires that an entity adopt cleared AICPA Industry Audit and Accounting Guides, and cleared AICPA Statements of Position that become

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[1] Governmental enterprises should report extraordinary items and the effect of discontinued operations in the statement of operations immediately preceding *net income*; the cumulative effect of an accounting change should be reported as an adjustment to *beginning fund balance* in the period of the change. Investor-owned enterprises should report extraordinary items, the effect of discontinued operations and the cumulative effect of an accounting change in the statement of operations immediately preceding net income.

> effective after March 15, 1992. As used in SAS 69, cleared means that the FASB has indicated that it does not object to the issuance of the proposed pronouncement."

The FASB has indicated that it does not object to the more specific reporting requirements contained in this Guide for health care organizations.

Appendix C

Statement of Position 98-2

Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising

March 11, 1998

Amendment to
AICPA Audit and Accounting Guides
Health Care Organizations,
***Not-for-Profit Organizations,* and**
***Audits of State and Local Governmental Units*[§]**

Issued by the Accounting
Standards Executive Committee

[§] The AICPA Audit and Accounting Guide *State and Local Governments,* supersedes the 1994 AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units,* and subsequent editions of that Guide with conforming changes made by the AICPA staff. AICPA Audit and Accounting Guide *State and Local Governments,* provides guidance on the application of this Statement of Position (SOP) to state and local governments. [Footnote added, June 2004, to reflect conforming changes due to the issuance of the AICPA Audit and Accounting Guide *State and Local Governments.*]

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position that have been cleared by either the Financial Accounting Standards Board (for financial statements of nongovernmental entities) or the Governmental Accounting Standards Board (for financial statements of state and local governmental entities), as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

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SUMMARY

This Statement of Position (SOP) applies to all nongovernmental not-for-profit organizations (NPOs) and all state and local governmental entities that solicit contributions.

This SOP requires—

- If the criteria of purpose, audience, and content as defined in this SOP are met, the costs of joint activities that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function.
- If any of the criteria of purpose, audience, and content are not met, all costs of the activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising.
- Certain financial statement disclosures if joint costs are allocated.
- Some commonly used and acceptable allocation methods are described and illustrated although no methods are prescribed or prohibited.

This SOP amends existing guidance in AICPA Audit and Accounting Guides *Health Care Organizations, Not-for-Profit Organizations* (which was issued in August 1996 and supersedes SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, because the provisions of SOP 87-2 are incorporated into the Guide), and *Audits of State and Local Governmental Units*.[§]

This SOP is effective for financial statements for years beginning on or after December 15, 1998. Earlier application is encouraged in fiscal years for which financial statements have not been issued. If comparative financial statements are presented, retroactive application is permitted but not required.

[§] The AICPA Audit and Accounting Guide *State and Local Governments*, supersedes the 1994 AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, and subsequent editions of that Guide with conforming changes made by the AICPA staff. AICPA Audit and Accounting Guide *State and Local Governments*, provides guidance on the application of this Statement of Position (SOP) to state and local governments. [Footnote added, June 2004, to reflect conforming changes due to the issuance of the AICPA Audit and Accounting Guide *State and Local Governments*.]

FOREWORD

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB and the GASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members and three of the five GASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.[†]

The criteria applied by the FASB and the GASB in their review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB and the GASB will propose suggestions, many of which are included in the documents.

[†] This document was cleared prior to July 1, 1997. In July 1997, the GASB increased to seven members. Documents considered by the GASB after July 1, 1997 are cleared if at least four of the seven GASB members do not object. [Footnote renumbered, June 2004, to reflect conforming changes necessary due to the issuance of the AICPA Auidt and Accounting Guide *State and Local Governments*.]

Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising

Introduction

1. Some nongovernmental not-for-profit organizations (NPOs) and some state and local governmental entities,[1] such as governmental colleges and universities and governmental health care providers, solicit support through a variety of **fund-raising activities.**[2] These **activities** include direct mail, telephone solicitation, door-to-door canvassing, telethons, special events, and others. Sometimes fund-raising activities are conducted with activities related to other functions, such as **program activities** or supporting services, such as **management and general activities.**[3] Sometimes fund-raising activities include components that would otherwise be associated with program or supporting services, but in fact support fund raising.

2. External users of financial statements—including contributors, creditors, accreditation agencies, and regulators—want assurance that fund-raising costs, as well as program costs and management and general costs, are stated fairly.

3. In 1987, the AICPA issued Statement of Position (SOP) 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal.*[4] SOP 87-2 required that

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[1] This Statement of Position (SOP) uses the term *entity* to refer to both nongovernmental not-for-profit organizations (NPOs) and state and local governments.

[2] Terms that appear in the Glossary are set in **boldface type** the first time they appear.

[3] The functional classifications of fund raising, program, and management and general are discussed throughout this SOP for purposes of illustrating how the guidance in this SOP would be applied by entities that use those functional classifications. Some entities have a functional structure that does not include fund raising, program, or management and general, or that includes other functional classifications, such as **membership development**. This SOP is not intended to require reporting the functional classifications of fund raising, program, and management and general. In circumstances in which entities that have a functional structure that includes other functional classifications conduct joint activities, all costs of those joint activities should be charged to fund raising (or the category in which fund raising is reported—see the following two parenthetical sentences), unless the purpose, audience, and content of those joint activities are appropriate for achieving those other functions. (An example of an entity that reports fund raising in a category other than fund raising is a state and local governmental entity applying the accounting and financial reporting principles in the AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8. As discussed in paragraph D.5 of this SOP, those entities are required to report fund raising as part of the "institutional support" function. See also footnote ** to paragraph D.5.) [Footnote revised, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statements No. 34 and No. 35.]

[4] In August 1996, the AICPA issued the Audit and Accounting Guide *Not-for-Profit Organizations*. The Guide supersedes SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, because the provisions of SOP 87-2 are incorporated into paragraphs 13.36 to 13.45 of *Not-for-Profit Organizations. Not-for-Profit Organizations* applies to all nongovernmental NPOs other than those required to follow the Audit and Accounting Guide *Health Care Organizations.* The discussion in this SOP of SOP 87-2 refers to both SOP 87-2 and the guidance included in paragraphs 13.36 to 13.45 of *Not-for-Profit Organizations.* Also, SOP 87-2 was not applicable to entities that are within the scope of Governmental Accounting Standards Board (GASB) Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities.*

all circumstances concerning informational materials and activities that include a fund-raising appeal be considered in accounting for **joint costs** of those materials and activities and that certain criteria be applied in determining whether joint costs of those materials and activities should be charged to fund raising or allocated to program or management and general. Those criteria include requiring verifiable indications of the reasons for conducting the activity, such as the content, audience, and action, if any, requested of the participant, as well as other corroborating evidence. Further, SOP 87-2 required that all joint costs of those materials and activities be charged to fund raising unless the appeal is designed to motivate its audience to action other than providing financial support to the organization.

4. The provisions of SOP 87-2 have been difficult to implement and have been applied inconsistently in practice. (Appendix B, "Background," discusses this further.)

5. This SOP establishes financial accounting standards for accounting for **costs of joint activities**. In addition, this SOP requires financial statement disclosures about the nature of the activities for which joint costs have been allocated and the amounts of joint costs. Appendix F provides explanations and illustrations of some acceptable allocation methods.

Scope

6. This SOP applies to all nongovernmental NPOs and all state and local governmental entities that solicit **contributions**.

Conclusions

Accounting for Joint Activities

7. If the criteria of purpose, audience, and content are met, the costs of a **joint activity** that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function. If any of the criteria are not met, all costs of the joint activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising.

Purpose

8. The purpose criterion is met if the purpose of the joint activity includes accomplishing program or management and general functions. (Paragraphs 9 and 10 provide guidance that should be considered in determining whether the purpose criterion is met. Paragraph 9 provides guidance pertaining to program functions only. Paragraph 10 provides guidance pertaining to both program and management and general functions.)

9. *Program functions.* To accomplish program functions, the activity should call for specific action by the audience that will **help accomplish the entity's mission**. For purposes of applying the guidance in this SOP, the

following are examples of activities that do and do not call for specific action by the audience that will help accomplish the entity's mission:

- An entity's mission includes improving individuals' physical health. For that entity, motivating the audience to take specific action that will improve their physical health is a call for specific action by the audience that will help accomplish the entity's mission. An example of an activity that motivates the audience to take specific action that will improve their physical health is sending the audience a brochure that urges them to stop smoking and suggests specific methods, instructions, references, and resources that may be used to stop smoking.
- An entity's mission includes educating individuals in areas other than the causes, conditions, needs, or concerns that the entity's programs are designed to address (referred to hereafter in this SOP as "causes"). For that entity, educating the audience in areas other than causes or motivating the audience to otherwise engage in specific activities that will educate them in areas other than causes is a call for specific action by the audience that will help accomplish the entity's mission. Examples of entities whose mission includes educating individuals in areas other than causes are universities and possibly other entities. An example of an activity motivating individuals to engage in education in areas other than causes is a university inviting individuals to attend a lecture or class in which the individuals will learn about the solar system.
- Educating the audience about causes or motivating the audience to otherwise engage in specific activities that will educate them about causes is not a call for specific action by the audience that will help accomplish the entity's mission. Such activities are considered in support of fund raising. (However, some educational activities that might otherwise be considered as educating the audience about causes may implicitly call for specific action by the audience that will help accomplish the entity's mission. For example, activities that educate the audience about environmental problems caused by not recycling implicitly call for that audience to increase recycling. If the need for and benefits of the specific action are clearly evident from the educational message, the message is considered to include an implicit call for specific action by the audience that will help accomplish the entity's mission.)
- Asking the audience to make contributions is not a call for specific action by the audience that will help accomplish the entity's mission.

If the activity calls for specific action by the audience that will help accomplish the entity's mission, the guidance in paragraph 10 should also be considered in determining whether the purpose criterion is met.

10. *Program and management and general functions.* The following factors should be considered, in the order in which they are listed,[5] to determine whether the purpose criterion is met:

a. *Whether **compensation or fees** for performing the activity are based on contributions raised.* The purpose criterion is *not* met if a majority

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[5] In considering the guidance in paragraph 10, the factor in paragraph 10*a* (the compensation or fees test) is the preeminent guidance. If the factor in paragraph 10*a* is not determinative, the factor in paragraph 10*b* (whether a similar program or management and general activity is conducted separately and on a similar or greater scale) should be considered. If the factor in paragraph 10*b* is not determinative, the factor in paragraph 10*c* (other evidence) should be considered.

of compensation or fees for any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity.[6, 7]

b. *Whether a similar program or management and general activity is conducted separately and on a similar or greater scale.* The purpose criterion is met if either of the following two conditions is met:

(1) *Condition 1:*

— The program component of the joint activity calls for specific action by the recipient that will help accomplish the entity's mission and

— A similar program component is conducted without the fund-raising component using the same **medium** and on a scale that is similar to or greater than the scale on which it is conducted with the fund raising.[8]

(2) *Condition 2:*

A management and general activity that is similar to the management and general component of the joint activity being accounted for is conducted without the fund-raising component using the same medium and on a scale that is similar to or greater than the scale on which it is conducted with the fund raising.

If the purpose criterion is met based on the factor in paragraph 10*b*, the factor in paragraph 10*c* should not be considered.

c. *Other evidence.* If the factors in paragraph 10*a* or 10*b* do not determine whether the purpose criterion is met, other evidence may determine whether the criterion is met. All available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, the purpose criterion is met.

11. The following are examples of indicators that provide evidence for determining whether the purpose criterion is met:

a. Evidence that the purpose criterion may be met includes—

- *Measuring program results and accomplishments of the activity.* The facts may indicate that the purpose criterion is met if the

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[6] Some compensation contracts provide that compensation for performing the activity is based on a factor other than contributions raised, but not to exceed a specified portion of contributions raised. For example, a contract may provide that compensation for performing the activity is $10 per contact hour, but not to exceed 60 percent of contributions raised. In such circumstances, compensation is not considered based on amounts raised, unless the stated maximum percentage is met. In circumstances in which it is not yet known whether the stated maximum percentage is met, compensation is not considered based on amounts raised, unless it is probable that the stated maximum percentage will be met.

[7] The *compensation or fees test* is a negative test in that it either (*a*) results in failing the purpose criterion or (*b*) is not determinative of whether the purpose criterion is met. Therefore, if the activity fails the purpose criterion based on this factor (the compensation or fees test), the activity fails the purpose criterion and the factor in paragraph 10*b* should not be considered. If the purpose criterion is not failed based on this factor, this factor is not determinative of whether the purpose criterion is met and the factor in paragraph 10*b* should be considered.

[8] Determining the scale on which an activity is conducted may be a subjective determination. Factors to consider in determining the scale on which an activity is conducted may include dollars spent, the size of the audience reached, and the degree to which the characteristics of the audience are similar to the characteristics of the audience of the activity being evaluated.

entity measures program results and accomplishments of the activity (other than measuring the extent to which the public was educated about causes).

- *Medium.* The facts may indicate that the purpose criterion is met if the program component of the joint activity calls for specific action by the recipient that will help accomplish the entity's mission and if the entity conducts the program component without a significant fund-raising component in a different medium. Also, the facts may indicate that the purpose criterion is met if the entity conducts the management and general component of the joint activity without a significant fund-raising component in a different medium.

b. Evidence that the purpose criterion may not be met includes—

- *Evaluation or compensation.* The facts may indicate that the purpose criterion is not met if (*a*) the evaluation of any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity or (*b*) some, but less than a majority, of compensation or fees for any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity.

c. Evidence that the purpose criterion may be either met or not met includes—

- *Evaluation of measured results of the activity.* The entity may have a process to evaluate measured program results and accomplishments of the activity (other than measuring the extent to which the public was educated about causes). If the entity has such a process, in evaluating the effectiveness of the joint activity, the entity may place significantly greater weight on the activity's effectiveness in accomplishing program goals or may place significantly greater weight on the activity's effectiveness in raising contributions. The former may indicate that the purpose criterion is met. The latter may indicate that the purpose criterion is not met.
- *Qualifications.* The qualifications and duties of those performing the joint activity should be considered.
  - — If a third party, such as a consultant or contractor, performs part or all of the joint activity, such as producing brochures or making telephone calls, the third party's experience and the range of services provided to the entity should be considered in determining whether the third party is performing fund-raising, program (other than educating the public about causes), or management and general activities on behalf of the entity.
  - — If the entity's employees perform part or all of the joint activity, the full range of their job duties should be considered in determining whether those employees are performing fund-raising, program (other than educating the public about causes), or management and general activities on behalf of the entity. For example, (*a*) employees who are not members of the fund-raising department and (*b*) employees who are members of the fund-raising department but

who perform non-fund-raising activities are more likely to perform activities that include program or management and general functions than are employees who otherwise devote significant time to fund raising.

- *Tangible evidence of intent.* Tangible evidence indicating the intended purpose of the joint activity should be considered. Examples of such tangible evidence include
  - The entity's written mission statement, as stated in its fund-raising activities, bylaws, or annual report.
  - Minutes of board of directors', committees', or other meetings.
  - Restrictions imposed by donors (who are not related parties) on gifts intended to fund the joint activity.
  - Long-range plans or operating policies.
  - Written instructions to other entities, such as script writers, consultants, or list brokers, concerning the purpose of the joint activity, audience to be targeted, or method of conducting the joint activity.
  - Internal management memoranda.

Audience

12. A rebuttable presumption exists that the audience criterion is not met if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute to the entity. That presumption can be overcome if the audience is also selected for one or more of the reasons in paragraph 13*a*, 13*b*, or 13*c*. In determining whether that presumption is overcome, entities should consider the extent to which the audience is selected based on its ability or likelihood to contribute to the entity and contrast that with the extent to which it is selected for one or more of the reasons in paragraph 13*a*, 13*b*, or 13*c*. For example, if the audience's ability or likelihood to contribute is a significant factor in its selection and it has a need for the action related to the program component of the joint activity, but having that need is an insignificant factor in its selection, the presumption would not be overcome.

13. In circumstances in which the audience includes no prior donors and is not otherwise selected based on its ability or likelihood to contribute to the entity, the audience criterion is met if the audience is selected for one or more of the following reasons:

a. The audience's need to use or reasonable potential for use of the specific action called for by the program component of the joint activity

b. The audience's ability to take specific action to assist the entity in meeting the goals of the program component of the joint activity

c. The entity is required to direct the management and general component of the joint activity to the particular audience or the audience has reasonable potential for use of the management and general component

Content

14. The content criterion is met if the joint activity supports program or management and general functions, as follows:

a. *Program.* The joint activity calls for specific action by the recipient that will help accomplish the entity's mission. If the need for and benefits of the action are not clearly evident, information describing the action and explaining the need for and benefits of the action is provided.

b. *Management and general.* The joint activity fulfills one or more of the entity's management and general responsibilities through a component of the joint activity.[9]

15. Information identifying and describing the entity, causes, or how the contributions provided will be used is considered in support of fund raising.

Allocation Methods

16. The cost allocation methodology used should be rational and systematic, it should result in an allocation of joint costs that is reasonable, and it should be applied consistently given similar facts and circumstances.

Incidental Activities

17. Some fund-raising activities conducted in conjunction with program or management and general activities are incidental to such program or management and general activities. For example, an entity may conduct a fund-raising activity by including a generic message, "Contributions to Organization X may be sent to [*address*]" on a small area of a message that would otherwise be considered a program or management and general activity based on its purpose, audience, and content. That fund-raising activity likely would be considered incidental to the program or management and general activity being conducted. Similarly, entities may conduct program or management and general activities in conjunction with fund-raising activities that are incidental to such fund-raising activities. For example, an entity may conduct a program activity by including a generic program message such as "Continue to pray for [*a particular cause*]" on a small area of a message that would otherwise be considered fund raising based on its purpose, audience, and content. That program activity would likely be considered incidental to the fund-raising activity being conducted. Similarly, an entity may conduct a management and general activity by including a brief management and general message—"We recently changed our phone number. Our new number is 123-4567"—on a small area of a message that would otherwise be considered a program or fund-raising activity based on its purpose, audience, and content. That management and general activity would likely be considered incidental to the program or fund-raising activity being conducted. In circumstances in which a fund-raising, program, or management and general activity is conducted in conjunction with another activity and is incidental to that other activity, and the conditions in this SOP for allocation are met, joint costs are permitted but not required to be allocated and may therefore be charged to the functional classification related to the activity that is not the incidental activity. However, in circumstances in which the program or management and general activities are incidental to the fund-raising activities, it is unlikely that the conditions required by this SOP to permit allocation of joint costs would be met.

Disclosures

18. Entities that allocate joint costs should disclose the following in the notes to their financial statements:

a. The types of activities for which joint costs have been incurred

b. A statement that such costs have been allocated

[9] Some states or other regulatory bodies require that certain disclosures be included when soliciting contributions. For purposes of applying the guidance in this SOP, communications that include such required disclosures are considered fund-raising activities and are not considered management and general activities.

c. The total amount allocated during the period and the portion allocated to each functional expense category

19. This SOP encourages, but does not require, that the amount of joint costs for each kind of joint activity be disclosed, if practical.

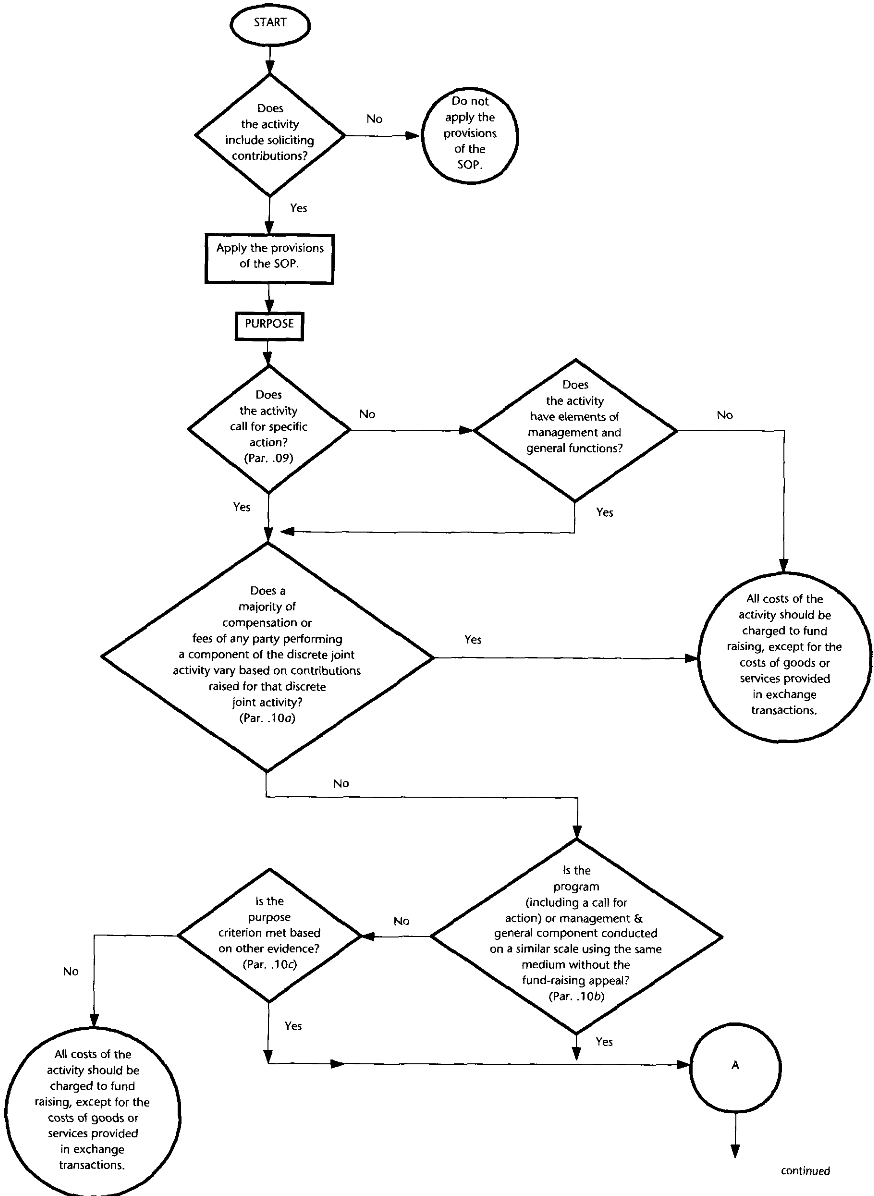
Effective Date

20. This SOP is effective for financial statements for years beginning on or after December 15, 1998. Earlier application is encouraged in fiscal years for which financial statements have not been issued. If comparative financial statements are presented, retroactive application is permitted but not required.

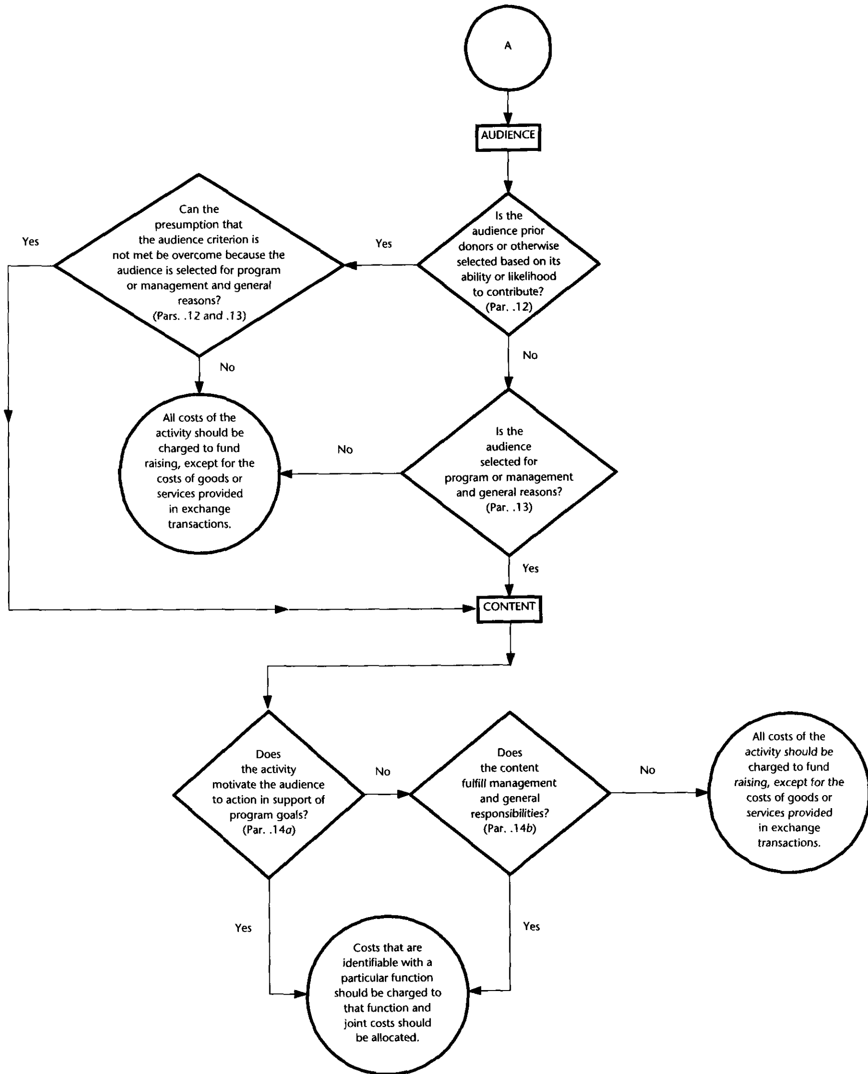
The provisions of this Statement of Position need not be applied to immaterial items.

APPENDIX A

Accounting for Joint Activities[10]



[10] ***Note:*** This flowchart summarizes certain guidance in this SOP and is not intended as a substitute for the SOP.


A
AUDIENCE
Is the audience prior donors or otherwise selected based on its ability or likelihood to contribute? (Par. .12)
Yes
Can the presumption that the audience criterion is not met be overcome because the audience is selected for program or management and general reasons? (Pars. .12 and .13)
Yes
No
All costs of the activity should be charged to fund raising, except for the costs of goods or services provided in exchange transactions.
No
Is the audience selected for program or management and general reasons? (Par. .13)
No
Yes
CONTENT
Does the activity motivate the audience to action in support of program goals? (Par. .14a)
No
Does the content fulfill management and general responsibilities? (Par. .14b)
No
All costs of the activity should be charged to fund raising, except for the costs of goods or services provided in exchange transactions.
Yes
Yes
Costs that are identifiable with a particular function should be charged to that function and joint costs should be allocated.

APPENDIX B

Background

B.1. As stated in paragraph 4, the provisions of Statement of Position (SOP) 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, have been difficult to implement and applied inconsistently in practice. That difficulty has been due in part to the following:

- The second sentence of paragraph 1 of SOP 87-2 stated that "some of the costs incurred by such organizations are clearly identifiable with fundraising, such as the cost of fund-raising consulting services." It is unclear whether activities that would otherwise be considered program activities should be characterized as program activities if they are performed or overseen by professional fund raisers. Also, it is unclear whether activities would be reported differently (for example, as program rather than fund raising) depending on whether the fund-raising consultant is compensated by a predetermined fee or by some other method, such as a percentage of contributions raised.
- SOP 87-2 was unclear about whether allocation of costs to fund-raising expense is required if the activity for which the costs were incurred would not have been undertaken without the fund-raising component.
- SOP 87-2 defined joint costs through examples, and it is therefore unclear what kinds of costs were covered by SOP 87-2. For example, it is unclear whether salaries and indirect costs can be joint costs.
- Some believe the guidance in SOP 87-2 was inadequate to determine whether joint activities, such as those that request contributions and also list the warning signs of a disease, are designed to motivate their audiences to action other than to provide contributions to the entity. It is unclear what attributes the targeted audience should possess in order to conclude that a program function is being conducted.

B.2. In 1992, the Accounting Standards Executive Committee (AcSEC) undertook a project to supersede SOP 87-2, to provide clearer guidance than that provided by SOP 87-2, as well as to provide guidance that would improve on the guidance in SOP 87-2. In September 1993, AcSEC released an exposure draft of a proposed SOP, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include a Fund-Raising Appeal*, for public comment. AcSEC received more than 300 comment letters on the exposure draft. AcSEC redeliberated the issues based on the comments received.

B.3. In 1996, after redeliberating the issues based on the comments received and making certain revisions to the draft SOP, AcSEC conducted a field test of the draft SOP. The objectives of the field test were to determine whether the provisions of the draft SOP were sufficiently clear and definitive to generate consistent and comparable application of the SOP. Based on the field test results, AcSEC concluded that the provisions of the draft SOP, with certain revisions, were sufficiently clear and definitive to generate consistent and comparable application of the SOP.

B.4. Some respondents who commented on the exposure draft, as well as some interested parties who followed the project through its due process sub-

sequent to the exposure draft, commented that the SOP should be reexposed for public comment. Reasons cited include:

- Approximately three years had passed between the end of the comment period and AcSEC's decision to issue the SOP.
- AcSEC made significant revisions to the SOP subsequent to releasing the exposure draft for comment.

Considering whether a proposed standard should be reexposed for public comment is inherently a subjective process. Factors that AcSEC considered include—

- The significance of changes made to the exposure draft and whether those changes result in guidance that the public did not have an opportunity to consider.
- Whether the scope was revised in such a way that affected entities did not have an opportunity to comment.
- New information about or changes in the nature of the transactions being considered, practice, or other factors.

AcSEC believes that the length of time between exposure and final issuance is not pertinent to whether the SOP should be reexposed for public comment.

B.5. Based on consideration of the factors identified, AcSEC believes that the SOP should not be reexposed for public comment. AcSEC notes that although the SOP has been revised based on comments received on the exposure draft, those revisions do not change the overall model in the SOP. Those revisions were made primarily to clarify the SOP and improve its operationality. Further, AcSEC believes that the project received a high level of attention from interested parties. AcSEC provided working drafts to interested parties and those parties provided input throughout the process, up to and including the Financial Accounting Standard Board's and the Governmental Accounting Standards Board's clearance of the SOP for issuance.

B.6. Appendix C discusses the key issues in the exposure draft and comments received on those issues, as well as the basis for AcSEC's conclusions on those and certain other issues.

APPENDIX C

Basis for Conclusions

C.1. This section discusses considerations that were deemed significant by members of the Accounting Standards Executive Committee (AcSEC) in reaching the conclusions in this Statement of Position (SOP). It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

Overall Framework

C.2. This SOP uses the model in SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal,* as a starting point and clarifies guidance that was unclear, provides more detailed guidance, revises some guidance, and expands the scope of costs covered to include all costs of joint activities. The model established by SOP 87-2 was to account for joint costs as fund raising unless an entity could demonstrate that a program or management and general function had been conducted. SOP 87-2 used verifiable indications of the reasons for conducting the activity, such as content, audience, the action requested, if any, and other corroborating evidence as a basis for determining whether a program or management and general function had been conducted.

C.3. On an overall basis, the majority of respondents who commented on the September 1993 exposure draft of a proposed SOP, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include a Fund-Raising Appeal*, opposed it, for various reasons, including the following:

- The guidance in SOP 87-2 is operational, results in sound financial reporting, and should be retained.
- The guidance in SOP 87-2 should be retained but clarified.
- The guidance proposed in the exposure draft should be revised. (Some commented that it overstates fund raising; others commented that it understates fund raising.)

C.4. AcSEC concluded that it supports the model in the exposure draft, subject to certain revisions. AcSEC believes that this SOP provides clear, detailed accounting guidance that, when applied, will increase comparability of financial statements. Those statements will also include more meaningful disclosures without incurring increased costs.

C.5. Some respondents commented that the model in the exposure draft would adversely affect entities both financially and operationally. Various reasons were given, including the following:

- It would inhibit the ability of entities, particularly small entities and entities that raise contributions through direct solicitations, to generate the necessary revenue to perform their program services.
- Most entities would not meet the criteria in this SOP for reporting costs of joint activities as program or management and general, because they must combine their mission statements, public information and education, and fund-raising appeals due to a lack of resources. Some noted that this may result in unsatisfactory ratings from public watchdog groups.

AcSEC did not find these arguments compelling. This SOP provides accounting guidance; it provides no guidance concerning how entities should undertake their activities. Also, this SOP does not prohibit allocation merely because activities carrying out different functions are combined. In fact, this SOP provides guidance for reporting costs as program or management and general in circumstances in which those activities are combined with fund-raising. Moreover, actions taken by financial statement users are not the direct result of the requirements of this SOP. Rather, those actions may result from more relevant and useful information on which to base decisions.

C.6. Some respondents commented that the exposure draft is biased toward reporting expenses as fund raising. AcSEC believes that determining whether the costs of joint activities should be classified as program, management and general, or fund raising sometimes is difficult, and such distinctions sometimes are subject to a high degree of judgment. AcSEC believes that external financial statement users focus on and have perceptions about amounts reported as program, management and general, and fund raising. That focus and those perceptions provide incentives for entities to report expenses as program or management and general rather than fund raising. Therefore, in circumstances in which joint activities are conducted, a presumption exists that expenses should be reported as fund raising rather than as program or management and general. The criteria in this SOP provide guidance for entities to overcome that presumption.

Accounting for Joint Activities

C.7. This SOP requires that if any of the criteria of purpose, audience, and content are not met, all costs of the activity should be reported as fund raising, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising. (This SOP expands on the model established by SOP 87-2 by including all costs of joint activities other than costs of goods or services provided in exchange transactions, rather than merely joint costs.) AcSEC believes that the criteria of purpose, audience, and content are each relevant in determining whether a joint activity should be reported as fund raising, program, or management and general because each provides significant evidence about the benefits expected to be obtained by undertaking the activity.

C.8. Some respondents commented that reporting costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity as fund raising is misleading and that the scope of the SOP should include only joint costs of joint activities. Some commented that reporting costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity as fund raising conflicts with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, which defines fund raising, program, and management and general and requires not-for-profit organizations (NPOs) to report information about expenses using those functional classifications.

C.9. AcSEC believes that the purpose for which costs other than joint costs are incurred may be fund raising, program, or management and general,

depending on the context in which they are used in the activity undertaken. For example, a program-related pamphlet may be sent to an audience in need of the program. In that context, the pamphlet is used for program purposes. However, in order to demonstrate to potential donors that the entity's programs are worthwhile, that same pamphlet may be sent to an audience that is likely to contribute, but that has no need or reasonable potential for use of the program. In that context, the pamphlet is used for fund raising. AcSEC believes this broader scope will result in more comparability and more meaningful financial reporting by covering all costs of activities that include fund raising and by assigning those costs to the function for which they are incurred, consistent with the guidance in Statement No. 117.

C.10. AcSEC believes that costs of goods or services provided in exchange transactions should not be charged to fund raising because those costs are incurred in exchange for revenues other than contributions.

Criteria of Purpose, Audience, and Content

Call For Action

C.11. The definition of *program* in FASB Statement No. 117 includes public education. As noted in paragraph C.6, AcSEC believes that in circumstances in which joint activities are conducted, a presumption exists that expenses should be reported as fund raising rather than as program or management and general. AcSEC believes that in order to overcome that presumption, it is not enough that (*a*) the purpose of the activity include educating the public about causes, (*b*) the audience has a need or reasonable potential for use of any educational component of the activity pertaining to causes, or (*c*) the audience has the ability to assist the entity in meeting the goals of the program component of the activity by becoming educated about causes. Therefore, AcSEC concluded that for purposes of this SOP, in order to conclude that the criteria of purpose, audience, and content are met program activities are required to call for specific action by the recipient (other than becoming educated about causes) that will help accomplish the entity's mission. As discussed in paragraph 9, in certain circumstances educational activities may call for specific action by the recipient that will help accomplish the entity's mission.

Purpose

C.12. AcSEC believes meeting the purpose criterion demonstrates that the purpose of the activity includes accomplishing program or management and general functions. Inherent in the notion of a joint activity is that the activity has elements of more than one function. Accordingly, the purpose criterion provides guidance for determining whether the purpose of the activity includes accomplishing program or management and general functions in addition to fund raising.

Compensation and Evaluation Tests

C.13. The exposure draft proposed that all costs of the joint activity should be charged to fund raising if (*a*) substantially all compensation or fees for performing the activity are based on amounts raised or (*b*) the evaluation of the party performing the activity is based on amounts raised. Some respondents commented that basing the method of compensation or evaluating the performance

of the party performing the activity based on contributions raised should not lead to the conclusion that all costs of the activity should be charged to fund raising. Others commented that the method of compensation is unrelated to whether the purpose criterion is met. The reasons given included the following:

- It is counterintuitive to imply that those performing multipurpose activities that include fund raising would not be compensated or evaluated based on amounts raised.
- Such guidance would create a bias toward entities that use employees to raise contributions and against entities that hire professional fund raisers and public relations firms and is therefore not neutral.

Some respondents gave examples of circumstances in which substantially all compensation is based on contributions raised and asserted that the activity was nevertheless a program activity. In each of those examples, AcSEC considered all the facts presented and concluded that the activity was fund raising.

C.14. AcSEC continues to support the spirit of the proposed guidance, because AcSEC believes that basing a majority of compensation on funds raised is persuasive evidence that the activity is a fund-raising activity. Nevertheless, AcSEC believes that the proposed guidance was unclear and would be difficult to implement, primarily because of the broad definition of "based on contributions raised" included in the glossary of the exposure draft. In connection with that issue, AcSEC was concerned that any joint activities performed by a fund-raising department or by individuals whose duties include fund raising, such as executive officers of small NPOs who are employed based on their ability to raise contributions, would be required to be reported as fund raising because the compensation of the parties performing those activities is based on amounts raised. Also, AcSEC had concerns that it would be difficult to determine whether fixed contract amounts were negotiated based on expected contributions. Therefore, AcSEC concluded that the compensation test should be revised to provide that the purpose criterion is not met if a majority of compensation or fees for any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity. AcSEC believes that guidance is sound and is operational.

C.15. AcSEC believes that the guidance in paragraph 10*a* is not biased against entities that hire professional fund raisers, because it applies to the entity's employees as well as professional fund raisers. For example, if a majority of an employee's compensation or fees for performing a component of a discrete joint activity varies based on contributions raised for that discrete joint activity, the purpose criterion is not met.

Similar Function-Similar Medium Test

C.16. Some respondents misinterpreted the exposure draft as providing that, in order to meet the purpose criterion, the program or management and general activity must be conducted without the fund-raising component, using the same medium and on a scale that is similar to or greater than the program or management and general component of the activity being accounted for. That was not a requirement proposed by the exposure draft. The exposure draft proposed that meeting that condition would result in meeting the purpose criterion. Failing the criterion merely leads to consideration of other evidence, such as the indicators in paragraph 11. AcSEC has revised the SOP to state this more clearly.

Other Evidence

C.17. The compensation test and the similar function-similar medium test may not always be determinative because the attributes that they consider may not be present. Therefore, this SOP includes indicators that should be considered in circumstances in which the compensation test and the similar function-similar medium test are not determinative. The nature of those indicators is such that they may be present in varying degrees. Therefore, all available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, the purpose criterion is met.

Audience

C.18. The exposure draft proposed that if the audience for the materials or activities is selected principally on its ability or likelihood to contribute, the audience criterion is not met and all the costs of the activity should be charged to fund raising. Further, the exposure draft proposed that if the audience is selected principally based on its need for the program or because it can assist the entity in meeting its program goals other than by financial support provided to the entity, the audience criterion is met. Some respondents commented that that audience criterion is too narrow, because it is based on the principal reason for selecting the audience. They asserted that for some activities no principal reason exists for selecting an audience; entities select the audience for those activities for multiple reasons, such as both the audience's ability to contribute and its ability to help meet program goals. Some commented that for some activities, entities select audiences that have provided past financial support because, by providing financial support, those audiences have expressed an interest in the program.

C.19. AcSEC believes that meeting the audience criterion should demonstrate that the audience is selected because it is a suitable audience for accomplishing the activity's program or management and general functions. Therefore, the reasons for selecting the audience should be consistent with the program or management and general content of the activity. However, AcSEC believes it is inherent in the notion of joint activities that the activity has elements of more than one function, including fund raising, and acknowledges that it may be difficult to determine the principal reason for selecting the audience. Accordingly, AcSEC concluded that if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute, a rebuttable presumption should exist that the audience was selected to raise funds. AcSEC believes that the reasons for selecting the audience that can overcome that presumption, which are included in paragraph 13 of this SOP, demonstrate that the audience is selected because it is a suitable audience for accomplishing the activity's program or management and general functions based on the program or management and general content of the activity.

Content

C.20. AcSEC believes that meeting the content criterion demonstrates that the content of the activity supports program or management and general functions. AcSEC believes that accounting guidance should not impose value judgments about whether the entity's mission, programs, and responsibilities are worthwhile. Therefore, whether the content criterion is met depends on the relationship of the content to the entity's mission, programs, and management and general responsibilities.

C.21. Paragraph 14 provides that, to meet the content criterion, program activities should call for specific action by the recipient that will help accomplish the entity's mission. The exposure draft proposed that slogans, general calls to prayer, and general calls to protest do not meet the content criterion; some respondents disagreed. AcSEC concluded that this SOP should be silent concerning whether slogans, general calls to prayer, and general calls to protest are calls to action that meet the content criterion. AcSEC believes that determining whether those items are calls to action that meet the content criterion requires judgments based on the particular facts and circumstances.

C.22. Some respondents commented that educating the public about causes without calling for specific action should satisfy the content criterion. They noted that this is particularly relevant for NPOs subject to Internal Revenue Code (IRC) Section 501(c)4, because those NPOs are involved in legislative reform. Also, some noted that it may be the entity's mission or goal to educate the public about causes. They believe that, in those cases, the NPO's program is to educate the public about causes without necessarily calling for specific action by the recipient.

C.23. As discussed in paragraph C.11, AcSEC concluded that education that does not motivate the audience to action is in fact done in support of fund raising. However, this SOP acknowledges that some educational messages motivate the audience to specific action, and those messages meet the content criterion. AcSEC believes that that provision will result in the activities of some NPOs subject to IRC Section 501(c)4 (and some other entities, whose mission or goal is to educate the public) meeting the content criterion.

C.24. Paragraph 13*c* provides that one way that the audience criterion is met is if the entity is required to direct the management and general component of the activity to the particular audience. Further, as discussed in paragraph D.13, in *Discussion of Conclusions*, an audience that includes prior donors and is selected because the entity is required to send them certain information to comply with requirements of the Internal Revenue Service (IRS) is an example of an audience that is selected because the entity is required to direct the management and general component of the activity to that audience. Paragraph 14*b* provides that one way that the content criterion is met is if the activity fulfills one or more of the entity's management and general responsibilities through a component of the joint activity. However, footnote 9 to paragraph 14*b* provides that disclosures made when soliciting contributions to comply with requirements of states or other regulatory bodies are considered fund-raising activities, and are not considered management and general activities. AcSEC considered whether it is inconsistent to conclude both that (*a*) activities conducted to comply with requirements of regulatory bodies concerning contributions that have been received are management and general activities, and that (*b*) activities conducted to comply with requirements of regulatory bodies concerning soliciting contributions are fund-raising activities. AcSEC believes that those provisions are not inconsistent. AcSEC believes there is a distinction between (*a*) requirements that must be met as a result of receiving contributions and (*b*) requirements that must be met in order to solicit contributions. AcSEC believes that activities that are undertaken as a result of receiving contributions are management and general activities while activities that are undertaken in order to solicit contributions are fund-raising activities.

Incidental Activities

C.25. Many entities conduct fund-raising activities in conjunction with program or management and general activities that are incidental to such program

or management and general activities. Similarly, entities may conduct program or management and general activities in conjunction with fund-raising activities that are incidental to such fund-raising activities. Such efforts may be a practical and efficient means for entities to conduct activities, although the principal purpose of the activity may be to fulfill either fund-raising, program, or management and general functions. The exposure draft proposed that incidental activities need not be considered in applying this SOP. Some respondents disagreed with that guidance, while others commented that it was confusing. AcSEC continues to support that guidance. AcSEC believes that guidance is necessary to avoid requiring complex allocations in circumstances in which the criteria of purpose, audience, and content are met but the activity is overwhelmingly either fund raising, program, or management and general.

Allocation Methods

C.26. Respondents had various comments concerning allocation methods, including the following:

- The SOP should focus on allocation methods rather than on circumstances in which entities should allocate.
- The SOP should prescribe allocation methods.
- The approach taken in the SOP—discussing, rather than requiring or prohibiting allocation methods—is sound.
- Certain allocation methods should be prohibited.
- The SOP should set maximum allocation percentages.

AcSEC believes that no particular allocation method or methods are necessarily more desirable than other methods in all circumstances. Therefore, this SOP neither prescribes nor prohibits any particular allocation methods. AcSEC believes entities should apply the allocation methods that result in the most reasonable cost allocations for their activities. Appendix F of this SOP illustrates several allocation methods, any one of which may result in a reasonable or unreasonable allocation of costs in particular circumstances. The methods illustrated are not the only acceptable methods. However, AcSEC believes that the methods illustrated in this SOP are among those most likely to result in meaningful cost allocations.

C.27. Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, states in paragraph 7 that "the term *accounting principle* includes 'not only accounting principles and practices but also the methods of applying them.'" APB Opinion 20 also states in paragraphs 15 and 16 that

> . . . In the preparation of financial statements there is a presumption that an accounting principle once adopted should not be changed in accounting for events and transactions of a similar type . . . . The presumption that an entity should not change an accounting principle may be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle [*allocation method*] on the basis that it is preferable.

A change in cost allocation methodology may be a change in accounting principle for entities covered by this SOP. Accordingly, paragraph 16 of this SOP provides that the cost allocation methodology used should be applied consistently, given similar facts and circumstances.

Disclosures

C.28. Respondents made various comments concerning the required and encouraged disclosures, including recommendations for additional disclosures

and recommendations that certain disclosures be deleted. AcSEC was not persuaded that the costs of the other disclosures recommended by respondents are justified by their benefits. AcSEC believes that, with the exception of one disclosure, the disclosures prescribed by the exposure draft provide relevant information about the kinds of activities for which joint costs have been incurred and the manner in which those costs are reported in the financial statements. In considering disclosures proposed by the exposure draft about the allocation method, AcSEC observed that there are no requirements to disclose methods of allocating other expenses and questioned the utility of disclosing the allocation method in this circumstance. AcSEC concluded that the requirement to disclose the allocation method should be deleted.

C.29. Paragraph 19 encourages, but does not require, certain disclosures. AcSEC believes those disclosures provide useful information but that they should be encouraged rather than required because the costs of making them may not be justified by the benefits in all cases.

Effective Date

C.30. Some respondents commented that the effective date should be deferred. AcSEC believes that the accounting systems required to implement this SOP are already in place and that implementation should be relatively straightforward. However, AcSEC acknowledges that some entities may change their operations based on the reporting that would result from this SOP. Therefore, AcSEC concluded that this SOP should be effective for financial statements for years beginning on or after December 15, 1998.

Cost-Benefit

C.31. Some respondents commented that the guidance would increase record keeping costs. AcSEC believes that implementing this SOP will not significantly increase record keeping costs, which are primarily the costs of documenting reasons for undertaking joint activities. Further, AcSEC believes that the costs of making the disclosures required by this SOP should be minimal, because entities should already have the information that is required to be disclosed. AcSEC believes that implementing this SOP will result in more relevant, meaningful, and comparable financial reporting and that the cost of implementing this SOP will be justified by its benefits.

APPENDIX D

Discussion of Conclusions

Scope

D.1. This Statement of Position (SOP) applies only to costs of joint activities. It does not address allocations of costs in other circumstances.

Reporting Models and Related Requirements

D.2. Paragraph 26 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, specifies that a statement of activities or notes to the financial statements should provide information about expenses reported by their functional classification, such as major classes of program services and supporting activities. Paragraph 13.34 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* provides that the financial statements of not-for-profit organizations (NPOs) should disclose the total fund-raising expenses. [Revised, June 2004, to reflect conforming changes necessary due to conforming changes made to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.]

D.3. Governmental Accounting Standards Board (GASB) Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, provides that governmental entities should not change their accounting and financial reporting to apply the provisions of FASB Statements No. 116, *Accounting for Contributions Received and Contributions Made*, and No. 117. GASB Statement No. 29 permits governmental entities that have applied the accounting and financial reporting principles in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, or in the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* (modified by all applicable FASB pronouncements issued through November 30, 1989, and by most applicable GASB pronouncements) to continue to do so, pending GASB pronouncements on the accounting and financial reporting model for governmental entities. Alternatively, those governmental entities are permitted to change to the current governmental financial reporting model.[||]

D.4. GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models*, requires governmental colleges and universities to use one of two accounting and financial reporting models. One model, referred to as the "AICPA College Guide Model," encompasses the accounting and financial reporting guidance in the 1973 AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*, and as modified by applicable FASB pronouncements issued through November 30, 1989, and all applicable GASB pronouncements. (The other model, referred to as the "Governmental

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[||] GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, supersedes the provisions of GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, relating to the use of the AICPA Not-for-Profit model. See GASB Statement No. 34, including paragraph 147. The AICPA Audit and Accounting Guide *State and Local Governments*, provides guidance on the application of this SOP to state and local governments.

Model," is based on the pronouncements of the National Council on Governmental Accounting [NCGA] and the GASB.)[#]

D.5. For state and local governmental entities, some are required to report expenses by function using the functional classifications of program, management and general, and fund raising. Other state and local governmental entities that report expenses or expenditures by function have a functional structure that does not include fund raising, program, or management and general. Still other state and local governmental entities do not report expenses or expenditures by function. Examples of those various reporting requirements are as follows:[**]

- Entities applying the accounting and financial reporting principles in the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations*, as well as those that follow SOP 78-10 and that receive significant amounts of contributions from the public, are required to report separately the costs of the fund-raising, program, and management and general functions.
- Entities applying the accounting and financial reporting principles in the AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8, are required to report fund raising as part of the "institutional support" function.

D.6. As discussed in footnote 3 to paragraph 1 of this SOP, this SOP is not intended to require reporting the functional classifications of fund raising, program, and management and general. Rather, those functional classifications are discussed throughout this SOP for purposes of illustrating how the guidance in this SOP would be applied by entities that use those functional classifications. Entities that do not use the functional classifications of fund raising, program, and management and general should apply the guidance in this SOP for purposes of accounting for joint activities, using their reporting model. For example, some entities may conduct membership-development activities. As discussed in the Glossary of this SOP, if there are no significant benefits or duties connected with membership, the substance of the membership-development activities may, in fact, be fund raising. In such circumstances, the costs of those activities should be charged to fund raising. To the extent that member benefits are received, membership is an exchange transaction. In circumstances in which membership development is in part soliciting revenues from exchange transactions and in part soliciting contributions and the purpose, audience, and content of the activity are appropriate for achieving membership development, joint costs should be allocated between fund raising and the exchange transaction.

Assigning Costs of Joint Activities

D.7. Paragraph 7 provides: "If the criteria of purpose, audience, and content are met, the costs of a joint activity that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general

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[#] GASB Statement No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*, supersedes GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models*. See GASB Statements No. 34 and 35. The AICPA Audit and Accounting Guide *State and Local Governments*, provides guidance on the application of this SOP to governmental (public) colleges and universities. [Footnote revised, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statement No. 35.]

[**] This discussion is no longer applicable. See footnotes | | and ** to paragraphs D.3 and D.4. [Footnote added, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statements No. 34 and No. 35.]

function. If any of the criteria are not met, all costs of the joint activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity. . . ." For example, if the criteria are met, the costs of materials that accomplish program goals and that are unrelated to fund raising, such as the costs of a program-related pamphlet included in a joint activity, should be charged to program, while joint costs, such as postage, should be allocated between fund raising and program. However, if the pamphlet is used in fund-raising packets and the criteria are not met, the costs of the pamphlets used in the fund-raising packets, as well as the joint costs, should be charged to fund raising. (If some pamphlets are used in program activities that include no fund raising, the cost of the pamphlets used in those separate program activities that include no fund raising should be charged to program.)

Educational Activities

D.8. Some entities have missions that include educating the public (students) in areas other than causes. Paragraph 9 provides that, for those entities, educating the audience in areas other than causes or motivating the audience to engage in specific activities, such as attending a lecture or class, that will educate them in areas other than causes is considered a call for specific action by the recipients that will help accomplish the entity's mission. Educating the audience about causes or motivating the audience to engage in specific activities that will educate them about causes without educating them in other subjects is not considered a call for specific action by the audience that will help accomplish the entity's mission. An example of a lecture or class that will educate students in an area other than causes is a lecture on the nesting habits of the bald eagle, given by the Save the Bald Eagle Society, an NPO whose mission is to save the bald eagle from extinction and educate the public about the bald eagle. An example of a lecture or class that will address particular causes is a lecture by the Bald Eagle Society on the potential extinction of bald eagles and the need to raise contributions to prevent their extinction. For purposes of applying the guidance in this SOP, motivating the audience to attend a lecture on the nesting habits of the bald eagle is a call for specific action that will help accomplish the entity's mission. If the lecture merely addresses the potential extinction of bald eagles and the need to raise contributions to prevent their extinction, without addressing the nesting habits of the bald eagle, motivating the audience to attend the lecture is not considered a call for specific action by the recipient that will help accomplish the entity's mission.

D.9. AcSEC notes that most transactions in which a student attends a lecture or class are exchange transactions and are not joint activities. Such transactions are joint activities only if the activity includes fund raising.

Audience

D.10. Paragraph 12 provides that a rebuttable presumption exists that the audience criterion is not met if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute to the entity. That presumption can be overcome if the audience is also selected for the program or management and general reasons specified in paragraph 13. Further, paragraph 12 provides that in determining whether that presumption is overcome, entities should consider the extent to which the audience is selected based on its ability or likelihood to contribute to the entity and contrast that with the extent to which it is selected for the reasons that may overcome that presumption. Some organizations conduct joint activities that are special events, such as symposia, dinners, dances, and theater parties, in which the

attendee receives a direct benefit (for example, a meal or theater ticket) and for which the admission price includes a contribution. For example, it may cost $500 to attend a dinner with a fair value of $50. In that case, the audience is required to make a $450 contribution in order to attend. In circumstances in which the audience is required to make a contribution to participate in a joint activity, such as attending a special event, the audience's ability or likelihood to contribute is a significant factor in its selection. Therefore, in circumstances in which the audience is required to make a contribution to participate in a joint activity, the extent to which the audience is selected for the program or management and general reasons in paragraph 13 must be overwhelmingly significant in order to rebut the presumption that the audience criterion is not met.

D.11. The source of the names and the characteristics of the audience should be considered in determining the reason for selecting the audience. Some entities use lists compiled by others to reach new audiences. The source of such lists may indicate the purpose or purposes for which they were selected. For example, lists acquired from entities with similar or related programs are more likely to meet the audience criterion than are lists acquired from entities with dissimilar or unrelated programs. Also, the characteristics of those on the lists may indicate the purpose or purposes for which they were selected. For example, a list based on a consumer profile of those who buy environmentally friendly products may be useful to an entity whose mission addresses environmental concerns and could therefore indicate that the audience was selected for its ability to take action to assist the entity in meeting program goals. However, a list based on net worth would indicate that the audience was selected based on its ability or likelihood to contribute, unless there was a correlation between net worth and the program or management and general components of the activity.

D.12. Some audiences may be selected because they have an interest in or affinity to the program. For example, homeowners may have an interest in the homeless because they are sympathetic to the plight of the homeless. Nevertheless, including homeowners in the audience of a program activity to provide services to the homeless would not meet the audience criterion, because they do not have a need or reasonable potential for use of services to the homeless.

D.13. Paragraph 13*c* provides that the audience criterion is met if the entity is required to direct the management and general component of the joint activity to the particular audience or the audience has reasonable potential for use of the management and general component. An example of a joint activity in which the audience is selected because the entity is required to direct the management and general component of the joint activity to the particular audience is an activity in which the entity sends a written acknowledgment or other information to comply with requirements of the Internal Revenue Service to prior donors and includes a request for contributions. An example of a joint activity in which the audience is selected because the audience has reasonable potential for use of the management and general component is an activity in which the entity sends its annual report to prior donors and includes a request for contributions.

Content

D.14. Paragraph 14 provides that, to meet the content criterion, program activities should call for specific action by the recipient that will help accomplish the entity's mission. As discussed in the Glossary, the action should benefit the recipient or society. Examples of actions that benefit the recipient (such as by improving the recipient's physical, mental, emotional, or spiritual health and

well-being) or society (such as by addressing societal problems) include the following:

a. Actions that benefit the recipient:
- *Stop smoking.* Specific methods, instructions, references, and resources should be suggested.
- *Do not use alcohol or drugs.* Specific methods, instructions, references, and resources should be suggested.

b. Actions that benefit society:
- *Write or call.* The party to communicate with and the subject matter to be communicated should be specified.
- *Complete and return the enclosed questionnaire.* The results of the questionnaire should help the entity achieve its mission. For example, if the entity discards the questionnaire, it does not help the entity achieve its mission.
- *Boycott.* The particular product or company to be boycotted should be specified.

D.15. Paragraph 14*b* provides that to meet the content criterion, management and general functions are required to fulfill one or more of the entity's management and general responsibilities through a component of the joint activity. Some states or other regulatory bodies require that certain disclosures be included when soliciting contributions. Paragraph 14, footnote 9, of this SOP provides that for purposes of applying the guidance in this SOP, communications that include such required disclosures are considered fund-raising activities and are not considered management and general activities. Some examples of such disclosures include the following:

- Information filed with the attorney general concerning this charitable solicitation may be obtained from the attorney general of [*the state*] by calling 123-4567. Registration with the attorney general does not imply endorsement.
- A copy of the registration and financial information may be obtained from the Division of Consumer Services by calling toll-free, within [*the state*], 1-800-123-4567. Registration does not imply endorsement, approval, or recommendation by [*the state*].
- Information about the cost of postage and copying, and other information required to be filed under [*the state*] law, can be obtained by calling 123-4567.
- The organization's latest annual report can be obtained by calling 123-4567.

Allocation Methods

D.16. Paragraph 16 of this SOP states, "The cost allocation methodology used should be rational and systematic, it should result in an allocation of joint costs that is reasonable, and it should be applied consistently given similar facts and circumstances." The allocation of joint costs should be based on the degree to which costs were incurred for the functions to which the costs are allocated (that is, program, management and general, or fund raising). For purposes of determining whether the allocation methodology for a particular joint activity should be consistent with methodologies used for other particular joint activities, facts and circumstances that may be considered include factors related to the content and relative costs of the components of the activity. The audience should not be considered in determining whether the facts and circumstances are

similar for purposes of determining whether the allocation methodology for a particular joint activity should be consistent with methodologies used for other particular joint activities.

Practicability of Measuring Joint Costs

D.17. The Glossary of this SOP includes a definition of joint costs. Some costs, such as utilities, rent, and insurance, commonly referred to as indirect costs, may be joint costs. For example, the telephone bill for a department that, among other things, prepares materials that include both fund-raising and program components may commonly be referred to as an indirect cost. Such telephone bills may also be joint costs. However, for some entities, it is impracticable to measure and allocate the portion of the costs that are joint costs. Considerations about which joint costs should be measured and allocated, such as considerations about materiality and the costs and benefits of developing and providing the information, are the same as considerations about cost allocations in other circumstances.

APPENDIX E

Illustrations of Applying the Criteria of Purpose, Audience, and Content to Determine Whether a Program or Management and General Activity Has Been Conducted

Illustration 1

Facts

E.1. Entity A's mission is to prevent drug abuse. Entity A's annual report states that one of its objectives in fulfilling that mission is to assist parents in preventing their children from abusing drugs.

E.2. Entity A mails informational materials to the parents of all junior high school students explaining the prevalence and dangers of drug abuse. The materials encourage parents to counsel children about the dangers of drug abuse and inform them about how to detect drug abuse. The mailing includes a request for contributions. Entity A conducts other activities informing the public about the dangers of drug abuse and encouraging parents to counsel their children about drug abuse that do not include requests for contributions and that are conducted in different media. Entity A's executive director is involved in the development of the informational materials as well as the request for contributions. The executive director's annual compensation includes a significant bonus if total annual contributions exceed a predetermined amount.

Conclusion

E.3. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.4. The activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse and informing them about how to detect drug abuse) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10*a* or 10*b* is determinative of whether the purpose criterion is met. (Although Entity A's executive director's annual compensation varies based on annual contributions, the executive director's compensation does not vary based on contributions raised for this discrete joint activity.) Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the program component of this activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse) that will help accomplish the entity's mission, and it otherwise conducts the program activity in this illustration without a request for contributions, and (*b*) performing such programs helps accomplish Entity A's mission. (Note that had Entity A conducted the activity using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions, the purpose criterion would have been met under paragraph 10*b*.)

E.5. The audience criterion is met because the audience (parents of junior high school students) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.6. The content criterion is met because the activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse and informing them about how to detect drug abuse) that will help accomplish the entity's mission (assisting parents in preventing their children from abusing drugs), and it explains the need for and benefits of the action (the prevalence and dangers of drug abuse).

Illustration 2

Facts

E.7. Entity B's mission is to reduce the incidence of illness from ABC disease, which afflicts a broad segment of the population. One of Entity B's objectives in fulfilling that mission is to inform the public about the effects and early warning signs of the disease and specific action that should be taken to prevent the disease.

E.8. Entity B maintains a list of its prior donors and sends them donor renewal mailings. The mailings include messages about the effects and early warning signs of the disease and specific action that should be taken to prevent it. That information is also sent to a similar-sized audience but without the request for contributions. Also, Entity B believes that recent donors are more likely to contribute than nondonors or donors who have not contributed recently. Prior donors are deleted from the mailing list if they have not contributed to Entity B recently, and new donors are added to the list. There is no evidence of a correlation between recent contributions and participation in the program component of the activity. Also, the prior donors' need to use or reasonable potential for use of the messages about the effects and early warning signs of the disease and specific action that should be taken to prevent it is an insignificant factor in their selection.

Conclusion

E.9. The purpose and content criteria are met. The audience criterion is not met.[11] All costs, including those that might otherwise be considered program or management and general costs if they had been incurred in a different activity, should be charged to fund raising.

E.10. The activity calls for specific action by the recipient (action that should be taken to prevent ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. The purpose criterion is met because (*a*) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (to reduce the incidence of illness from the disease), and (*b*) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (a similar mailing is done without the request for contributions, to a similar-sized audience).

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[11] Paragraph 7 of this SOP provides that all costs of joint activities, except for costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should be charged to fund raising if any of the criteria of purpose, audience, or content are not met. Accordingly, if one or more criteria are not met, the other criteria need not be considered. However, the illustrations in this Appendix provide conclusions about whether each of the criteria would be met in circumstances in which one or more criteria are not met in order to provide further guidance.

E.11. The audience criterion is not met. The rebuttable presumption that the audience criterion is not met because the audience includes prior donors is not overcome in this illustration. Although the audience has a need to use or reasonable potential for use of the program component, that was an insignificant factor in its selection.

E.12. The content criterion is met because the activity calls for specific action by the recipient (actions to prevent ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

Illustration 3

Facts

E.13. Entity C's mission is to reduce the incidence of illness from ABC disease, which afflicts a broad segment of the population. One of Entity C's objectives in fulfilling that mission is to increase governmental funding for research about ABC disease.

E.14. Entity C maintains a list of its prior donors and its employees call them on the telephone reminding them of the effects of ABC disease, asking for contributions, and encouraging them to contact their elected officials to urge increased governmental funding for research about ABC disease. The callers are educated about ABC, do not otherwise perform fund-raising functions, and are not compensated or evaluated based on contributions raised. Entity C's research indicates that recent donors are likely to contact their elected officials about such funding while nonrecent donors are not. Prior donors are deleted from the calling list if they have not contributed to Entity C recently, and new donors are added to the list.

Conclusion

E.15. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.16. The activity calls for specific action by the recipient (contacting elected officials concerning funding for research about ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10*a* or 10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the callers are educated about ABC and do not otherwise perform fund-raising functions), (*b*) the method of compensation for performing the activity does not indicate that it is a fund-raising activity (the employees are not compensated or evaluated based on contributions raised), and (*c*) performing such programs helps accomplish Entity C's mission.

E.17. The audience criterion is met because the audience (recent donors) is selected based on its ability to assist Entity C in meeting the goals of the program component of the activity (recent donors are likely to contact their elected officials about such funding while nonrecent donors are not).

E.18. The content criterion is met because the activity calls for specific action by the recipient (contacting elected officials concerning funding for re-

search about ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

Illustration 4

Facts

E.19. Entity D's mission is to improve the quality of life for senior citizens. One of Entity D's objectives included in that mission is to increase the physical activity of senior citizens. One of Entity D's programs to attain that objective is to send representatives to speak to groups about the importance of exercise and to conduct exercise classes.

E.20. Entity D mails a brochure on the importance of exercise that encourages exercise in later years to residents over the age of sixty-five in three zip code areas. The last two pages of the four-page brochure include a perforated contribution remittance form on which Entity D explains its program and makes an appeal for contributions. The content of the first two pages of the brochure is primarily educational; it explains how seniors can undertake a self-supervised exercise program and encourages them to undertake such a program. In addition, Entity D includes a second brochure on various exercise techniques that can be used by those undertaking an exercise program.

E.21. The brochures are distributed to educate people in this age group about the importance of exercising, to help them exercise properly, and to raise contributions for Entity D. These objectives are documented in a letter to the public relations firm that developed the brochures. The audience is selected based on age, without regard to ability to contribute. Entity D believes that most of the recipients would benefit from the information about exercise.

Conclusion

E.22. The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that the costs of the second brochure should be charged to program because all the costs of the brochure are identifiable with the program function.)

E.23. The activity calls for specific action by the recipient (exercising) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10*a* or 10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) performing such programs helps accomplish Entity D's mission, and (*b*) the objectives of the program are documented in a letter to the public relations firm that developed the brochure.

E.24. The audience criterion is met because the audience (residents over sixty-five in certain zip codes) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.25. The content criterion is met because the activity calls for specific action by the recipient (exercising) that will help accomplish the entity's mission (increasing the physical activity of senior citizens), and the need for and benefits of the action are clearly evident (explains the importance of exercising).

Illustration 5

Facts

E.26. The facts are the same as those in Illustration 4, except that Entity E employs a fund-raising consultant to develop the first brochure and pays that consultant 30 percent of contributions raised.

Conclusion

E.27. The content and audience criteria are met. The purpose criterion is not met, however, because a majority of compensation or fees for the fund-raising consultant varies based on contributions raised for this discrete joint activity (the fund-raising consultant is paid 30 percent of contributions raised). All costs should be charged to fund raising, including the costs of the second brochure and any other costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity.

Illustration 6

Facts

E.28. Entity F's mission is to protect the environment. One of Entity F's objectives included in that mission is to take action that will increase the portion of waste recycled by the public.

E.29. Entity F conducts a door-to-door canvass of a community that recycles a low portion of its waste. The purpose of the activity is to help increase recycling by educating the community about environmental problems created by not recycling, and to raise contributions. Based on the information communicated by the canvassers, the need for and benefits of the action are clearly evident. The ability or likelihood of the residents to contribute is not a basis for communities selected, and all neighborhoods in the geographic area are covered if their recycling falls below a predetermined rate. The canvassers are selected from individuals who are well-informed about the organization's environmental concerns and programs and who previously participated as volunteers in program activities such as answering environmental questions directed to the organization and developing program activities designed to influence legislators to take actions addressing those concerns. The canvassers have not previously participated in fund-raising activities.

Conclusion

E.30. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.31. The activity calls for specific action by the recipient (implicitly—to help increase recycling) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10*a* or 10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the canvassers are selected from individuals who are well-informed about the organization's environmental concerns and

programs and who previously participated as volunteers in program activities such as answering environmental questions directed to the organization and developing program activities designed to influence legislators to take actions addressing those concerns), and (*b*) performing such programs helps accomplish Entity F's mission (to protect the environment).

E.32. The audience criterion is met because the audience (neighborhoods whose recycling falls below a predetermined rate) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.33. The content criterion is met because the activity calls for specific action by the recipient (implicitly—to help increase recycling) that will help accomplish the entity's mission (to protect the environment), and the need for and benefits of the action are clearly evident (increased recycling will help alleviate environmental problems).

Illustration 7

Facts

E.34. Entity G's mission is to provide summer camps for economically disadvantaged youths. Educating the families of ineligible youths about the camps is not one of the program objectives included in that mission.

E.35. Entity G conducts a door-to-door solicitation campaign for its camp programs. In the campaign, volunteers with canisters visit homes in middle-class neighborhoods to collect contributions. Entity G believes that people in those neighborhoods would not need the camp's programs but may contribute. The volunteers explain the camp's programs, including why the disadvantaged children benefit from the program, and distribute leaflets to the residents regardless of whether they contribute to the camp. The leaflets describe the camp, its activities, who can attend, and the benefits to attendees. Requests for contributions are not included in the leaflets.

Conclusion

E.36. The purpose, audience, and content criteria are not met. All costs should be charged to fund raising.

E.37. The activity does not include a call for specific action because it only educates the audience about causes (describing the camp, its activities, who can attend, and the benefits to attendees). Therefore, the purpose criterion is not met.

E.38. The audience criterion is not met, because the audience is selected based on its ability or likelihood to contribute, rather than based on (*a*) its need to use or reasonable potential for use of the action called for by the program component, or (*b*) its ability to take action to assist the entity in meeting the goals of the program component of the activity. (Entity G believes that people in those neighborhoods would not need the camp's programs but may contribute.)

E.39. The content criterion is not met because the activity does not call for specific action by the recipient. (The content educates the audience about causes that the program is designed to address without calling for specific action.)

Illustration 8

Facts

E.40. Entity H's mission is to educate the public about lifesaving techniques in order to increase the number of lives saved. One of Entity H's objectives in fulfilling that mission, as stated in the minutes of the board's meetings, is to produce and show television broadcasts including information about lifesaving techniques.

E.41. Entity H conducts an annual national telethon to raise contributions and to reach the American public with lifesaving educational messages, such as summary instructions concerning dealing with certain life-threatening situations. Based on the information communicated by the messages, the need for and benefits of the action are clearly evident. The broadcast includes segments describing Entity H's services. Entity H broadcasts the telethon to the entire country, not merely to areas selected on the basis of giving potential or prior fund raising results. Also, Entity H uses national television broadcasts devoted entirely to lifesaving educational messages to conduct program activities without fund raising.

Conclusion

E.42. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.43. The activity calls for specific action by the recipient (implicitly—to save lives) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. The purpose criterion is met because (*a*) the program component of the activity calls for specific action by the recipient that will help accomplish Entity H's mission (to save lives by educating the public), and (*b*) a similar program activity is conducted without the fund raising using the same medium and on a scale that is similar to or greater than the scale on which it is conducted with the appeal (Entity H uses national television broadcasts devoted entirely to lifesaving educational messages to conduct program activities without fund raising).

E.44. The audience criterion is met because the audience (a broad segment of the population) is selected based on its need to use or reasonable potential for use of the action called for by the program activity.

E.45. The content criterion is met because the activity calls for specific action by the recipient (implicitly—to save lives) that will help accomplish the entity's mission (to save lives by educating the public), and the need for and benefits of the action are clearly evident (saving lives is desirable).

Illustration 9

Facts

E.46. Entity I's mission is to provide food, clothing, and medical care to children in developing countries.

E.47. Entity I conducts television broadcasts in the United States that describe its programs, show the needy children, and end with appeals for contributions. Entity I's operating policies and internal management memoranda state that these programs are designed to educate the public about the

needs of children in developing countries and to raise contributions. The employees producing the programs are trained in audiovisual production and are familiar with Entity I's programs. Also, the executive producer is paid $25,000 for this activity, with a $5,000 bonus if the activity raises over $1,000,000.

Conclusion

E.48. The purpose, audience, and content criteria are not met. All costs should be charged to fund raising.

E.49. The activity does not include a call for specific action because it only educates the audience about causes (describing its programs and showing the needy children). Therefore, the purpose criterion is not met. (Also, note that if the factor in paragraph 10*a* were considered, it would not be determinative of whether the purpose criterion is met. Although the executive producer will be paid $5,000 if the activity raises over $1,000,000, that amount would not be a majority of the executive producer's total compensation for this activity, because $5,000 would not be a majority of the executive producer's total compensation of $30,000 for this activity. Also, note that if other evidence, such as the indicators in paragraph 11, were considered, the purpose criterion would not be met based on the other evidence. Although the qualifications and duties of the personnel performing the activity indicate that the employees producing the program are familiar with Entity I's programs, the facts that some, but less than a majority, of the executive producer's compensation varies based on contributions raised, and that the operating policies and internal management memoranda state that these programs are designed to educate the public about the needs of children in developing countries [with no call for specific action by recipients] and to raise contributions, indicate that the purpose is fund raising.)

E.50. The audience criterion is not met because the audience is selected based on its ability or likelihood to contribute, rather than based on (*a*) its need to use or reasonable potential for use of the action called for by the program component, or (*b*) its ability to take action to assist the entity in meeting the goals of the program component of the activity. (The audience is a broad segment of the population of a country that is not in need of or has no reasonable potential for use of the program activity.)

E.51. The content criterion is not met because the activity does not call for specific action by the recipient that will help accomplish the entity's mission. (The content educates the audience about the causes without calling for specific action.)

Illustration 10

Facts

E.52. Entity J is a university that distributes its annual report, which includes reports on mission accomplishments, to those who have made significant contributions over the previous year, its board of trustees, and its employees. The annual report is primarily prepared by management and general personnel, such as the accounting department and executive staff. The activity is coordinated by the public relations department. Internal management memoranda indicate that the purpose of the annual report is to report on how management discharged its stewardship responsibilities, including the university's overall performance, goals, financial position, cash flows, and results of

operations. Included in the package containing the annual report are requests for contributions and donor reply cards.

Conclusion

E.53. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.54. The activity has elements of management and general functions. Therefore, no call for specific action is required. Neither of the factors in paragraph 10*a* or 10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the employees performing the activity are not members of the fund-raising department and perform other non-fund-raising activities and (*b*) internal management memoranda indicate that the purpose of the annual report is to fulfill one of the university's management and general responsibilities.

E.55. The audience criterion is met because the audience is selected based on its reasonable potential for use of the management and general component. Although the activity is directed primarily at those who have previously made significant contributions, the audience was selected based on its presumed interest in Entity J's annual report (prior donors who have made significant contributions are likely to have an interest in matters discussed in the annual report).

E.56. The content criterion is met because the activity (distributing annual reports) fulfills one of the entity's management and general responsibilities (reporting concerning management's fulfillment of its stewardship function).

Illustration 11

Facts

E.57. Entity K is an NPO. In accordance with internal management memoranda documenting its policies requiring it to comply with Internal Revenue Service (IRS) regulations, it mails prior donors who have made quid pro quo payments in excess of $75 documentation required by the IRS. The documentation is included on a perforated piece of paper. The information above the perforation line pertains to the documentation required by the IRS. The information below the perforation line includes a request for contributions and may be used as a donor reply card.

Conclusion

E.58. The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that the costs of the information below the perforation line are identifiable with fund raising and therefore should be charged to fund raising.)

E.59. The activity has elements of management and general functions. Therefore, no call for specific action is required. Neither of the factors in paragraph 10*a* or 10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because internal management memoranda indicate that the purpose of the activity is to fulfill one of Entity K's management and general responsibilities.

E.60. The audience criterion is met because the entity is required to direct the management and general component of the activity to the particular audience. Although the activity is directed at those who have previously contributed, the audience was selected based on its need for the documentation.

E.61. The content criterion is met because the activity (sending documentation required by the IRS) fulfills one of the entity's management and general responsibilities (complying with IRS regulations).

Illustration 12

Facts

E.62. Entity L is an animal rights organization. It mails a package of material to individuals included in lists rented from various environmental and other organizations that support causes that Entity L believes are congruent with its own. In addition to donor response cards and return envelopes, the package includes (*a*) materials urging recipients to contact their legislators and urge the legislators to support legislation to protect those rights, and (*b*) postcards addressed to legislators urging support for legislation restricting the use of animal testing for cosmetic products. The mail campaign is part of an overall strategy that includes magazine advertisements and the distribution of similar materials at various community events, some of which are undertaken without fund-raising appeals. The advertising and community events reach audiences similar in size and demographics to the audience reached by the mailing.

Conclusion

E.63. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.64. The activity calls for specific action by the recipient (mailing postcards to legislators urging support for legislation restricting the use of animal testing for cosmetic products) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10*a* or 10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the program component of this activity calls for specific action by the recipient that will help accomplish the entity's mission, and it otherwise conducts the program activity in this illustration without a request for contributions, and (*b*) performing such programs helps accomplish Entity L's mission.

E.65. The audience criterion is met because the audience (individuals included in lists rented from various environmental and other organizations that support causes that Entity L believes are congruent with its own) is selected based on its ability to take action to assist the entity in meeting the goals of the program component of the activity.

E.66. The content criterion is met because the activity calls for specific action by the recipient (mailing postcards to legislators urging support for legislation restricting the use of animal testing for cosmetic products) that will help accomplish the entity's mission (to protect animal rights), and the need for and benefits of the action are clearly evident (to protect animal rights).

Illustration 13

Facts

E.67. Entity M is a performing arts organization whose mission is to make the arts available to residents in its area. Entity M charges a fee for attending performances and sends advertisements, including subscription forms, for the performances to residents in its area. These advertisements include a return envelope with a request for contributions. Entity M evaluates the effectiveness of the advertising based on the number of subscriptions sold as well as contributions received. In performing that evaluation, Entity M places more weight on the number of subscriptions sold than on the contributions received. Also, Entity M advertises the performances on local television and radio without a request for contributions but on a smaller scale than the mail advertising.

Conclusion

E.68. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.69. The activity calls for specific action by the recipient (attending the performances) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10*a* or 10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) the entity measures program results and accomplishments of the joint activity and in evaluating the effectiveness of the activity, the entity places significantly greater weight on the activity's effectiveness in accomplishing program goals than on the activity's effectiveness in raising contributions (Entity M evaluates the effectiveness of the advertising based on the number of subscriptions sold as well as contributions received and places more weight on the number of subscriptions sold than on the contributions received), (*b*) it otherwise conducts the program activity without a request for contributions, and (*c*) performing such programs helps accomplish Entity M's mission (to make the arts available to residents in its area).

E.70. The audience criterion is met because the audience (a broad segment of the population in Entity M's area) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.71. The content criterion is met because the activity calls for specific action by the recipient (attending the performances) that will help accomplish the entity's mission (making the arts available to area residents), and the need for and benefits of the action are clearly evident (attending the performance is a positive cultural experience). (Note that the purchase of subscriptions is an exchange transaction and, therefore, is not a contribution.)

Illustration 14

Facts

E.72. Entity N is a university whose mission is to educate the public (students) in various academic pursuits. Entity N's political science department holds a special lecture series in which prominent world leaders speak about current events. The speakers command relatively high fees and, in order to cover costs and make a modest profit, the university sets a relatively expensive fee to attend. However, the tickets are priced at the fair value of the lecture

and no portion of the ticket purchase price is a contribution. Entity N advertises the lectures by sending invitations to prior attendees and to prior donors who have contributed significant amounts, and by placing advertisements in local newspapers read by the general public. At some of the lectures, including the lecture being considered in this illustration, deans and other faculty members of Entity N solicit significant contributions from attendees. Other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without requesting contributions. Entity N's records indicate that historically 75 percent of the attendees have attended prior lectures. Of the 75 percent who have attended prior lectures, 15 percent have made prior contributions to Entity N. Of the 15 percent who have made prior contributions to Entity N, 5 percent have made contributions in response to solicitations made at the events. (Therefore, one-half of one percent of attendees make contributions in response to solicitations made at the events. However, those contributions are significant.) Overall, the audience's ability or likelihood to contribute is an insignificant factor in its selection. Entity N evaluates the effectiveness of the activity based on the number of tickets sold, as well as contributions received. In performing that evaluation, Entity N places more weight on the number of tickets sold than on the contributions received.

Conclusion

E.73. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.74. The activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. The purpose criterion is met because (*a*) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and (*b*) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without requesting contributions).

E.75. The audience criterion is met. The rebuttable presumption that the audience criterion is not met because the audience includes prior donors is overcome in this illustration because the audience (those who have shown prior interest in the lecture series, prior donors, a broad segment of the population in Entity N's area, and those attending the lecture) is also selected for its reasonable potential for use of the program component (attending the lecture). Although the audience may make significant contributions, that was an insignificant factor in its selection.

E.76. The content criterion is met because the activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and the need for and benefits of the action are clearly evident (attending the lecture is a positive educational experience). (Note that the purchase of the tickets is an exchange transaction and, therefore, is not a contribution. As discussed in paragraph 7 of this SOP, costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event, should not be reported as fund raising.[12])

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[12] Paragraphs 13.21 to 13.26 of the Audit and Accounting Guide *Not-for-Profit Organizations* provide guidance concerning reporting special events. [Footnote revised, June 2004, to reflect conforming changes due to conforming changes made to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.]

Illustration 15

Facts

E.77. Entity O is a university whose mission is to educate the public (students) in various academic pursuits. Entity O's political science department holds a special lecture series in which prominent world leaders speak about current events. Admission is priced at $250, which is above the $50 fair value of the lecture and, therefore, $200 of the admission price is a contribution. Therefore, the audience's likelihood to contribute to the entity is a significant factor in its selection. Entity O advertises the lectures by sending invitations to prior attendees and to prior donors who have contributed significant amounts, and by placing advertisements in local newspapers read by the general public. Entity O presents similar lectures that are priced at the fair value of those lectures.

Conclusion

E.78. The purpose and content criteria are met. The audience criterion is not met. All costs, including those that might otherwise be considered program or management and general costs if they had been incurred in a different activity, except for the costs of the direct donor benefit (the lecture), should be charged to fund raising.

E.79. The activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. The purpose criterion is met because (*a*) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and (*b*) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without including a contribution in the admission price.)

E.80. The audience criterion is not met. The rebuttable presumption that the audience criterion is not met because the audience is selected based on its likelihood to contribute to the entity is not overcome in this illustration. The fact that the $250 admission price includes a $200 contribution leads to the conclusion that the audience's ability or likelihood to contribute is an overwhelmingly significant factor in its selection, whereas there is no evidence that the extent to which the audience is selected for its need to use or reasonable potential for use of the action called for by the program component (attending the lecture) is overwhelmingly significant.

E.81. The content criterion is met because the activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and the need for and benefits of the action are clearly evident (attending the lecture is a positive educational experience). (Note that the purchase of the tickets is an exchange transaction and, therefore, is not a contribution. As discussed in paragraph 7 of this SOP, costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event, should not be reported as fund raising.[13])

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[13] Paragraphs 13.21 to 13.26 of the Audit and Accounting Guide *Not-for-Profit Organizations* provide guidance concerning reporting special events. [Footnote revised, June 2004, to reflect conforming changes due to conforming changes made to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.]

Illustration 16

Facts

E.82. Entity P's mission is to reduce the incidence of illness from ABC disease, which primarily afflicts people over sixty-five years of age. One of Entity P's objectives in fulfilling that mission is to have all persons over sixty-five screened for ABC disease.

E.83. Entity P rents space at events attended primarily by people over sixty-five years of age and conducts free screening for ABC disease. Entity P's employees, who are educated about ABC disease and screening procedures and do not otherwise perform fund-raising functions, educate interested parties about the effects of ABC disease and the ease and benefits of screening for it. Entity P also solicits contributions at the events. The effectiveness of the activity is evaluated primarily based on how many screening tests are performed, and only minimally based on contributions raised. The employees are not compensated or evaluated based on contributions raised.

Conclusion

E.84. The purpose, audience, and content criteria are met, and the joint costs should be allocated.

E.85. The activity calls for specific action by the recipient (being screened for ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. Neither of the factors in paragraph 10*a* or 10*b* is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph 11, should be considered. The purpose criterion is met based on the other evidence, because (*a*) a process exists to evaluate measured program results and accomplishments and in evaluating the effectiveness of the joint activity, the entity places significantly greater weight on the activity's effectiveness in accomplishing program goals than on the activity's effectiveness in raising contributions (Entity P evaluates the effectiveness of the activity based on the number of screening tests conducted as well as contributions received and places more weight on the number of tests conducted than on the contributions received); (*b*) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the employees are educated about ABC disease and the testing procedures and do not otherwise perform fund-raising functions); (*c*) the method of compensation for performing the activity does not indicate that it is a fund-raising activity (the employees are not compensated or evaluated based on contributions raised); and (*d*) performing such programs helps accomplish Entity P's mission (to prevent ABC disease).

E.86. The audience criterion is met because the audience (people over sixty-five years of age) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

E.87. The content criterion is met because the activity calls for specific action by the recipient (being screened for ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

Illustration 17

Facts

E.88. Entity Q's mission is to provide cultural and educational television programming to residents in its area. Entity Q owns a public television station

and holds a membership drive in which it solicits new members. The drive is conducted by station employees and consists of solicitations that are shown during long breaks between the station's regularly scheduled programs. Entity Q's internal management memoranda state that these drives are designed to raise contributions. Entity Q evaluates the effectiveness of the activity based on the amount of contributions received. Entity Q shows the programs on a similar scale, without the request for contributions. The audience is members of the general public who watch the programs shown during the drive. Station member benefits are given to those who contribute and consist of tokens of appreciation with a nominal value.

Conclusion

E.89. The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that there would be few, if any, joint costs. Costs associated with the fund-raising activities, such as costs of airtime, would be separately identifiable from costs of the program activities, such as licensing costs for a particular television program. Also, note that because no significant benefits or duties are associated with membership, member dues are contributions. Therefore, the substance of the membership-development activities is, in fact, fund raising.)

E.90. The activity calls for specific action by the recipient (watching the television program) that will help accomplish the entity's mission. Therefore, the guidance in paragraph 10 should be considered. The purpose criterion is met because (*a*) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission, and (*b*) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (Entity Q shows the television programs on a similar scale, without the request for contributions).

E.91. The audience criterion is met. The rebuttable presumption that the audience criterion is not met because the audience is selected based on its likelihood to contribute is overcome in this illustration because the audience (members of the general public who watch the television programs shown during the drive) is also selected for its reasonable potential for use of the program component (watching the television programs). Although the audience may make contributions, that was an insignificant factor in its selection.

E.92. The content criterion is met because the activity calls for specific action by the recipient (watching the television programs) that will help accomplish the entity's mission (providing cultural and educational television programming to residents in its area), and the need for and benefits of the action are clearly evident (watching the programs is a positive cultural and educational experience).

APPENDIX F

Illustrations of Allocation Methods

F.1. Some commonly used cost allocation methods follow.

Physical Units Method

F.2. Joint costs are allocated to materials and activities in proportion to the number of units of output that can be attributed to each of the materials and activities. Examples of units of output are lines, square inches, and physical content measures. This method assumes that the benefits received by the fund-raising, program, or management and general component of the materials or activity from the joint costs incurred are directly proportional to the lines, square inches, or other physical output measures attributed to each component of the activity. This method may result in an unreasonable allocation of joint costs if the units of output, for example, line counts, do not reflect the degree to which costs are incurred for the joint activity. Use of the physical units method may also result in an unreasonable allocation if the physical units cannot be clearly ascribed to fund raising, program, or management and general. For example, direct mail and telephone solicitations sometimes include content that is not identifiable with fund raising, program, or management and general; or the physical units of such content are inseparable.

Illustration

F.3. Assume a direct mail campaign is used to conduct programs of the entity and to solicit contributions to support the entity and its programs. Further, assume that the appeal meets the criteria for allocation of joint costs to more than one function.

F.4. The letter and reply card include a total of one hundred lines. Forty-five lines pertain to program because they include a call for action by the recipient that will help accomplish the entity's mission, while fifty-five lines pertain to the fund-raising appeal. Accordingly, 45 percent of the costs are allocated to program and 55 percent to fund-raising.

Relative Direct Cost Method

F.5. Joint costs are allocated to each of the components on the basis of their respective direct costs. Direct costs are those costs that are incurred in connection with the multipurpose materials or activity and that are specifically identifiable with a function (program, fund raising, or management and general). This method may result in an unreasonable allocation of joint costs if the joint costs of the materials and activity are not incurred in approximately the same proportion and for the same reasons as the direct costs of the materials and activity. For example, if a relatively costly booklet informing the reader about the entity's mission (including a call for action by the recipient that will help accomplish the entity's mission) is included with a relatively inexpensive fund-raising letter, the allocation of joint costs based on the cost of these pieces may be unreasonable, particularly if the booklet and letter weigh approximately the same and therefore contribute equally to the postage costs.

Illustration

F.6. The costs of a direct mail campaign that can be specifically identified with program services are the costs of separate program materials and a postcard which calls for specific action by the recipient that will help accomplish the entity's mission. They total $20,000. The direct costs of the fund-raising component of the direct mail campaign consist of the costs to develop and produce the fund-raising letter. They total $80,000. Joint costs associated with the direct mail campaign total $40,000 and would be allocated as follows under the relative direct cost method:

Program	$20,000/$100,000 × $40,000 = $8,000
Fund raising	$80,000/$100,000 × $40,000 = $32,000

Stand-Alone Joint-Cost-Allocation Method

F.7. Joint costs are allocated to each component of the activity based on a ratio that uses estimates of costs of items included in joint costs that would have been incurred had the components been conducted independently. The numerator of the ratio is the cost (of items included in joint costs) of conducting a single component independently; the denominator is the cost (of items included in joint costs) of conducting all components independently. This method assumes that efforts for each component in the stand-alone situation are proportionate to the efforts actually undertaken in the joint cost situation. This method may result in an unreasonable allocation because it ignores the effect of each function, which is performed jointly with other functions, on other such functions. For example, the programmatic impact of a direct mail campaign or a telemarketing phone message may be significantly lessened when performed in conjunction with a fund-raising appeal.

Illustration

F.8. Assume that the joint costs associated with a direct mail campaign including both program and fund-raising components are the costs of stationery, postage, and envelopes at a total of $100,000. The costs of stationery, postage, and envelopes to produce and distribute each component separately would have been $90,000 for the program component and $70,000 for the fund-raising component. Under the stand-alone joint-cost-allocation method, the $100,000 in joint costs would be allocated as follows: $90,000/$160,000 × $100,000 = $56,250 to program services and $70,000/$160,000 × $100,000 = $43,750 to fund raising.

APPENDIX G

Illustrations of Disclosures

G.1. The disclosures discussed in paragraphs 18 and 19 are illustrated below. Alternative 1 reports the required and encouraged information in narrative format. Alternative 2 reports that information in tabular format, as well as information concerning joint costs incurred for each kind of activity by functional classification, which is neither required nor encouraged, but which is not prohibited.

Alternative 1

Note X. Allocation of Joint Costs

In 19XX, the organization conducted activities that included requests for contributions, as well as program and management and general components. Those activities included direct mail campaigns, special events, and a telethon. The costs of conducting those activities included a total of $310,000 of joint costs, which are not specifically attributable to particular components of the activities (joint costs). [***Note to reader:*** *The following sentence is encouraged but not required.*] Joint costs for each kind of activity were $50,000, $150,000, and $110,000 respectively. These joint costs were allocated as follows:

Fund raising	$180,000
Program A	80,000
Program B	40,000
Management and general	10,000
Total	$310,000

Alternative 2

Note X. Allocation of Joint Costs

In 19XX, the organization conducted activities that included appeals for contributions and incurred joint costs of $310,000. These activities included direct mail campaigns, special events, and a telethon. Joint costs were allocated as follows:

	Direct Mail	*Special Events*	*Telethon*	*Total*
Fund raising	$40,000	$50,000	$90,000	$180,000
Program A	10,000	65,000	5,000	80,000
Program B		25,000	15,000	40,000
Management and general		10,000		10,000
Total	$50,000	$150,000	$110,000	$310,000

[***Note to reader:*** *Shading is used to highlight information that is neither required nor encouraged, but which is not prohibited. However, entities may prefer to disclose it. Disclosing the total joint costs for each kind of activity ($50,000, $150,000, and $110,000) is encouraged but not required.*]

APPENDIX H

Contrast of Guidance in This SOP With the Guidance in SOP 87-2[14,††]

This SOP	*SOP 87-2*
Applies to all entities that solicit contributions, including state and local governments.	Applied to entities that follow the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* or SOP 78-10. (SOP 87-2 was not applicable to entities that are within the scope of Governmental Accounting Standards Board Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*.)
Covers *all* costs of joint activities. (Costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, except for costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event [for example, a meal], should be charged to fund raising unless the criteria in the SOP are met.)	Covers only joint costs of joint activities.
Criteria of purpose, audience, and content should all be met in order to charge costs of the activity to program or management and general.	Unclear concerning whether all criteria should be met in order to charge costs of the activity to program or management and general.

(continued)

[14] In August 1996, the AICPA issued the Audit and Accounting Guide *Not-for-Profit Organizations*, which superseded SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, because the guidance in SOP 87-2 is incorporated into paragraphs 13.36 to 13.45 of the Guide. Also, *Not-for-Profit Organizations* superseded the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* and SOP 78-10. *Not-for-Profit Organizations* applies to all nongovernmental not-for-profit organizations other than those required to follow the Audit and Accounting Guide *Health Care Organizations*. Therefore, incorporating the guidance in SOP 87-2 into *Not-for-Profit Organizations* broadened the scope of the guidance previously included in SOP 87-2 to all not-for-profit organizations other than those required to follow *Health Care Organizations*. The discussion in this SOP of SOP 87-2 refers to both SOP 87-2 and the guidance included in paragraphs 13.36 to 13.45 of *Not-for-Profit Organizations*, except that the guidance in *Not-for-Profit Organizations* applies to all not-for-profit organizations other than those required to follow *Health Care Organizations*.

[††] See footnotes | | and # to paragraphs D.3 and D.4 of this SOP. [Footnote revised, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statement No. 35.]

This SOP	*SOP 87-2*
Neither prescribes nor prohibits any allocation methods. Includes a discussion to help users determine whether an allocation is reasonable, and provides some illustrations.	Neither prescribes nor prohibits any allocation methods. No illustrations are provided.
Requires note disclosures about the types of activities for which joint costs have been incurred, amounts allocated during the period, and amounts allocated to each functional expense or expenditure category.	Requires less extensive note disclosures: total amount allocated during the period and amounts allocated to each functional expense category.

APPENDIX I

Effects on Other Guidance

I.1. For nongovernmental organizations, this Statement of Position (SOP) amends the AICPA Audit and Accounting Guide *Health Care Organizations* and paragraphs 13.35 to 13.44 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*. [Revised, June 2004, to reflect conforming changes due to conforming changes made to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.]

I.2. Also, this SOP amends the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* to clarify that costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund-raising. In particular, paragraphs 13.21, 13.23, and 13.24 of *Not-for-Profit Organizations* are amended as follows:

> **13.21** Some organizations conduct joint activities* that are special events, including special social and educational events (such as symposia, dinners, dances, and theater parties) in which the attendee receives a direct benefit (for example, a meal or theater ticket). FASB Statement No. 117 requires the reporting of the gross amounts of revenues and expenses from special events and other fund-raising activities that are ongoing major or central activities, but permits (but does not require) reporting net amounts if the receipts and related costs result from special events that are peripheral or incidental activities.
>
> ---
>
> [9] See footnote 1.
>
> **13.23** For example, assume that an organization has a special event that is an ongoing and major activity with a ticket price of $100. Assume that the activity does not meet the audience criterion in SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*, and, therefore, all costs of the activity, other than the direct donor benefits, should be reported as fund raising. The event includes a dinner that costs the organization $25 and that has a fair value of $30. (Chapter 5, "Contributions Received and Agency Transactions," of this Guide, discusses the appropriate reporting if the meal or other items of value are donated to the organization for resale.) In addition, the organization incurs other direct costs of the event in connection with promoting and conducting the event, including incremental direct costs incurred in transactions with independent third parties and the payroll and payroll-related costs for the activities of employees who are directly associated with, and devote time to, the event. Those other direct costs, which include (*a*) $5 that otherwise might be considered management and general costs if they had been incurred in a different activity, and (*b*) fund-raising costs of $10, are unrelated to the direct benefits to donors and, accordingly, should not be included as costs of benefits to donors. In addition, the organization has the following transactions, which are unrelated to the special event: unrestricted contributions of $200, program expenses of $60, management and general expenses of $20, and fund-raising expenses of $20.
>
> **13.24** Some ways in which the organization could display the results of the special event as part of its statement of activities are illustrated as follows:

Illustration 1

Changes in unrestricted net assets:		
Contributions		$200
Special event revenue	100	
Less: Costs of direct benefits to donors	(25)	
Net revenues from special events		75
Contributions and net revenues from special events		275
Other expenses:		
Program		60
Management and general		20
Fund raising		35
Total other expenses		115
Increase in unrestricted net assets		$160

Illustration 2

Changes in unrestricted net assets:	
Revenues:	
Contributions	$200
Special event revenue	100
Total revenues	300
Expenses:	
Program	60
Costs of direct benefits to donors	25
Management and general	20
Fund raising	35
Total expenses	140
Increase in unrestricted net assets	$160

Illustration 3

Changes in unrestricted net asset:	
Contributions	$270
Dinner sales	30
Less: Costs of direct benefits to donors	(25)
Gross profit on special events	5
Contributions and net revenues from special events	275
Other expenses:	
Program	60
Management and general	20
Fund raising	35
Total other expenses	115
Increase in unrestricted net assets	$160

[Revised, June 2004, to reflect conforming changes due to conforming changes made to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.]

I.3. For governmental entities that have applied the accounting and financial reporting principles in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, or the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* (modified by all applicable Financial Accounting Standards Board [FASB] pronouncements issued through November 30, 1989, and by most applicable Governmental Accounting Standards Board [GASB] pronouncements) in conformity with GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, this SOP amends the principles—based on SOP 78-10 and *Audits of Voluntary Health and Welfare Organizations*, as modified—that those entities apply. For governmental entities that have applied the accounting and financial reporting principles in the 1973 AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*, and as modified by applicable FASB pronouncements issued through November 30, 1989, and all applicable GASB pronouncements in conformity with GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models*, this SOP amends the principles—based on *Audits of Colleges and Universities*, as amended and modified—that those entities apply. For other governmental organizations, this SOP amends the Audit and Accounting Guide *Audits of State and Local Governmental Units*.[#]

[#] See footnotes | | and # to paragraphs D.3 and D.4 of this SOP. Also, the AICPA Audit and Accounting Guide *Audits of State and Local Governments*, supersedes the 1994 AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, and subsequent editions of that Guide with conforming changes made by the AICPA staff. AICPA Audit and Accounting Guide *State and Local Governments*, provides guidance on the application of this SOP to state and local governments. [Footnote added, June 2004, to reflect conforming changes necessary due to the issuance of GASB Statements No. 34, No. 35, and the AICPA Audit and Accounting Guide *State and Local Governments*.]

Glossary

Activities. Activities are efforts to accomplish specific objectives. Some activities include producing and distributing materials. For example, if an entity undertakes a mass mailing that includes a letter and a pamphlet, producing and distributing the letter and pamphlet are part of the activity. Other activities may include no materials, such as an annual dinner or a radio commercial.

Compensation or fees. Reciprocal transfers of cash or other assets in exchange for services performed.

Contributions. Contributions are unconditional transfers of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner.

Costs of joint activities. Costs of joint activities are costs incurred for a joint activity. Costs of joint activities may include joint costs and costs other than joint costs. Costs other than joint costs are costs that are identifiable with a particular function, such as fund raising, program, management and general, and cost of sales. For example, some costs incurred for printing, paper, professional fees, and salaries to produce donor cards are not joint costs, although they may be incurred in connection with conducting joint activities.

Fund-raising activities. Fund-raising activities are activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets, or time. They include publicizing and conducting fund-raising campaigns; maintaining donor mailing lists; conducting special fund-raising events; preparing and distributing fund-raising manuals, instructions, and other materials; and conducting other activities involved with soliciting contributions from individuals, foundations, governments, and others.

Help accomplish the entity's mission. Actions that help accomplish the entity's mission are actions that either benefit the recipient (such as by improving the recipient's physical, mental, emotional, or spiritual health and well-being) or benefit society (by addressing societal problems).

Joint activity. A joint activity is an activity that is part of the fund-raising function and has elements of one or more other functions, such as program, management and general, membership development, or any other functional category used by the entity.

Joint costs. Joint costs are the costs of conducting joint activities that are not identifiable with a particular component of the activity. For example, the cost of postage for a letter that includes both fund-raising and program components is a joint cost. Joint costs may include the costs of salaries, contract labor, consultants, professional fees, paper, printing, postage, event advertising, telephones, airtime, and facility rentals.

Management and general activities. Management and general activities are those that are not identifiable with a single program, fund-raising activity, or membership-development activity but that are indispensable to the conduct of those activities and to an organization's existence. They

include oversight, business management, general recordkeeping, budgeting, financing, soliciting revenue from exchange transactions, such as government contracts and related administrative activities, and all management and administration except for direct conduct of program services or fund-raising activities. Disseminating information to inform the public of the organization's "stewardship" of contributed funds, announcements concerning appointments, and the annual report, among other activities, are management and general activities, as are soliciting funds other than contributions, including exchange transactions (whether program-related or not).

Medium. A medium is a means of mass communication, such as direct mail, direct response advertising, or television.

Membership-development activities. Membership-development activities include soliciting for prospective members and membership dues, membership relations, and similar activities. If there are no significant benefits or duties connected with membership, however, the substance of membership-development activities may, in fact, be fund-raising.

Program activities. Program activities are the activities that result in goods or services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the organization exists. Those services are the major purpose for and the major output of the organization and often relate to several major programs. For example, a large university may have programs for student instruction, research, and patient care, among others. Similarly, a health and welfare organization may have programs for health and family services, research, disaster relief, and public education, among others.

Appendix D

Statement of Position 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

May 21, 1999

Issued Under the Authority of the
Audit Standards Board

NOTE

This Statement of Position presents the recommendations of the AICPA Health Care Pilot Task Force regarding the application of Statements on Standards for Attestation Engagements to agreed-upon procedures attestation engagements performed to assist a health care provider in evaluating the effectiveness of its corporate compliance program consistent with the requirements of a Corporate Integrity Agreement entered into with the Office of Inspector General of the U.S. Department of Health and Human Services. The Auditing Standards Board has found the recommendations in this Statement of Position to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the recommendations in this Statement of Position.

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SUMMARY

This Statement of Position (SOP) 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 to assist a health care provider in evaluating the effectiveness of its corporate compliance program consistent with the requirements of a Corporate Integrity Agreement (CIA) entered into with the Office of Inspector General (OIG) of the U.S. Department of Health and Human Services. CIAs are specific to the entity involved; consequently, users of this SOP should be familiar with the specific requirements of the entity's CIA.

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

Introduction and Background

1. Within the past several years, the health care industry has experienced a significant increase in the number and magnitude of allegations of fraud and abuse involving federal health care programs (for example, Medicare and Medicaid) and private health care insurance. These allegations have triggered regulatory scrutiny, litigation, significant monetary settlements, and negative publicity related to—among other things—coding and billing practices, patient referrals, cost reporting, quality of care, and clinical practices. Typically, as part of the global resolution of these allegations, the entity enters into a Corporate Integrity Agreement (CIA) with the Office of Inspector General (OIG) of the U.S. Department of Health and Human Services. Such agreements require that management annually report on its compliance with the terms of the CIA and that there be an assessment of the entity's compliance with the CIA. This assessment includes a billing analysis, which may be performed by an independent review organization (such as a practitioner or consultant) or the provider (if permitted by the OIG), and an agreed-upon procedures engagement.

2. This SOP provides guidance to practitioners in conducting and reporting on an agreed-upon procedures engagement performed pursuant to the American Institute of Certified Public Accountants (AICPA) Statements on Standards for Attestation Engagements (SSAEs) to assist an entity in evaluating the effectiveness of its corporate compliance program consistent with the requirements of a CIA.[1] The terms of a CIA are unique to the entity; consequently, users of this SOP need to be familiar with the actual CIA and its requirements.

3. This SOP applies to agreed-upon procedures engagements to assist in evaluating an entity's compliance for a specified period. Such engagements should follow the AICPA attestation standards, including SSAE No. 1, *Attestation Standards* (AICPA, *Professional Standards*, vol. 1, AT sec. 100); SSAE No. 3, *Compliance Attestation* (AICPA, *Professional Standards*, vol. 1, AT sec. 500); and SSAE No. 4, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 600). The engagement should be conducted in accordance with standards established by the AICPA, including the criteria set forth in this SOP. However, this SOP is not intended to provide all the required

[1] The practitioner also might be engaged to assist in other areas beyond an agreed-upon procedures engagement such as providing consulting services in connection with evaluating the company's billing practices, policies, and procedures as required by the CIA or in implementing, assessing, and reporting on voluntarily adopted compliance programs. In addition, the practitioner may assist in preparing an entity's self-disclosure reports to federal health agencies related to billing errors and other compliance matters. Similarly, practitioners may be involved in an entity's preparation of government-required (but not CIA-imposed) compliance reporting (for example, contract requirements for Medicare part C) beyond an agreed-upon procedures engagement.

criteria set forth in individual CIAs, nor all the applicable standards established by the AICPA. Additionally, the SOP contains some guidance that may be applied in evaluating an organization's corporate compliance program, even though the program was not imposed by a CIA.

Overview of a Typical Corporate Integrity Agreement

4. A CIA is an agreement between a health care provider and the OIG in conjunction with a global settlement of a fraud investigation. Such an agreement typically seeks to establish a compliance program within the health care provider (for example, hospital, clinical lab, physician group) that will promote compliance with the requirements of Medicare, Medicaid, and all other federal health care programs.

5. CIAs are case-specific. Their terms are tailored to address the organizational and operating deficiencies related to providing and billing for health care services that have been identified by the OIG, the entity, or others. Detailed compliance requirements are imposed as a condition for continued participation in federal health care programs. A sample CIA, provided by the OIG and intended to identify potential requirements, is included in appendix A, "Sample Corporate Integrity Agreement." Typical agreements cover five years and require the entity to address the following areas:

- Appointment of a compliance officer and establishment of a compliance committee
- Establishment of a code of conduct
- Establishment of policies and procedures regarding the compliance program
- Development of an information and education program as to CIA requirements, compliance program and code of conduct
- Annual assessment of billing policies, procedures, and practices
- Establishment of a confidential disclosure program
- Prohibition of employment of excluded or convicted persons
- Notification to OIG of investigation or legal proceedings
- Reporting of credible evidence of misconduct
- Notifications to OIG of new provider locations
- Provision of implementation and annual reports
- Proper notification and submission of required reports
- Granting of OIG access to documents and individuals to conduct assessments
- Documentation of record retention requirements
- Awareness of disclosure criteria
- Agreement to comply with certain default provisions, penalties, and remedies
- Review of rights as to dispute resolution
- Review of effective and binding agreement clauses

Conditions for Engagement Performance

6. A practitioner may perform an agreed-upon procedures engagement related to management's compliance with a CIA if all of the conditions specified in SSAE No. 4 (AT sec. 600.10) and SSAE No. 3 (AT sec. 500.09–.11) are met.

7. As discussed more fully in the SSAEs noted in paragraph 6, management's assertions as to its compliance must be capable of evaluation against reasonable criteria that either have been established by a recognized body or are stated in or attached to the practitioner's report in a sufficiently clear and comprehensive manner. Generally, to avoid confusion, management's assertions, which are based on the specific terms of its CIA, should be attached to the practitioner's report. If the entity is not subject to a CIA, management may develop its assertions using the model CIA. A sample based on the model CIA, which is not meant to be all-inclusive, is included as appendix B, "Sample Statement of Management's Assertions."

Establishing an Understanding With the Client

8. The practitioner should document the understanding in the working papers, preferably through a written communication with the client, such as an engagement letter. Appendix C, "Sample Engagement Letter," contains a sample engagement letter that may be used for this kind of engagement.

Users' Responsibilities

9. Users typically would be the management of the health care provider and the OIG. Management is responsible for ensuring that the entity complies with the requirements of the CIA. That responsibility encompasses (*a*) identifying applicable compliance requirements, (*b*) establishing and maintaining internal control policies and procedures to provide reasonable assurance that the entity complies with those requirements, (*c*) evaluating and monitoring the entity's compliance, and (*d*) preparing reports that satisfy legal, regulatory, or contractual requirements. Management's evaluation may include documentation such as accounting or statistical data, policy manuals, accounting manuals, narrative memoranda, procedural write-ups, flowcharts, completed questionnaires, internal auditors' reports, and other special studies or analyses. The form and extent of documentation will vary depending on the nature of the compliance requirements and the size and complexity of the entity. Management may engage the practitioner to gather information to assist it in evaluating the entity's compliance. Regardless of the procedures performed by the practitioner, management must accept responsibility for its assertions and must not base such assertions solely on the practitioner's procedures.

10. Specified users are responsible for the sufficiency (nature, timing, and extent) of the agreed-upon procedures because they best understand their own needs. The specified users assume the risk that such procedures might be insufficient for their purposes. In addition, the specified users assume the risk that they might misunderstand or otherwise inappropriately use findings properly reported by the practitioner.

Practitioner's Responsibilities

11. The objective of the practitioner's agreed-upon procedures is to present specific findings to assist users in evaluating an entity's compliance with the requirements specified in the CIA. (See appendix D, "Sample Procedures.")

12. The practitioner's procedures generally may be as limited or extensive as the specified users desire, as long as the specified users agree upon the procedures performed or to be performed and take responsibility for the sufficiency of the agreed-upon procedures for their purposes.

13. To satisfy the requirements that the practitioner and the specified users agree upon the procedures performed or to be performed and that the specified users take responsibility for the sufficiency of the agreed-upon procedures for their purposes, ordinarily the practitioner should communicate directly with and obtain affirmative acknowledgment from each of the specified users. For the purposes of these engagements, an effective way to obtain this agreement ordinarily is to distribute a draft of the report, detailing the procedures, that is expected to be issued to the OIG with a request for any comments it may have.

14. To avoid possible misunderstandings, the practitioner should circulate the draft with a legend stating that these are the procedures expected to be performed, and unless informed otherwise, the practitioner assumes that there are no additional procedures that he or she is expected to perform. A legend such as the following might be used.

> This draft is furnished solely for the purpose of indicating the form of report that we would expect to be able to furnish pursuant to the request by Management of [*Provider*] for our performance of limited procedures relating to [*Provider's*] compliance with the Corporate Integrity Agreement with the Office of Inspector General (OIG) of the U.S. Department of Heath and Human Services. Based on our discussions with [*Provider*], it is our understanding that the procedures outlined in this draft report are those we are expected to follow. Unless informed otherwise within ninety (90) days of this transmittal, we shall assume that there are no additional procedures that we are expected to follow. The text of the definitive report will depend, of course, on the results of the procedures.

Involvement of a Specialist[2]

15. The practitioner's education and experience enable him or her to be knowledgeable about business matters in general, but he or she is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation. In certain circumstances, it may be appropriate to involve a specialist to assist the practitioner in the performance of one or more procedures. The following are examples:

- An attorney might provide assistance concerning the application of laws, regulations, or rules to a client's situation.
- A medical specialist might provide assistance in understanding the characteristics of diagnosis codes documented in patient medical records.

16. The practitioner and the specified users should agree to the involvement of a specialist in assisting a practitioner in the performance of an agreed-upon procedures engagement. This agreement may be reached when obtaining agreement on the procedures performed or to be performed and acknowledgment of responsibility for the sufficiency of the procedures, as discussed previously. The practitioner's report should describe the nature of the assistance provided by the specialist.

17. A practitioner may agree to apply procedures to the report or work product of a specialist that does not constitute assistance by the specialist to the practitioner in an agreed-upon procedures engagement. For example, the practitioner may make reference to information contained in a report of a specialist in describing an agreed-upon procedure. However, it is inappropriate

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[2] A *specialist* is a person (or firm) possessing special skill or knowledge in a particular field other than the attest function. As used herein, a specialist does not include a person employed by the practitioner's firm who participates in the attestation engagement.

for the practitioner to agree to merely read the specialist's report solely to describe or repeat the findings, or to take responsibility for all or a portion of any procedures performed by a specialist or the specialist's work product.

Internal Auditors and Other Personnel[3]

18. The agreed-upon procedures to be enumerated or referred to in the practitioner's report are to be performed entirely by the practitioner except as discussed in paragraphs 15–17 of this SOP. However, internal auditors or other personnel may prepare schedules, accumulate data, perform an internal assessment of management's compliance, or provide other information for the practitioner's use in performing the agreed-upon procedures.

19. A practitioner may agree to perform procedures on information documented in the working papers of internal auditors. For example, the practitioner may agree to—

- Repeat all or some of the procedures.
- Determine whether the internal auditors' working papers contain documentation of procedures performed and whether the findings documented in the working papers are presented in a report by the internal auditors.

20. However, it is inappropriate for the practitioner to—

- Agree to merely read the internal auditor's report solely to describe or repeat its findings.
- Take responsibility for all or a portion of any procedures performed by internal auditors by reporting those findings as the practitioner's own.
- Report in any manner that implies shared responsibility for the procedures with the internal auditors.

Planning the Engagement

21. Planning an agreed-upon procedures engagement involves working with the users to develop an overall strategy for the expected conduct and scope of the engagement. To develop such a strategy, practitioners should have adequate technical training and proficiency in the attestation standards and have adequate knowledge in health care regulatory matters to enable them to sufficiently understand the events, transactions, and practices that, in their judgment, have a significant effect on the presentation of the assertions.

Working Papers

22. The practitioner should prepare and maintain working papers in connection with an engagement under the attestation standards; such working papers should be appropriate to the circumstances and the practitioner's needs on the engagement to which they apply.

23. Concern over access to the practitioner's working papers might cause some clients to inquire about working paper requirements. In situations where the practitioner is requested to not maintain copies of certain client documentation, or to not prepare and maintain documentation similar to client documents,

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[3] SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 322), does not apply to agreed-upon procedures engagements.

the practitioner may refer to the Auditing Interpretation, "The Auditor's Consideration of the Completeness Assertion" (AICPA, *Professional Standards*, vol. 1, AU sec. 9326.06–.17), for guidance. See the Attest Interpretation, "Providing Access to or Photocopies of Working Papers to a Regulator" (AICPA, *Professional Standards*, vol. 1, AT sec. 9100.58), for guidance related to providing access to or photocopies of working papers to a regulator in connection with work performed on an attestation engagement.

Management's Representations

24. The practitioner should obtain written representation from management on various matters including the following:

a. Acknowledging management's responsibility for complying with the CIA

b. Acknowledging management's responsibility for establishing and maintaining effective internal control over compliance

c. Stating that management has performed an evaluation of the entity's compliance with CIA-specified requirements

d. Stating management's assertions about the entity's compliance with all aspects of the CIA, including the specific issues that gave rise to the CIA[4]

e. Stating that management has disclosed to the practitioner all known noncompliance with the CIA

f. Stating that management has made available all documentation relating to compliance with the CIA

g. Stating management's interpretation of any compliance requirements that have varying interpretations

h. Stating that management has disclosed any communication from regulatory agencies, internal auditors, legal counsel, and other parties concerning matters regarding the design, implementation, and monitoring of the policies and procedures in place, including communication received between the end of the reporting period and the date of the practitioner's report (the date of signature)

i. Stating that management has disclosed any known noncompliance occurring subsequent to the end of the reporting period

j. Describing any related material fraud or abuse, other fraud, abuse or illegal acts that, whether or not material, involve management or other employees who have a significant role in the entity's design, implementation, and monitoring of the policies and procedures in place upon which compliance is based

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[4] Depending on the circumstances, representations in the following areas might be appropriate.

- Violations or possible violations of laws or regulations, such as those related to the Medicare and Medicaid antifraud and abuse statutes
- Compliance of third-party billings with applicable coding guidelines (for example, ICD-9-CM, CPT) and laws and regulations (including medical necessity, proper approvals, and proper rendering of care)
- Proper filing of all required Medicare, Medicaid, and similar reports under the applicable reimbursement rules and regulations (including nature of costs—allowable, patient-related, properly allocated, in accordance with applicable rules and regulations, properly adjusted to reflect prior audit adjustments) and adequacy of disclosures (including disputed costs)

k. Stating that management has disclosed to the practitioners, orally or in writing, information about past noncompliance issues covered in the settlement agreement that gave rise to the CIA and the related corrective measures taken to support compliance in those areas

Management's refusal to furnish all appropriate written representations constitutes a limitation on the scope of the engagement sufficient to require withdrawal from the engagement.

Reporting Considerations

25. A practitioner should present the results of applying agreed-upon procedures to the specific subject matter in the form of findings. The practitioner should not provide negative assurance about whether the assertion is fairly stated in accordance with established or stated criteria. For example, the practitioner should not include a statement that "nothing came to my attention that caused me to believe that the assertion is not fairly stated in accordance with (established or stated) criteria."

26. The practitioner should report all findings from the application of the agreed-upon procedures. The concept of materiality does not apply to findings to be reported in an agreed-upon procedures engagement unless the definition of materiality is agreed to by the specified users. Any agreed-upon materiality limits should be described in the practitioner's report.

27. The practitioner has no obligation to perform procedures beyond the agreed-upon procedures. However, if noncompliance related to management's assertion comes to the practitioner's attention by other means, such information ordinarily should be included in his or her report.

28. The practitioner may become aware of noncompliance related to management's assertion that occurs subsequent to the reporting period but before the date of the practitioner's report. The practitioner should consider including information regarding such noncompliance in his or her report. However, the practitioner has no responsibility to perform procedures to detect such noncompliance other than obtaining management's representation about noncompliance in the subsequent period.

29. The practitioner should follow the reporting guidance in SSAE No. 4 (AT sec. 600.33–.38). A sample report is included in appendix E, "Sample Report."

30. Evaluating compliance with certain requirements may require interpretation of the laws, regulations, rules, contracts, or other agreements that establish those requirements. In such situations, the practitioner should consider whether he or she is provided with the reasonable criteria required to evaluate an assertion under the third general attestation standard. If these interpretations are significant, the practitioner may include a paragraph stating the description and the source of interpretations made by the entity's management. An example of such a paragraph, which should precede the procedures and findings paragraph(s), follows:

> We have been informed that, under [*name of entity's*] interpretation of [*identify the compliance requirement*], [*explain the nature and source of the relevant interpretation*].

31. The date of completion of the agreed-upon procedures should be used as the date of the practitioner's report.

Appendix A

Sample Corporate Integrity Agreement Between the Office of Inspector General of the Department of Health and Human Services and [*Provider*]

I. Preamble

[*Provider*] ("[*Provider*]") hereby enters into this Corporate Integrity Agreement ("CIA") with the Office of Inspector General ("OIG") of the United States Department of Health and Human Services ("HHS") to ensure compliance by its employees with the requirements of Medicare, Medicaid and all other Federal health care programs (as defined in 42 U.S.C. 1320a-7b(f)) (hereinafter collectively referred to as the "Federal health care programs"). [*Provider's*] compliance with the terms and conditions in this CIA shall constitute an element of [*Provider's*] present responsibility with regard to participation in the Federal health care programs. Contemporaneously with this CIA, [*Provider*] is entering into a Settlement Agreement with the United States, and this CIA is incorporated by reference into the Settlement Agreement.

II. Term of the CIA

The period of the compliance obligations assumed by [*Provider*] under this CIA shall be 5 years from the effective date of this CIA (unless otherwise specified). The effective date of this CIA will be the date on which the final signatory of this CIA executes this CIA (the "effective date").*

III. Corporate Integrity Obligations

[*Provider*] shall establish a compliance program that includes the following elements:

A. *Compliance Officer*

Within ninety (90) days after the effective date of this CIA, [*Provider*] shall appoint an individual to serve as Compliance Officer, who shall be responsible for developing and implementing policies, procedures, and practices designed to ensure compliance with the requirements set forth in this CIA and with the requirements of the Federal health care programs. The Compliance Officer shall be a member of senior management of [*Provider*], shall make regular (at least quarterly) reports regarding compliance matters directly to the CEO and/or to the Board of Directors of [*Provider*] and shall be authorized to report to the Board of Directors at any time. The Compliance Officer shall be responsible for monitoring the day-to-day activities engaged in by [*Provider*] to further its compliance objectives as well as any reporting obligations created under this CIA. In the event a new Compliance Officer is appointed during the term of this CIA, [*Provider*] shall notify the OIG, in writing, within fifteen (15) days of such a change.

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* *Source:* Office of the Inspector General of the United States Department of Health and Human Services.

[*Provider*] shall also appoint a Compliance Committee within ninety (90) days after the effective date of this CIA. The Compliance Committee shall, at a minimum, include the Compliance Officer and any other appropriate officers as necessary to meet the requirements of this CIA within the provider's corporate structure (e.g., senior executives of each major department, such as billing, clinical, human resources, audit, and operations). The Compliance Officer shall chair the Compliance Committee and the Committee shall support the Compliance Officer in fulfilling his/her responsibilities.

B. Written Standards

1. *Code of Conduct.* Within ninety (90) days of the effective date of this CIA, [*Provider*] shall establish a Code of Conduct. The Code of Conduct shall be distributed to all employees within ninety (90) days of the effective date of this CIA. [*Provider*] shall make the promotion of, and adherence to, the Code of Conduct an element in evaluating the performance of managers, supervisors, and all other employees. The Code of Conduct shall, at a minimum, set forth:

   a. [*Provider's*] commitment to full compliance with all statutes, regulations, and guidelines applicable to Federal health care programs, including its commitment to prepare and submit accurate billings consistent with Federal health care program regulations and procedures or instructions otherwise communicated by the Health Care Financing Administration ("HCFA") (or other appropriate regulatory agencies) and/or its agents;

   b. [*Provider's*] requirement that all of its employees shall be expected to comply with all statutes, regulations, and guidelines applicable to Federal health care programs and with [*Provider's*] own policies and procedures (including the requirements of this CIA);

   c. the requirement that all of [*Provider's*] employees shall be expected to report suspected violations of any statute, regulation, or guideline applicable to Federal health care programs or with [*Provider's*] own policies and procedures;

   d. the possible consequences to both [*Provider*] and to any employee of failure to comply with all statutes, regulations, and guidelines applicable to Federal health care programs and with [*Provider's*] own policies and procedures or of failure to report such non-compliance; and

   e. the right of all employees to use the confidential disclosure program, as well as [*Provider's*] commitment to confidentiality and non-retaliation with respect to disclosures.

   Within ninety (90) days of the effective date of the CIA, each employee shall certify, in writing, that he or she has received, read, understands, and will abide by [*Provider's*] Code of Conduct. New employees shall receive the Code of Conduct and shall complete the required certification within two (2) weeks after the commencement of their employment or within ninety (90) days of the effective date of the CIA, whichever is later.

   [*Provider*] will annually review the Code of Conduct and will make any necessary revisions. These revisions shall be distributed within

thirty (30) days of initiating such a change. Employees shall certify on an annual basis that they have received, read, understand and will abide by the Code of Conduct.

2. *Policies and Procedures.* Within ninety (90) days of the effective date of this CIA, [*Provider*] shall develop and initiate implementation of written Policies and Procedures regarding the operation of [*Provider's*] compliance program and its compliance with all federal and state health care statutes, regulations, and guidelines, including the requirements of the Federal health care programs. At a minimum, the Policies and Procedures shall specifically address *[insert language relevant to allegations in the case]*. In addition, the Policies and Procedures shall include disciplinary guidelines and methods for employees to make disclosures or otherwise report on compliance issues to [*Provider*] management through the Confidential Disclosure Program required by section III.E. [*Provider*] shall assess and update as necessary the Policies and Procedures at least annually and more frequently, as appropriate. A summary of the Policies and Procedures will be provided to OIG in the Implementation Report. The Policies and Procedures will be available to OIG upon request.

   Within ninety (90) days of the effective date of the CIA, the relevant portions of the Policies and Procedures shall be distributed to all appropriate employees. Compliance staff or supervisors should be available to explain any and all policies and procedures.

C. *Training and Education*

1. *General Training.* Within ninety (90) days of the effective date of this CIA, [*Provider*] shall provide at least two (2) hours of training to each employee. This general training shall explain [*Provider's*]:

   a. Corporate Integrity Agreement requirements;

   b. Compliance Program (including the Policies and Procedures as they pertain to general compliance issues); and

   c. Code of Conduct.

   These training materials shall be made available to the OIG, upon request.

   New employees shall receive the general training described above within thirty (30) days of the beginning of their employment or within ninety (90) days after the effective date of this CIA, whichever is later. Each year, every employee shall receive such general training on an annual basis.

2. *Specific Training.* Within ninety (90) days of the effective date of this CIA, each employee who is involved directly or indirectly in the delivery of patient care and/or in the preparation or submission of claims for reimbursement for such care (including, but not limited to, coding and billing) for any Federal health care programs shall receive at least [*insert number of training hours*] hours of training in addition to the general training required above. This training shall include a discussion of:

   a. the submission of accurate bills for services rendered to Medicare and/or Medicaid patients;

b. policies, procedures and other requirements applicable to the documentation of medical records;

c. the personal obligation of each individual involved in the billing process to ensure that such billings are accurate;

d. applicable reimbursement rules and statutes;

e. the legal sanctions for improper billings; and

f. examples of proper and improper billing practices.

These training materials shall be made available to OIG, upon request. Persons providing the training must be knowledgeable about the subject area.

Affected new employees shall receive this training within thirty (30) days of the beginning of their employment or within ninety (90) days of the effective date of this CIA, whichever is later. If a new employee has any responsibility for the delivery of patient care, the preparation or submission of claims and/or the assignment of procedure codes prior to completing this specific training, a [*Provider*] employee who has completed the substantive training shall review all of the untrained person's work regarding the assignment of billing codes.

Each year, every employee shall receive such specific training on an annual basis.

3. *Certification.* Each employee shall certify, in writing, that he or she has attended the required training. The certification shall specify the type of training received and the date received. The Compliance Officer shall retain the certifications, along with specific course materials. These shall be made available to OIG upon request.

D. Review Procedures

[*Provider*] shall retain an entity, such as an accounting, auditing or consulting firm (hereinafter "Independent Review Organization"), to perform review procedures to assist [*Provider*] in assessing the adequacy of its billing and compliance practices pursuant to this CIA. This shall be an annual requirement and shall cover a twelve (12) month period. The Independent Review Organization must have expertise in the billing, coding, reporting and other requirements of the Federal health care programs from which [*Provider*] seeks reimbursement. The Independent Review Organization must be retained to conduct the assessment of the first year within ninety (90) days of the effective date of this CIA. For purposes of complying with this review procedures requirement, the OIG at its discretion, may permit the [*Provider*] to utilize internal auditors to perform the review(s). In such case, the [*Provider*] will engage the Independent Review Organization to verify the propriety of the internal auditors' methods and accuracy of their results. The [*Provider*] will request the Independent Review Organization to produce a report on its findings which report shall be included in the Annual Report to the OIG.

The Independent Review Organization (or the [*Provider*], if permitted by the OIG, as set forth above) will conduct two separate engagements. One will be an analysis of [*Provider's*] billing to the Federal health care programs to assist the [*Provider*] and OIG in determining

compliance with all applicable statutes, regulations, and directives/guidance ("billing engagement"). The second engagement will assist the [*Provider*] and OIG in determining whether [*Provider*] is in compliance with this CIA ("compliance engagement").

1. *Billing Engagement.* The billing engagement shall consist of a review of a statistically valid sample of claims for the relevant period. The sample size shall be determined through the use of a probe sample.[1] At a minimum, the full sample must be within a ninety (90) percent confidence level and a precision of twenty-five (25) percent. The probe sample must contain at least thirty (30) sample units and cannot be used as part of the full sample. Both the probe sample and the sample must be selected through random numbers. [*Provider*] shall use OIG's Office of Audit Services Statistical Sampling Software, also known as "RAT-STATS", which is available through the Internet at www.hhs.gov/progorg /ratstat.html.

   Each annual billing engagement analysis shall include the following components in its methodology:

   a. Billing Engagement Objective: Provide a statement stating clearly the objective intended to be achieved by the billing engagement and the procedure or combination of procedures that will be applied to achieve the objective.

   b. Billing Engagement Population: Identify the population, which is the group about which information is needed. Explain the methodology used to develop the population and provide the basis for this determination.

   c. Sources of Data: Provide a full description of the source of the information upon which the billing engagement conclusions will be based, including the legal or other standards applied, documents relied upon, payment data, and/or any contractual obligations.

   d. Sampling Unit: Define the sampling unit, which is any of the designated elements that comprise the population of interest.

   e. Sampling Frame: Identify the sampling frame, which is the totality of the sampling units from which the sample will be selected.

   As part of the billing engagement:

   a. Inquire of management as to the procedures and controls affecting the billing process subject to the annual assessment as specified in the CIA. Document that aspect of the billing process (e.g., flow of documents, processing activities), and those controls that will be tested in the sample. The documentation may consist of flow charts, excerpts from policies and procedures manuals, control questionnaires, etc.

   b. Report the sample results, including the overall error rate and the nature of the errors found (e.g., no documentation, inadequate documentation, assignment of incorrect code).

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[1] Probe sample is defined as a small, random preliminary sample.

c. Document findings related to [*Provider's*] procedures to correct inaccurate billings and codings to the Federal health care programs and findings regarding the steps [*Provider*] is taking to bring its operations into compliance or to correct problems identified by the audit.

2. *Agreed-upon Procedures or Compliance Engagement.* An Independent Review Organization (or the [*Provider*], if permitted by the OIG) shall also conduct an agreed-upon procedures or compliance engagement, which shall assist the users in determining whether [*Provider's*] program, policies, procedures, and operations comply with the terms of this CIA. This engagement shall include a section by section analysis of the requirements of this CIA.

   A complete copy of the Independent Review Organization's billing and agreed-upon procedures or compliance engagement shall be included in each of [*Provider's*] Annual Reports to OIG.

3. *Disclosure of Overpayments and Material Deficiencies.* If, as a result of these engagements, [*Provider*] or the Independent Review Organization identifies any billing, coding or other policies, procedures and/or practices that result in an overpayment, [*Provider*] shall notify the payor (e.g., Medicare fiscal intermediary or carrier) within 30 days of discovering the deficiency or overpayment and take remedial steps within 60 days of discovery (or such additional time as may be agreed to by the payor) to correct the problem, including preventing the deficiency from recurring. The notice to the payor shall include:

   a. a statement that the refund is being made pursuant to this CIA;

   b. a description of the complete circumstances surrounding the overpayment;

   c. the methodology by which the overpayment was determined;

   d. the amount of the overpayment;

   e. any claim-specific information used to determine the overpayment (e.g., beneficiary health insurance number, claim number, service date, and payment date);

   f. the cost reporting period; and

   g. the provider identification number under which the repayment is being made.

   If [*Provider*] determines an overpayment represents a material deficiency, contemporaneous with [*Provider's*] notification to the payor as provided above, [*Provider*] shall also notify OIG of:

   a. a complete description of the material deficiency;

   b. amount of overpayment due to the material deficiency;

   c. [*Provider's*] action(s) to correct and prevent such material deficiency from recurring;

   d. the payor's name, address, and contact person where the overpayment was sent;

e. the date of the check and identification number (or electronic transaction number) on which the overpayment was repaid.

For purposes of this CIA, an "overpayment" shall mean the amount of money the provider has received in excess of the amount due and payable under the Federal health care programs' statutes, regulations or program directives, including carrier and intermediary instructions.

For purposes of this CIA, a "material deficiency" shall mean anything that involves: (i) a substantial overpayment or improper payment relating to the Medicare and/or Medicaid programs; (ii) conduct or policies that clearly violate the Medicare and/or Medicaid statute, regulations or directives issued by HCFA and/or its agents; or (iii) serious quality of care implications for federal health care beneficiaries or recipients. A material deficiency may be the result of an isolated event or a series of occurrences.

4. *Verification / Validation.* In the event that the OIG determines that it is necessary to conduct an independent review to determine whether or the extent to which [*Provider*] is complying with its obligations under this CIA, [*Provider*] agrees to pay for the reasonable cost of any such review or engagement by the OIG or any of its designated agents.

E. Confidential Disclosure Program

Within ninety (90) days after the effective date of this CIA, [*Provider*] shall establish a Confidential Disclosure Program, which must include measures (e.g., a toll-free compliance telephone line) to enable employees, contractors, agents or other individuals to disclose, to the Compliance Officer or some other person who is not in the reporting individual's chain of command, any identified issues or questions associated with [*Provider's*] policies, practices or procedures with respect to the Federal health care program, believed by the individual to be inappropriate. [*Provider*] shall publicize the existence of the hotline (e.g., e-mail to employees or post hotline number in prominent common areas).

The Confidential Disclosure Program shall emphasize a non-retribution, non-retaliation policy, and shall include a reporting mechanism for anonymous, confidential communication. Upon receipt of a complaint, the Compliance Officer (or designee) shall gather the information in such a way as to elicit all relevant information from the individual reporting the alleged misconduct. The Compliance Officer (or designee) shall make a preliminary good faith inquiry into the allegations set forth in every disclosure to ensure that he or she has obtained all of the information necessary to determine whether a further review should be conducted. For any disclosure that is sufficiently specific so that it reasonably: (1) permits a determination of the appropriateness of the alleged improper practice, and (2) provides an opportunity for taking corrective action, [*Provider*] shall conduct an internal review of the allegations set forth in such a disclosure and ensure that proper follow-up is conducted.

The Compliance Officer shall maintain a confidential disclosure log, which shall include a record and summary of each allegation received, the status of the respective investigations, and any corrective action taken in response to the investigation.

F. Ineligible Persons

[*Provider*] shall not hire or engage as contractors any "Ineligible Person." For purposes of this CIA, an "Ineligible Person" shall be any individual or entity who: (i) is currently excluded, suspended, debarred or otherwise ineligible to participate in the Federal health care programs; or (ii) has been convicted of a criminal offense related to the provision of health care items or services and has not been reinstated in the Federal health care programs after a period of exclusion, suspension, debarment, or ineligibility.

Within ninety (90) days of the effective date of this CIA, [*Provider*] will review its list of current employees and contractors against the General Services Administration's List of Parties Excluded from Federal Programs (available through the Internet at http://www.arnet.gov/ epls) and the HHS/OIG Cumulative Sanction Report (available through the Internet at http://www.dhhs.gov/progorg/oig) to ensure that it is not currently employing or contracting with any Ineligible Person. Thereafter, [*Provider*] will review the list once semi-annually to ensure that no current employees or contractors are or have become Ineligible Persons.

To prevent hiring or contracting with any Ineligible Person, [*Provider*] shall screen all prospective employees and prospective contractors prior to engaging their services by (i) requiring applicants to disclose whether they are Ineligible Persons, and (ii) reviewing the General Services Administration's List of Parties Excluded from Federal Programs (available through the Internet at http://www.arnet.gov/epls) and the HHS/OIG Cumulative Sanction Report (available through the Internet at http://www.dhhs.gov/progorg/oig).

If [*Provider*] has notice that an employee or agent is charged with a criminal offense related to any Federal health care program, or is suspended or proposed for exclusion during his or her employment or contract with [*Provider*], within 10 days of receiving such notice [*Provider*] will remove such employee from responsibility for, or involvement with, [*Provider's*] business operations related to the Federal health care programs until the resolution of such criminal action, suspension, or proposed exclusion. If [*Provider*] has notice that an employee or agent has become an Ineligible Person, [*Provider*] will remove such person from responsibility for, or involvement with, [*Provider's*] business operations related to the Federal health care programs and shall remove such person from any position for which the person's salary or the items or services rendered, ordered, or prescribed by the person are paid in whole or in part, directly or indirectly, by Federal health care programs or otherwise with Federal funds at least until such time as the person is reinstated into participation in the Federal health care programs.

G. Notification of Proceedings

Within thirty (30) days of discovery, [*Provider*] shall notify OIG, in writing, of any ongoing investigation or legal proceeding conducted or brought by a governmental entity or its agents involving an allegation that [*Provider*] has committed a crime or has engaged in fraudulent activities or any other knowing misconduct. This notification shall include a description of the allegation, the identity of the

investigating or prosecuting agency, and the status of such investigation or legal proceeding. [*Provider*] shall also provide written notice to OIG within thirty (30) days of the resolution of the matter, and shall provide OIG with a description of the findings and/or results of the proceedings, if any.

H. Reporting

1. *Credible evidence of misconduct.* If [*Provider*] discovers credible evidence of misconduct from any source and, after reasonable inquiry, has reason to believe that the misconduct may violate criminal, civil, or administrative law concerning [*Provider's*] practices relating to the Federal health care programs, then [*Provider*] shall promptly report the probable violation of law to OIG. Defendants shall make this disclosure as soon as practicable, but, not later than thirty (30) days after becoming aware of the existence of the probable violation. The [*Provider's*] report to OIG shall include:

   a. the findings concerning the probable violation, including the nature and extent of the probable violation;

   b. [*Provider's*] actions to correct such probable violation; and

   c. any further steps it plans to take to address such probable violation and prevent it from recurring.

   To the extent the misconduct involves an overpayment, the report shall include the information listed in section III.D.3 regarding material deficiencies.

2. *Inappropriate Billing.* If [*Provider*] discovers inappropriate or incorrect billing through means other than the Independent Review Organization's engagement, the provider shall follow procedures in section III.D.3 regarding overpayments and material deficiencies.

IV. New Locations

In the event that [*Provider*] purchases or establishes new business units after the effective date of this CIA, [*Provider*] shall notify OIG of this fact within thirty (30) days of the date of purchase or establishment. This notification shall include the location of the new operation(s), phone number, fax number, Federal health care program provider number(s) (if any), and the corresponding payor(s) (contractor specific) that has issued each provider number. All employees at such locations shall be subject to the requirements in this CIA that apply to new employees (e.g., completing certifications and undergoing training).

V. Implementation and Annual Reports

A. Implementation Report

Within one hundred and twenty (120) days after the effective date of this CIA, [*Provider*] shall submit a written report to OIG summarizing the status of its implementation of the requirements of this CIA. This Implementation Report shall include:

1. the name, address, phone number and position description of the Compliance Officer required by section III.A;
2. the names and positions of the members of the Compliance Committee required by section III.A;
3. a copy of [*Provider's*] Code of Conduct required by section III.B.1;

4. the summary of the Policies and Procedures required by section III.B.2;
5. a description of the training programs required by section III.C including a description of the targeted audiences and a schedule of when the training sessions were held;
6. a certification by the Compliance Officer that:
   a. the Policies and Procedures required by section III.B have been developed, are being implemented, and have been distributed to all pertinent employees;
   b. all employees have completed the Code of Conduct certification required by section III.B.1; and;
   c. all employees have completed the training and executed the certification required by section III.C;
7. a description of the confidential disclosure program required by section III.E;
8. the identity of the Independent Review Organization(s) and the proposed start and completion date of the first audit; and
9. a summary of personnel actions taken pursuant to section III.F.

B. Annual Reports

[*Provider*] shall submit to OIG an Annual Report with respect to the status and findings of [*Provider's*] compliance activities. The Annual Reports shall include:

1. any change in the identity or position description of the Compliance Officer and/or members of the Compliance Committee described in section III.A;
2. a certification by the Compliance Officer that:
   a. all employees have completed the annual Code of Conduct certification required by section III.B.1; and
   b. all employees have completed the training and executed the certification required by section III.C;
3. notification of any changes or amendments to the Policies and Procedures required by section III.B and the reasons for such changes (e.g., change in contractor policy);
4. a complete copy of the report prepared pursuant to the Independent Review Organization's billing and compliance engagement, including a copy of the methodology used;
5. [*Provider's*] response/corrective action plan to any issues raised by the Independent Review Organization;
6. a summary of material deficiencies reported throughout the course of the previous twelve (12) months pursuant to III.D.3 and III.H;
7. a report of the aggregate overpayments that have been returned to the Federal health care programs that were discovered as a direct or indirect result of implementing this CIA. Overpayment amounts should be broken down into the following categories: Medicare, Medicaid (report each applicable state separately) and other Federal health care programs;

8. a copy of the confidential disclosure log required by section III.E;
9. a description of any personnel action (other than hiring) taken by [*Provider*] as a result of the obligations in section III.F;
10. a summary describing any ongoing investigation or legal proceeding conducted or brought by a government entity involving an allegation that [*Provider*] has committed a crime or has engaged in fraudulent activities, which have been reported pursuant to section III.G. The statement shall include a description of the allegation, the identity of the investigating or prosecuting agency, and the status of such investigation, legal proceeding or requests for information;
11. a corrective action plan to address the probable violations of law identified in section III.H; and
12. a listing of all of the [*Provider's*] locations (including locations and mailing addresses), the corresponding name under which each location is doing business, the corresponding phone numbers and fax numbers, each location's Federal health care program provider identification number(s) and the payor (specific contractor) that issued each provider identification number.

The first Annual Report shall be received by the OIG no later than one year and thirty (30) days after the effective date of this CIA. Subsequent Annual Reports shall be submitted no later than the anniversary date of the due date of the first Annual Report.

C. Certifications

The Implementation Report and Annual Reports shall include a certification by the Compliance Officer under penalty of perjury, that: (1) [*Provider*] is in compliance with all of the requirements of this CIA, to the best of his or her knowledge; and (2) the Compliance Officer has reviewed the Report and has made reasonable inquiry regarding its content and believes that, upon such inquiry, the information is accurate and truthful.

VI. Notifications and Submission of Reports

Unless otherwise stated in writing subsequent to the effective date of this CIA, all notifications and reports required under this CIA shall be submitted to the entities listed below:

OIG: Civil Recoveries Branch—Compliance Unit
Office of Counsel to the Inspector General
Office of Inspector General
U.S. Department of Health and Human Services
Cohen Building, Room 5527
330 Independence Avenue, SW
Washington, DC 20201
Phone 202-619-2078; Fax 202-205-0604

[*Provider*]:

[*Address and Telephone number of Provider's Compliance Contact*]

VII. OIG Inspection, Audit and Review Rights

In addition to any other rights OIG may have by statute, regulation, or contract, OIG or its duly authorized representative(s), may examine [*Provider's*] books, records, and other documents and supporting materials for

the purpose of verifying and evaluating: (*a*) [*Provider's*] compliance with the terms of this CIA; and (*b*) [*Provider's*] compliance with the requirements of the Federal health care programs in which it participates. The documentation described above shall be made available by [*Provider*] to OIG or its duly authorized representative(s) at all reasonable times for inspection, audit or reproduction. Furthermore, for purposes of this provision, OIG or its duly authorized representative(s) may interview any of [*Provider*'s] employees who consent to be interviewed at the employee's place of business during normal business hours or at such other place and time as may be mutually agreed upon between the employee and OIG. [*Provider*] agrees to assist OIG in contacting and arranging interviews with such employees upon OIG's request. [*Provider's*] employees may elect to be interviewed with or without a representative of [*Provider*] present.

VIII. Document and Record Retention

[*Provider*] shall maintain for inspection all documents and records relating to reimbursement from the Federal health care programs or to compliance with this CIA one year longer than the term of this CIA (or longer if otherwise required by law).

IX. Disclosures

Subject to HHS's Freedom of Information Act ("FOIA") procedures, set forth in 45 C.F.R. Part 5, the OIG shall make a reasonable effort to notify [*Provider*] prior to any release by OIG of information submitted by [*Provider*] pursuant to its obligations under this CIA and identified upon submission by [*Provider*] as trade secrets, commercial or financial information and privileged and confidential under the FOIA rules. [*Provider*] shall refrain from identifying any information as trade secrets, commercial or financial information and privileged and confidential that does not meet the criteria for exemption from disclosure under FOIA.

X. Breach and Default Provisions

[*Provider*] is expected to fully and timely comply with all of the obligations herein throughout the term of this CIA or other time frames herein agreed to.

A. *Stipulated Penalties for Failure to Comply with Certain Obligations*

As a contractual remedy, [*Provider*] and OIG hereby agree that failure to comply with certain obligations set forth in this CIA may lead to the imposition of the following monetary penalties (hereinafter referred to as "Stipulated Penalties") in accordance with the following provisions.

1. A Stipulated Penalty of $2,500 (which shall begin to accrue on the day after the date the obligation became due) for each day, beginning 120 days after the effective date of this CIA and concluding at the end of the term of this CIA, [*Provider*] fails to have in place any of the following:

    a. a Compliance Officer;

    b. a Compliance Committee;

    c. a written Code of Conduct;

    d. written Policies and Procedures;

    e. a training program; and

    f. a Confidential Disclosure Program;

2. A Stipulated Penalty of $2,500 (which shall begin to accrue on the day after the date the obligation became due) for each day [*Provider*] fails to meet any of the deadlines to submit the Implementation Report or the Annual Reports to the OIG.
3. A Stipulated Penalty of $2,000 (which shall begin to accrue on the date the failure to comply began) for each day [*Provider*]:
   a. hires or contracts with an Ineligible Person after that person has been listed by a federal agency as excluded, debarred, suspended or otherwise ineligible for participation in the Medicare, Medicaid or any other Federal health care program (as defined in 42 U.S.C. 1320a7b(f)). This Stipulated Penalty shall not be demanded for any time period if [*Provider*] can demonstrate that it did not discover the person's exclusion or other ineligibility after making a reasonable inquiry (as described in section III.F) as to the status of the person;
   b. employs or contracts with an Ineligible Person and that person: (i) has responsibility for, or involvement with, [*Provider's*] business operations related to the Federal health care programs or (ii) is in a position for which the person's salary or the items or services rendered, ordered, or prescribed by the person are paid in whole or in part, directly or indirectly, by the Federal health care programs or otherwise with Federal funds (this Stipulated Penalty shall not be demanded for any time period during which [*Provider*] can demonstrate that it did not discover the person's exclusion or other ineligibility after making a reasonable inquiry (as described in III.F) as to the status of the person);
   c. employs or contracts with a person who: (i) has been charged with a criminal offense related to any Federal health care program, or (ii) is suspended or proposed for exclusion, and that person has responsibility for, or involvement with, [*Provider's*] business operations related to the Federal health care programs (this Stipulated Penalty shall not be demanded for any time period before 10 days after [*Provider*] received notice of the relevant matter or after the resolution of the matter).
4. A Stipulated Penalty of $1,500 (which shall begin to accrue on the date the [*Provider*] fails to grant access) for each day [*Provider*] fails to grant access to the information or documentation as required in section V of this CIA.
5. A Stipulated Penalty of $1,000 (which shall begin to accrue ten (10) days after the date that OIG provides notice to [*Provider*] of the failure to comply) for each day [*Provider*] fails to comply fully and adequately with any obligation of this CIA. In its notice to [*Provider*], the OIG shall state the specific grounds for its determination that the [Provider] has failed to comply fully and adequately with the CIA obligation(s) at issue.

B. Payment of Stipulated Penalties

1. *Demand Letter.* Upon a finding that [*Provider*] has failed to comply with any of the obligations described in section X.A and

determining that Stipulated Penalties are appropriate, OIG shall notify [*Provider*] by personal service or certified mail of (*a*) [*Provider's*] failure to comply; and (*b*) the OIG's exercise of its contractual right to demand payment of the Stipulated Penalties (this notification is hereinafter referred to as the "Demand Letter").

Within fifteen (15) days of the date of the Demand Letter, [*Provider*] shall either (*a*) cure the breach to the OIG's satisfaction and pay the applicable stipulated penalties, or (*b*) request a hearing before an HHS administrative law judge ("ALJ") to dispute the OIG's determination of noncompliance, pursuant to the agreed-upon provisions set forth below in section X.D. In the event [*Provider*] elects to request an ALJ hearing, the Stipulated Penalties shall continue to accrue until [*Provider*] cures, to the OIG's satisfaction, the alleged breach in dispute. Failure to respond to the Demand Letter in one of these two manners within the allowed time period shall be considered a material breach of this CIA and shall be grounds for exclusion under section X.C.

2. *Timely Written Requests for Extensions.* [*Provider*] may submit a timely written request for an extension of time to perform any act or file any notification or report required by this CIA. Notwithstanding any other provision in this section, if OIG grants the timely written request with respect to an act, notification, or report, Stipulated Penalties for failure to perform the act or file the notification or report shall not begin to accrue until one day after [*Provider*] fails to meet the revised deadline as agreed to by the OIG-approved extension. Notwithstanding any other provision in this section, if OIG denies such a timely written request, Stipulated Penalties for failure to perform the act or *file* the notification or report shall not begin to accrue until two (2) business days after [*Provider*] receives OIG's written denial of such request. A "timely written request" is defined as a request in writing received by OIG at least five (5) business days prior to the date by which any act is due to be performed or any notification or report is due to be filed.

3. *Form of Payment.* Payment of the Stipulated Penalties shall be made by certified or cashier's check, payable to "Secretary of the Department of Health and Human Services," and submitted to OIG at the address set forth in section VI.

4. *Independence from Material Breach Determination.* Except as otherwise noted, these provisions for payment of Stipulated Penalties shall not affect or otherwise set a standard for the OIG's determination that [*Provider*] has materially breached this CIA, which decision shall be made at the OIG's discretion and governed by the provisions in section X.C, below.

C. Exclusion for Material Breach of this CIA

1. *Notice of Material Breach and Intent to Exclude.* The parties agree that a material breach of this CIA by [*Provider*] constitutes an independent basis for [*Provider's*] exclusion from participation in the Federal health care programs (as defined in 42 U.S.C. 1320a7b(f)). Upon a determination by OIG that [*Provider*] has materially breached this CIA and that exclusion should be imposed, the OIG shall notify [Provider] by certified mail of (*a*) [*Provider's*] material breach; and (*b*) OIG's intent to exercise its

contractual right to impose exclusion (this notification is hereinafter referred to as the "Notice of Material Breach and Intent to Exclude").

2. *Opportunity to Cure.* [*Provider*] shall have thirty-five (35) days from the date of the Notice of Material Breach and Intent to Exclude Letter to demonstrate to the OIG's satisfaction that:

   a. [*Provider*] is in *full* compliance with this CIA;

   b. the alleged material breach has been cured; or

   c. the alleged material breach cannot be cured within the 35-day period, but that: (i) [*Provider*] has begun to take action to cure the material breach, (ii) [*Provider*] is pursuing such action with due diligence, and (iii) [*Provider*] has provided to OIG a reasonable timetable for curing the material breach.

3. *Exclusion Letter.* If at the conclusion of the thirty-five (35) day period, [*Provider*] fails to satisfy the requirements of section X.C.2, OIG may exclude [*Provider*] from participation in the Federal health care programs. OIG will notify [*Provider*] in writing of its determination to exclude [*Provider*] (this letter shall be referred to hereinafter as the "Exclusion Letter"). Subject to the Dispute Resolution provisions in section X.D, below, the exclusion shall go into effect thirty (30) days after the date of the Exclusion Letter. The exclusion shall have national effect and will also apply to all other federal procurement and non-procurement programs. If [*Provider*] is excluded under the provisions of this CIA, [*Provider*] may seek reinstatement pursuant to the provisions at 42 C.F.R. §§1001.3001–.3004.

4. *Material Breach.* A material breach of this CIA means:

   a. a failure by [*Provider*] to report a material deficiency, take corrective action and pay the appropriate refunds, as provided in section III.D;

   b. repeated or flagrant violations of the obligations under this CIA, including, but not limited to, the obligations addressed in section X.A of this CIA;

   c. a failure to respond to a Demand Letter concerning the payment of Stipulated Penalties in accordance with section X.B above; or

   d. a failure to retain and use an Independent Review Organization for review purposes in accordance with section III.D.

D. Dispute Resolution

1. *Review Rights.* Upon the OIG's delivery to [*Provider*] of its Demand Letter or of its Exclusion Letter, and as an agreed-upon contractual remedy for the resolution of disputes arising under the obligation of this CIA, [*Provider*] shall be afforded certain review rights comparable to the ones that are provided in 42 U.S.C. §§1320a7(f) and 42 C.F.R. §1005 as if they applied to the Stipulated Penalties or exclusion sought pursuant to this CIA. Specifically, the OIG's determination to demand payment of Stipulated Penalties or to seek exclusion shall be subject to review

by an ALJ and, in the event of an appeal, the Departmental Appeals Board ("DAB"), in a manner consistent with the provisions in 42 C.F.R. §§1005.2–.21. Notwithstanding the language in 42 C.F.R. §1005.2(c), the request for a hearing involving stipulated penalties shall be made within fifteen (15) days of the date of the Demand Letter and the request for a hearing involving exclusion shall be made within thirty (30) days of the date of the Exclusion Letter.

2. *Stipulated Penalties Review.* Notwithstanding any provision of Title 42 of the United States Code or Chapter 42 of the Code of Federal Regulations, the only issues in a proceeding for stipulated penalties under this CIA shall be (*a*) whether [*Provider*] was in full and timely compliance with the obligations of this CIA for which the OIG demands payment; and (*b*) the period of noncompliance. [*Provider*] shall have the burden of proving its full and timely compliance and the steps taken to cure the noncompliance, if any. If the ALJ finds for the OIG with regard to a finding of a breach of this CIA and orders [*Provider*] to pay Stipulated Penalties, such Stipulated Penalties shall become due and payable twenty (20) days after the ALJ issues such a decision notwithstanding that [*Provider*] may request review of the ALJ decision by the DAB.

3. *Exclusion Review.* Notwithstanding any provision of Title 42 of the United States Code or Chapter 42 of the Code of Federal Regulations, the only issues in a proceeding for exclusion based on a material breach of this CIA shall be (*a*) whether [*Provider*] was in material breach of this CIA; (*b*) whether such breach was continuing on the date of the Exclusion Letter; and (*c*) the alleged material breach cannot be cured within the 35-day period, but that (i) [*Provider*] has begun to take action to cure the material breach, (ii) [*Provider*] is pursuing such action with due diligence, and (iii) [*Provider*] has provided to OIG a reasonable timetable for curing the material breach.

   For purposes of the exclusion herein, exclusion shall take effect only after an ALJ decision that is favorable to the OIG. [*Provider's*] election of its contractual right to appeal to the DAB shall not abrogate the OIG's authority to exclude [*Provider*] upon the issuance of the ALJ's decision. If the ALJ sustains the determination of the OIG and determines that exclusion is authorized, such exclusion shall take effect twenty (20) days after the ALJ issues such a decision, notwithstanding that [*Provider*] may request review of the ALJ decision by the DAB.

4. *Finality of Decision.* The review by an ALJ or DAB provided for above shall not be considered to be an appeal right arising under any statutes or regulations. Consequently, the parties to this CIA agree that the DAB's decision (or the ALJ's decision if not appealed) shall be considered final for all purposes under this CIA and [*Provider*] agrees to waive any right it may have to appeal the decision administratively, judicially or otherwise seek review by any court or other adjudicative forum.

XI. Effective and Binding Agreement

Consistent with the provisions in the Settlement Agreement pursuant to which this CIA is entered, and into which this CIA is incorporated, [*Provider*] and OIG agree as follows:

a. This CIA shall be binding on the successors, assigns and transferees of [*Provider*];

b. This CIA shall become final and binding on the date the final signature is obtained on the CIA;

c. Any modifications to this CIA shall be made with the prior written consent of the parties to this CIA; and

d. The undersigned [*Provider*] signatories represent and warrant that they are authorized to execute this CIA. The undersigned OIG signatory represents that he is signing this CIA in his official capacity and that he is authorized to execute this CIA.

On Behalf of [*Provider*]

____________________ ____________________
[*Date*]

____________________ ____________________
[*Date*]

____________________ ____________________
[*Date*]

[*Please identify all signatories*]

ON BEHALF OF THE OFFICE OF INSPECTOR GENERAL OF THE DEPARTMENT OF HEALTH AND HUMAN SERVICES

____________________ ____________________
Lewis Moris [*Date*]

Assistant Inspector General for Legal Affairs
Office of Inspector General
U.S. Department of Health and Human Services

Appendix B

Sample Statement of Management's Assertions

[*Date*]

In connection with the Corporate Integrity Agreement (CIA) entered into with the Office of the Inspector General of the United States Department of Health and Human Services dated [*date*], we make the following assertions, which are true to the best of our knowledge and belief.

Governance

Within 90 days of the date of the CIA, we—

1. Established a Compliance Committee, which meets at least monthly and requires a quorum to meet.
2. Appointed to our Compliance Committee members who include at a minimum those individuals specified in the CIA.
3. Delegated to the Compliance Committee the authority to implement and monitor the CIA, as evidenced by the organization chart or the Compliance Committee's charter.
4. Appointed a compliance officer, who reports directly to the individual specified in the CIA.

We appointed a compliance officer who—

1. Has sufficient staff and resources to carry out his or her responsibilities.
2. Actively participates in compliance training.
3. Has authority to conduct full and complete internal investigations without restriction.
4. Periodically revises the compliance program to meet changing circumstances and risks.

Billing Practices, Policies, and Procedures

Although no system of internal controls can provide absolute assurance that all bills comply in all respects with Medicare, Medicaid, and other federal health care program guidelines, we are not aware of any material weaknesses in our billing practices, policies, and procedures. Billings to third-party payors comply in all material respects with applicable coding principles and laws and regulations (including those dealing with Medicare and Medicaid antifraud and abuse) and only reflect charges for goods and services that were medically necessary, properly approved by regulatory bodies (e.g., the Food and Drug Administration), if required and properly rendered. [*Insert other assertions as necessary to address matters covered in the CIA.*] Any Medicare, Medicaid, and other federal health program billing deficiencies that we identified have been properly reported to the applicable payor within 60 days of discovery of the deficiency.

Corporate Integrity Policy

1. Our policy was developed and implemented within [*number*] days of execution of the CIA.

2. The policy addresses the Company's commitment to preparation and submission of accurate billings consistent with the standards set forth in federal health care program statutes, regulations, procedures and guidelines or as otherwise communicated by Health Care Financing Administration (HCFA), its agents or any other agency engaged in the administration of the applicable federal health care program.

3. The policy addressed the specific issues that gave rise to the settlement, as well as other risk areas identified by the OIG in published Fraud Alerts issued through [*date*].

4. Further details on the development and implementation of our policy were provided to the OIG in our letter dated [*date*].

5. Our policy was distributed to all employees, physicians and independent contractors involved in submitting or preparing requests for reimbursement.

6. We have prominently displayed a copy of our policy on the Company's premises.

Information and Education Program

As discussed more fully in our letter to the OIG dated [*date*], we conducted an Information and Education Program within [*number*] days of the CIA. The Information and Education Program requires that each officer, employee, agent and contractor charged with administering federal health care programs (including, but not limited to billers, coders, nurses, physicians, medical records, hospital administration and other individuals directly involved in billing federal health care programs) receive at least [*number*] hours of training.

The training provided to employees involved in billing, coding, and/or charge capture consisted of instructions on submitting accurate bills, the personal obligations of each individual to ensure billings are accurate, the nature of company-imposed disciplinary actions on individuals who violate company policies and/or laws and regulations, applicable federal health care program rules, legal sanctions against the company for submission of false or fraudulent information, and how to report potential abuses or fraud. The training material addresses those issues underlying our settlement with the OIG.

The experience of the trainers is consistent with the topics presented.

Confidential Disclosure Program

Our Confidential Disclosure Program—

1. Was established within [*number*] days of the CIA.

2. Enables any employee to disclose any practices or billing procedures relating to federal health care programs.

3. Provides a toll-free telephone line maintained by the Company, which Company representatives have indicated is maintained twenty-four hours a day, seven days a week, for the purpose of making any disclosures regarding compliance with the Company's Compliance Program, the obligations in the CIA, and Company's overall compliance with federal and state standards.

4. Includes policies requiring the review of any disclosures to permit a determination of the appropriateness of the billing practice alleged to be involved and any corrective action to be taken to ensure that proper follow-up is conducted.
5. A detailed summary of the communications (including the number of disclosures by employees and the dates of such disclosures) concerning billing practices reported as, and found to be, inappropriate under the Confidential Disclosure Program, and the results of any internal review and the follow-up on such disclosures are summarized in Attachment [*title*] to our Annual Report.

Excluded Individuals or Entities

Company policy—

1. Prohibits the employment of or contracting with an individual or entity that is listed by a federal agency as convicted of abuse or excluded, suspended or otherwise ineligible for participation in federal health care programs.
2. Includes a process to make an inquiry into the status of any potential employee or independent contractor.
3. Provides for an annual review of the status of all existing employees and contractors to verify whether any individual had been suspended or excluded or charged with a criminal offense relating to the provision of federal health care services.

We are not aware of any individuals employed in contravention of the prohibitions in the CIA.

Record Retention

Our record retention policy is consistent with the requirements of the CIA.

Signed by:

____
[*Chief Executive Officer*]

____
[*Chief Financial Officer*]

____
[*Corporate Compliance Officer*]

Appendix C

Sample Engagement Letter

The following is an illustration of a sample engagement letter that may be used for this kind of engagement.

[*CPA Firm Letterhead*]

[*Client's Name and Address*]

Dear ____________________:

This will confirm our understanding of the arrangements for our performance of certain agreed-upon procedures in connection with management's compliance with the terms of the Corporate Integrity Agreement (CIA) with the Office of Inspector General (OIG) of the U.S. Department of Health and Human Services (HHS) dated [*date of CIA*] for the period ending [*date*].

We will perform those procedures enumerated in the attachment to this letter. Our responsibility is to carry out these procedures and report our findings. We will conduct our engagement in accordance with standards established by the American Institute of Certified Public Accountants. Our planned procedures were agreed to by management and will be communicated to the OIG for its review and are based on the terms specified in the CIA. The sufficiency of these procedures is solely the responsibility of the specified users of the report. Consequently, it is understood that we make no representation regarding the sufficiency of the procedures described in the attachment for the purpose for which this report has been requested or for any other purpose.

Management is responsible for the Company's compliance with all applicable laws, regulations, and contracts and agreements, including the CIA. Management also is responsible for the design, implementation, and monitoring of the policies and procedures upon which compliance is based.

Our engagement to perform agreed-upon procedures is substantially less in scope than an examination, the objective of which is the expression of an opinion on management's compliance with the CIA. Accordingly, we will not express such an opinion or any other form of assurance thereon.[1]

Working papers that are prepared in connection with this engagement are the property of the independent accountant. The working papers are prepared for the purpose of providing the principal support for the independent accountant's report. At the completion of our work, we expect to issue an agreed-upon procedures report in the attached form.

---

[1] The independent accountant may wish to include an understanding with the client about any limitation or other arrangements regarding liability of the practitioner or the client in the engagement letter. For example, the following might be included in the letter:

> Our maximum liability relating to services rendered under this letter (regardless of form of action, whether in contract, negligence or otherwise) shall be limited to the charges paid to us for the portion of the services or work products giving rise to liability. We will not be liable for consequential or punitive damages (including lost profits or savings) even if aware of their possible existence.
>
> You will indemnify us against any damage or expense that may result from any third-party claim relating to our services or any use by you of any work product, and you will reimburse us for all expenses (including counsel fees) as incurred by us in connection with any such claim, except to the extent such claim (i) is finally determined to have resulted from our gross negligence or willful misconduct or (ii) is covered by any of the preceding indemnities.

If, however, we are not able to complete all of the specified procedures, we will so advise you. At that time, we will discuss with you the form of communication, if any, that you desire for our findings. We will ask you to confirm your request in writing at that time. If you request that we delay issuance of our report until corrective action is taken that will result in compliance with all aspects of the CIA, we will do so only at your written request. Our working papers will be retained in accordance with our firm's working paper retention policy.

The distribution of the independent accountant's report will be restricted to the governing board and management of the Company and the OIG.

Our fees will be billed as work progresses and are based on the amount of time required at various levels of responsibility plus actual out-of-pocket expenses. Invoices are payable upon presentation. We will notify you immediately of any circumstances we encounter that could significantly affect our initial estimate of total fees.

We agree that to the extent required by law, we will allow the Comptroller General of the United States, HHS, and their duly authorized representatives to have access to this engagement letter and our documents and records to the extent necessary to verify the nature and amount of costs of the services provided to the Company, until the expiration of four years after we have concluded providing services to the Company that are performed pursuant to this Engagement Letter. In the event the Comptroller General, HHS, or their duly authorized representatives request such records, we agree to notify the Company of such request as soon as practicable.

In the event we are requested or authorized by the Company or are required by government regulation, subpoena, or other legal process to produce our documents or our personnel as witnesses with respect to our engagements for the Company, the Company will, so long as we are not a party to the proceeding in which the information is sought, reimburse us for our professional time and expenses, as well as the fees and expenses of our counsel, incurred in responding to such requests.

If this letter correctly expresses your understanding of this engagement, please sign the enclosed copy where indicated and return it to us. We appreciate the opportunity to serve you.

Sincerely, ______________________________
[*Partner's Signature*]
[*Firm Name or Firm Representative*]

Accepted and agreed to: ________________
[*Client Representative's Signature*]

[*Title*] ________________________________

[*Date*] ________________________________

Appendix D

Sample Procedures

Procedure	*Findings*

Governance

1. We read the Company's corporate minutes and organization chart and ascertained that, within [*number*] days of the date of the Corporate Integrity Agreement (CIA), the Company—
   a. Established a Compliance Committee, which is to meet meets at least monthly and requires a quorum to meet.
   b. Appointed to its Compliance Committee members who include, at a minimum, those individuals specified in the CIA.
   c. Delegated to the Compliance Committee the authority to implement and monitor the CIA, as evidenced by the organization chart or the Compliance Committee's charter.
   d. Appointed a compliance officer who reports directly to the individual specified in the CIA.

2. We interviewed the compliance officer and were informed that, in his or her opinion, the Compliance Officer—
   a. Has sufficient staff and resources to carry out his or her responsibilities.
   b. Actively participates in compliance training.
   c. Has the authority to conduct full and complete internal investigations without restriction.
   d. Periodically revises the compliance program to meet changing circumstances and risks.

3. We read the OIG notification letter as specified in the CIA and noted that the appropriate official signed the letter, that it was addressed to the OIG, that it covered items (*a*) through (*d*) in Step 1, and that it was dated within [*number of*] days of the execution of the CIA.

Billing Practices, Policies, and Procedures

The practitioner might be engaged to provide consulting services in connection with the evaluation of the Company's billing practices, policies, and procedures. If so, generally no agreed-upon procedures would be performed relating to this area.

Alternatively, if the procedures relating to the Company's billing practices, policies, and procedures are performed by others such as the Company's internal audit staff, the practitioner performs Steps 4 through 9.

Procedure	*Findings*
4. We read the compliance work plan and noted the following: *a.* The work plan's stated objectives include the determination that billings are accurate and complete, for services rendered that have been deemed by medical specialists as being necessary, and are submitted in accordance with federal program guidelines. *b.* The work plan sampling methodology sets confidence levels consistent with those defined in the CIA. *c.* The work plan identifies risk areas, as defined in the CIA (if applicable), and specifies testing procedures by risk area. *d.* The work plan specifies that samples are taken in risk areas (if applicable) identified by the CIA. *e.* The work plan includes testing procedures, which the practitioner should modify as required by the CIA, for the following risks areas (if applicable) identified in the CIA: (1) Clinical documentation, as follows: (i) No documentation of service (ii) Insufficient documentation of service (iii) Improper diagnosis or treatment plan giving rise to the provision of a medically unnecessary service or treatment (iv) Service or treatment does not conform medically with the documented diagnosis or treatment plan (v) Services incorrectly coded (2) Billing and coding, as follows: (i) Noncovered or unallowable service (ii) Duplicate payment (iii) DRG window error (iv) Unbundling (v) Utilization (vi) Medicare credit balances [*Note to Practitioner:* Modify the preceding list as required by the CIA.]	
5. We selected [*quantity*] probe samples performed by the independent review organization for the following risk areas [*list risk areas tested*]. For the probe samples selected, we noted that the— *a.* Sample patient billing files were randomly selected. *b.* Sample size reflected confidence levels specified in the CIA. *c.* Sample plan describes how missing items (if any) would be treated.	

Procedure	*Findings*

d. Patient billing files tested were pulled per the listing of random numbers and all patient billing files were accounted for in the working papers.

e. Work plans for the specific sample described the risk areas (if applicable) being tested and the testing approach/procedures.

f. Working papers noted the completion of each work plan step.

g. Working papers contained a summary of findings for the sample.

6. We reperformed the work plan steps [*list of specific steps performed*] for the sample patient billing files. The reperformance of work plan steps related to the medical review of the sample patient billing files was performed by the following individuals [*note the professional qualifications of individuals without listing names*]. Any exceptions between our findings and the Company's are summarized in the Attachment to this report.

7. We read the summary findings of all internal compliance reviews that the Company's Internal Audit department indicated it had performed for the Company and noted that all material billing deficiencies [*specify material threshold as defined by the Company*] noted therein were discussed in written communications addressed to the appropriate payor (for example, Medicare Part B carrier) and were dated within 60 days from the time the deficiency occurred.[1]

8. We inquired of [*individual*] as to whether the Company took remedial steps within [*number of*] days (or such additional time as agreed to by the payor) to correct all material billing deficiencies noted in Step 7. We were informed that such remedial steps had been taken.

9. By reading applicable correspondence, we noted that any material billing deficiencies noted in Step 7 were communicated to the OIG, including specific findings relative to the deficiency, the Company's actions taken to correct the deficiency, and any further steps the Company plans to take to prevent any similar deficiencies from recurring.

---

[1] The CIA provides its own legal definition of a "material deficiency." Determination of whether a billing or other act meets this definition is normally beyond the auditor's professional competence and may have to await final determination by a court of law. Accordingly, to avoid confusion, a working definition different from that provided in the CIA (e.g., a specified dollar threshold) may be necessary.

Procedure	*Findings*

Corporate Integrity Policy

10. We read the Company's Corporate Integrity Policy and noted the following.
    a. The policy was developed and implemented within [*number of*] days of execution of the CIA.
    b. The policy addressed the Company's commitment to preparation and submission of accurate billings consistent with the standards set forth in federal health care program statutes, regulations, procedures, and guidelines or as otherwise communicated by HCFA, its agents, or any other agency engaged in the administration of the applicable federal health care program.
    c. The policy addressed the specific issues that gave rise to the settlement, as well as other risk areas identified by the OIG in published Fraud Alerts issued through [*agency*].
    d. Correspondence addressed to the OIG covered the development and implementation of the policy.
    e. Documentation indicating that the policy was distributed to all employees, physicians, and independent contractors involved in submitting or preparing requests for reimbursement.
    f. The prominent display of a copy of the policy on the Company's premises.

11. We selected a sample of ten employees (involved in submitting and preparing requests for reimbursement) and examined written confirmation in the employee's personnel file indicating receipt of a copy of the Corporate Integrity Policy.

Information and Education Program

12. We read the Company's Information and Education Program and noted the following.
    a. The Information and Education Program agenda was dated within [number of] days of execution of the CIA.
    b. Correspondence covering the development and implementation of the Information and Education Program was addressed to the OIG.
    c. The Information and Education Program requires that each officer, employee, agent, and contractor charged with administering federal health care programs (including, but not limited to billers, coders, nurses, physicians, medical records, hospital administration and other individuals directly involved in billing federal health care programs) receive at least [*number of*] hours of training.

Procedure	*Findings*
13. We selected a sample of ten employees involved in billing, coding and/or charge capture and examined sign-in logs of the training classes and noted that each had signed indicating that they had received at least [*number of*] hours of training as specified in the Information and Education Program. We also reviewed tests and surveys completed by each of the ten trained employees noting evidence that they were completed.	
14. We inquired as to the training of individuals not present during the regularly scheduled training programs and were informed that each such individual is trained either individually or in a separate make-up session. We inquired as to the names of individuals not initially present and selected one such individual and examined that individual's post-training test and survey for completion.	
15. We read the course agenda and noted that the training provided to employees involved in billing, coding, and/or charge capture consisted of instructions on submitting accurate bills, the personal obligations of each individual to ensure billings are accurate, the nature of company-imposed disciplinary actions on individuals who violate company policies and/or laws and regulations applicable to federal health care program rules, legal sanctions against the company for submission of false or fraudulent information, and how to report potential abuses or fraud. We also noted that the training material addressed the following issues which gave rise to the settlement [*practitioner list*].	
16. We inquired of the Corporate Compliance Officer as to the qualifications and experience of the trainers and were informed that, in the Corporate Compliance Officer's opinion, they were consistent with the topics presented.	
17. We noted that the Company's draft Annual Report to the OIG dated [*date*] addresses certification of training.	
Confidential Disclosure Program	
18. We read documentation of the Company's Confidential Disclosure Program and noted that it— *a.* Includes the printed effective date that was within [*number of*] days of execution of the CIA. *b.* Consists of a confidential disclosure program enabling any employee to disclose any practices or billing procedures relating to federal health care programs.	

Procedure	*Findings*

c. Provides a toll-free telephone line maintained by the Company, which Company representatives have indicated is maintained twenty-four hours a day, seven days a week, for the purpose of making any disclosures regarding compliance with the Company's Compliance Program, the obligations in the CIA, and Company's overall compliance with federal and state standards.

d. Includes policies requiring the review of any disclosures to permit a determination of the appropriateness of the billing practice alleged to be involved and any corrective action to be taken to ensure that proper follow-up is conducted.

19. We made five test calls to the toll-free telephone line (hotline) and noted the following.
    a. Each call was captured in the hotline logs and reported with all other incoming calls.
    b. Anonymity is not discouraged.

20. We noted that the Company included in its draft Annual Report addressed to OIG dated [*date*] a detailed summary of the communications (including the number of disclosures by employees and the dates of such disclosures) concerning billing practices reported as, and found to be, inappropriate under the Confidential Disclosure Program, and the results of any internal review and the follow-up on such disclosures.

21. We observed the display of the Company's Confidential Disclosure Program, including notice of the availability of its hotline, on the Company's premises.

Excluded Individuals or Entities

22. We read the Company's written policy relating to dealing with excluded or convicted persons or entities and noted that the policy—
    a. Prohibits the hiring of or contracting with an individual or entity that is listed by a federal agency as convicted of abuse or excluded, suspended, or otherwise ineligible for participation in federal health care programs.
    b. Includes a process to make an inquiry into the status of any potential employee or independent contractor.
    c. Provides for a semi-annual review of the status of all existing employees and contractors to verify whether any individual had been suspended or excluded or charged with a criminal offense relating to the provision of federal health care services.

Procedure	*Findings*

23. We selected a sample of ten employees hired over the course of the test period as defined in the CIA and examined support in the employee's personnel file documenting inquiries made into the status of the employee, including documentation of comparison to the [*source specified in the CIA*].

24. We performed the following procedures related to the Company's semi-annual review of employee status.
    a. Read documentation of the semi-annual review as evidence that a review was performed.
    b. Selected and reviewed the lesser of ten or all exceptions and determined that such employees were removed from responsibility for or involvement with Provider business operations related to the Federal health care programs.
    c. Examined a notification letter addressed to the OIG and dated within 30 days of the employee's removal from employment.
    d. Inquired of [*officer*] as to whether he or she was aware of any individuals employed in contravention of the prohibitions in the CIA. If so, we further noted that [*indicate specific procedures*] to confirm that such situation was cured within 30 days by [*indicate how situation was cured*].

Annual Report

25. We read the Company's draft Annual Report dated [*date*] and determined that it included the following items, to be modified as appropriate, by the practitioner:
    a. Compliance Program Charter and organization chart
    b. Amendments to policies
    c. Detailed descriptions of reviews and audits
    d. Summary of hotline communications
    e. Summary of annual review of employees
    f. Cross-referencing to items noted in the CIA

Record Retention

26. We read the Company's record retention policy and noted that it was consistent with the requirements as outlined in the CIA.

Appendix E

Sample Report

Independent Accountant's Report

[*Date*]

[*Sample Health Care Provider*]
Office of Inspector General of the U.S. Department of Health and Human Services

We have performed the procedures enumerated in the Attachment, which were agreed to by Sample Health Care Provider (Company) and the Office of Inspector General (OIG) of the U.S. Department of Health and Human Services, solely to assist the users in evaluating management's assertion about [*name of entity's*] compliance with the Corporate Integrity Agreement (CIA) with the OIG dated [*date of CIA*] for the [*period*] ending [*date*], which is included as Attachment A to this report. This agreed-upon procedures engagement was performed in accordance with standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of the specified users of the report. Consequently, we make no representation regarding the sufficiency of the procedures described in Attachment B either for the purpose for which this report has been requested or for any other purpose.

We were not engaged to and did not perform an examination, the objective of which would be the expression of an opinion on management's compliance with the CIA. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the Compliance Committee and management of the Company and the OIG, and is not intended to be and should not be used by anyone other than those specified parties.

[*Include as Attachments the CIA and the summary that enumerates procedures and findings.*]

[*Signature*]

Appendix E

Statement of Position 00-1

Auditing Health Care Third-Party Revenues & Related Receivables

March 10, 2000

Issued Under the Authority of the Auditing Standards Board

NOTE

This Statement of Position presents the recommendations of the AICPA Health Care Third-Party Revenue Recognition Task Force with regard to auditing financial statement assertions about third-party revenues and related receivables of health care entities. The Auditing Standards Board has found the recommendations in this Statement of Position to be consistent with existing standards covered by rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the recommendations in this Statement of Position.

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SUMMARY

This Statement of Position (SOP) provides guidance to auditors regarding uncertainties inherent in health care third-party revenue recognition. It discusses auditing matters to consider in testing third-party revenues and related receivables, and provides guidance regarding the sufficiency of evidential matter and reporting on financial statements of health care entities exposed to material uncertainties.

Auditing Health Care Third-Party Revenues and Related Receivables

Introduction and Background

1. Most health care providers participate in payment programs that pay less than full charges for services rendered. For example, some cost-based programs retrospectively determine the final amounts reimbursable for services rendered to their beneficiaries based on allowable costs. With increasing frequency, even non-cost-based programs (such as the Medicare Prospective Payment System) have become subject to retrospective adjustments (for example, billing denials and coding changes). Often, such adjustments are not known for a considerable period of time after the related services were rendered.

2. The lengthy period of time between rendering services and reaching final settlement, compounded further by the complexities and ambiguities of reimbursement regulations, makes it difficult to estimate the net patient service revenue associated with these programs. This situation has been compounded due to the frequency of changes in federal program guidelines.

3. The AICPA Audit and Accounting Guide *Health Care Organizations* (the Guide) requires that patient revenues be reported net of provisions for contractual and other adjustments (paragraph 10.20). As a result, patient receivables, including amounts due from third-party payors, are also reported net of expected contractual and other adjustments. However, amounts ultimately realizable will not be known until some future date, which may be several years after the period in which the services were rendered.

4. This SOP provides guidance to auditors regarding uncertainties inherent in health care third-party revenue recognition. It discusses auditing matters to consider in testing third-party revenue and related receivables, including the effects of settlements (both cost-based and non-cost-based third-party payment programs), and provides guidance regarding the sufficiency of evidential matter and reporting on financial statements of health care entities exposed to material uncertainties.

Scope and Applicability

5. This SOP applies to audits of health care organizations falling within the scope of the Guide. Its provisions are effective for audits of periods ending on or after June 30, 2000. Early application of the provisions of this SOP is permitted.

Third-Party Revenues and Related Receivables—Inherent Uncertainties

6. Health care entities need to estimate amounts that ultimately will be realizable in order for revenues to be fairly stated in accordance with generally accepted accounting principles (GAAP). The basis for such estimates may range from relatively straightforward calculations using information that is readily available to highly complex judgments based on assumptions about future decisions.

7. Entities doing business with governmental payors (for example, Medicare and Medicaid) are subject to risks unique to the government-contracting environment that are hard to anticipate and quantify and that may vary from entity to entity. For example—

- A health care entity's revenues may be subject to adjustment as a result of examination by government agencies or contractors. The audit process and the resolution of significant related matters (including disputes based on differing interpretations of the regulations) often are not finalized until several years after the services were rendered.
- Different fiscal intermediaries (entities that contract with the federal government to assist in the administration of the Medicare program) may interpret governmental regulations differently.
- Differing opinions on a patient's principal medical diagnosis, including the appropriate sequencing of codes used to submit claims for payment, can have a significant effect on the payment amount.[1]
- Otherwise valid claims may be determined to be nonallowable after the fact due to differing opinions on medical necessity.
- Claims for services rendered may be nonallowable if they are later determined to have been based on inappropriate referrals.[2]
- Governmental agencies may make changes in program interpretations, requirements, or "conditions of participation," some of which may have implications for amounts previously estimated.

8. Such factors often result in retrospective adjustments to interim payments. Reasonable estimates of such adjustments are central to the third-party revenue recognition process in health care, in order to avoid recognizing revenue that the provider will not ultimately realize. The delay between rendering services and reaching final settlement, as well as the complexities and ambiguities of billing and reimbursement regulations, makes it difficult to estimate net realizable third-party revenues.

Management's Responsibilities

9. Management is responsible for the fair presentation of its financial statements in conformity with GAAP. Management also is responsible for adopting sound accounting policies and for establishing and maintaining internal control that will, among other things, record, process, summarize, and report transactions (as well as events and conditions) consistent with management's assertions embodied in the financial statements. Despite the 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.

---

[1] Historically, the Health Care Financing Administration (HCFA) contracted with Peer Review Organizations (PROs) to validate the appropriateness of admissions and the clinical coding from which reimbursement was determined. Such reviews were typically performed within ninety days of the claim submission date. However, the government has modified its policies with respect to such reviews and now analyzes coding errors through other means, including in conjunction with investigations conducted by the Office of the Inspector General (OIG) of the U. S. Department of Health and Human Services.

[2] Effective January 1, 1995, the Limitation on Certain Physician Referrals law prohibited physicians from referring Medicare and Medicaid patients to health care organizations with which they had a financial relationship for the furnishing of designated health services. Implementing regulations have not yet been adopted as of the date of this publication.

10. Management's assertions regarding proper valuation of its revenues and receivables are embodied in the financial statements. Management is responsible for assuring that revenues are not recognized until their realization is reasonably assured. As a result, management makes a reasonable estimate of amounts that ultimately will be realized, considering—among other things—adjustments associated with regulatory reviews, audits, billing reviews, investigations, or other proceedings. Estimates that are significant to management's assertions about revenue include the provision for third-party payor contractual adjustments and allowances.

11. Management also 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.

The Auditor's Responsibilities

12. The auditor's responsibility is to express an opinion on the financial statements taken as a whole. In reaching this opinion, the auditor considers the evidence in support of recorded amounts. If amounts are not known with certainty, the auditor considers the reasonableness of management's estimates in the present circumstances. The auditor also considers the fairness of the presentation and adequacy of the disclosures made by management.

13. In planning the audit, the auditor considers current industry conditions, as well as specific matters affecting the entity.[3] Among a number of things, the auditor's procedures typically include an analysis of historical results (for example, prior fiscal intermediary audit adjustments and comparisons with industry benchmarks and norms) that enable the auditor to better assess the risk of material misstatements in the current period. When there are heightened risks, the auditor performs more extensive tests covering the current period. Exhibit 5-1 of the Guide includes a number of examples of procedures that auditors may consider.

14. 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. For example, under a typical fee-for-service contract with a commercial payor, if the provider has performed a service for a covered individual, the revenue to which the provider is entitled should be determinable at the time the service is rendered. On the other hand, if the service was provided under a cost-based government contract, the revenue ultimately collectible may not be known until certain future events occur (for example, a cost report has been submitted and finalized after desk review or audit). In this case, management estimates the effect of such potential future adjustments.

15. As stated previously, management is responsible for preparing the estimates contained in the financial statements. 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

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[3] Risk factors, including ones related to legislative and regulatory matters, are discussed annually in the AICPA Audit Risk Alert *Health Care Industry Developments*.

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 generally accepted auditing standards (GAAS) as described in this SOP with respect to auditing estimates.

Evidential Matter

16. The measurement of estimates is inherently uncertain and depends on the outcome of future events. Statement on Auditing Standards (SAS) No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), and SAS No. 79, *Amendment to SAS No. 58*, Reports on Audited Financial Statements (AICPA, *Professional Standards*, vol. 1, AU sec. 508) provide guidance to the auditor when the valuation of revenues is uncertain, pending the outcome of future events. 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 because the uncertainty associated with future program audits, administrative reviews, billing reviews, regulatory investigations, or other actions will not be resolved until sometime in the future.

17. 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.

18. 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. For example, if an entity has conducted an internal evaluation (for example, of coding or other billing matters) under attorney—client privilege and management and its legal counsel refuse to respond to the auditor's inquiries and the auditor determines the information is necessary, ordinarily the auditor qualifies his or her opinion for a scope limitation.

19. The auditor considers the reasonableness of management's assumptions in light of the entity's historical experience and the auditor's knowledge of general industry conditions, because the accuracy of management's assumptions will not be known until future events occur. For certain matters, the best evidential matter available to the auditor (particularly as it relates to clinical and legal interpretations) may be the representations of management and its legal counsel, as well as information obtained through reviewing correspondence from regulatory agencies.

20. Pursuant to SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), 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. Examples of specific representations include the following:

- Receivables
  - Adequate consideration has been given to, and appropriate provision made for, estimated adjustments to revenue, such as for denied claims and changes to diagnosis-related group (DRG) assignments.
  - Recorded valuation allowances are necessary, appropriate, and properly supported.
  - All peer review organizations, fiscal intermediary, and third-party payor reports and information have been made available.
- Cost reports filed with third parties
  - All required Medicare, Medicaid, and similar reports have been properly filed.
  - Management is responsible for the accuracy and propriety of all cost reports filed.
  - All costs reflected on such reports are appropriate and allowable under applicable reimbursement rules and regulations and are patient-related and properly allocated to applicable payors.
  - The reimbursement methodologies and principles employed are in accordance with applicable rules and regulations.
  - Adequate consideration has been given to, and appropriate provision made for, audit adjustments by intermediaries, third-party payors, or other regulatory agencies.
  - All items required to be disclosed, including disputed costs that are being claimed to establish a basis for a subsequent appeal, have been fully disclosed in the cost report.
  - Recorded third-party settlements include differences between filed (and to be filed) cost reports and calculated settlements, which are necessary based on historical experience or new or ambiguous regulations that may be subject to differing interpretations. While management believes the entity is entitled to all amounts claimed on the cost reports, management also believes the amounts of these differences are appropriate.
- Contingencies
  - There are no violations or possible violations of laws or regulations, such as those related to the Medicare and Medicaid antifraud and abuse statutes, including but not limited to the Medicare and Medicaid Anti-Kickback Statute, Limitations on Certain Physician Referrals (the Stark law), and the False Claims Act, in any jurisdiction, whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency other than those disclosed or accrued in the financial statements.
  - Billings to third-party payors comply in all material respects with applicable coding guidelines (for example, ICD-9-CM and CPT-4) and laws and regulations (including those dealing with Medicare and Medicaid antifraud and abuse), and billings reflect only charges for goods and services that were medically necessary; properly approved by regulatory bodies (for example, the Food and Drug Administration), if required; and properly rendered.
  - There have been no communications (oral or written) from regulatory agencies, governmental representatives, employees, or others concerning investigations or allegations of noncompliance with laws

and regulations in any jurisdiction (including those related to the Medicare and Medicaid antifraud and abuse statutes), deficiencies in financial reporting practices, or other matters that could have a material adverse effect on the financial statements.

21. Management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion and is ordinarily sufficient to cause an auditor to disclaim an opinion or withdraw from the engagement. However, based on the nature of the representations not obtained or the circumstances of the refusal, the auditor may conclude that a qualified opinion is appropriate.

Potential Departures From GAAP Related to Estimates and Uncertainties

22. 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. Such departures generally fall into one of the following categories:

- Unreasonable accounting estimates
- Inappropriate accounting principles
- Inadequate disclosure

Therefore, in order to render an opinion, the auditor's responsibility is to evaluate the reasonableness of management's estimates based on present circumstances and to determine that estimates are reported in accordance with GAAP and adequately disclosed.

23. As discussed in SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326), the auditor's objective is to obtain sufficient competent evidential matter to provide him or her with a reasonable basis for forming an opinion. As discussed previously, exhibit 5-1 of the Guide provides a number of sample procedures that the auditor might consider in auditing an entity's patient revenues and accounts receivable, including those derived from third-party payors. For example, the Guide notes that the auditor might "test the reasonableness of settlement amounts, including specific and unallocated reserves, in light of the payors involved, the nature of the payment mechanism, the risks associated with future audits, and other relevant factors."[4]

Unreasonable Accounting Estimates

24. 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 are right or wrong, because the accuracy of management's assumptions cannot be confirmed until future events occur.

25. Though difficult to predict, it is reasonable for the auditor to expect that management has made certain assumptions (either in detail or in the aggregate) in developing its estimates regarding conditions likely to result in adjustments. The auditor gathers evidence regarding the reasonableness of the

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[4] See paragraphs 25–28.

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

estimates (for example, consistency with historical experience and basis of management's underlying assumptions). In evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate. Based on that understanding, the auditor should use one or a combination of the following approaches:

a. Review and test the process used by management to develop the estimate.

b. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimates.

c. Review subsequent events or transactions occurring prior to completion of fieldwork (AU sec. 342.10).

26. Since no one accounting estimate can be considered accurate with certainty, the auditor recognizes that a difference between an estimated amount best supported by the audit evidence and the estimated amount included in the financial statements may be reasonable, and such difference would not be considered to be a likely misstatement. However, 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. For example, if each accounting estimate included in the financial statements was individually reasonable, but the effect of the difference between each estimate and the estimate best supported by the audit evidence was to increase income, the auditor should reconsider the reasonableness of the estimates taken as a whole (SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* [AICPA, *Professional Standards*, vol. 1, AU sec. 312.36]).

27. The auditor recognizes that approaches and estimates will vary from entity to entity. Some entities with significant prior experience may attempt to quantify the effects of individual potential intermediary or other governmental (for example, the Office of Inspector General and the Department of Justice) or private payor adjustments, basing their estimates on very detailed calculations and assumptions regarding potential future adjustments. Some may prepare cost report[6] analyses to estimate the effect of potential adjustments. Others may base their estimates on an analysis of potential adjustments in the aggregate, in light of the payors involved; the nature of the payment mechanism; the risks associated with future audits; and other relevant factors.

28. Normally, the auditor considers the historical experience of the entity (for example, the aggregate amount of prior cost-report adjustments and previous regulatory settlements) as well as the risk of potential future adjustments. The

[6] Medicare cost reimbursement is based on the application of highly complex technical rules, some of which are ambiguous and subject to different interpretations even among Medicare's fiscal intermediaries. It is not uncommon for fiscal intermediaries to reduce claims for reimbursement that were based on management's good faith interpretations of pertinent laws and regulations. Additionally, the Provider Reimbursement Review Board (PRRB) or the courts may be required to resolve controversies regarding the application of certain rules. To avoid recognizing revenues before their realization is reasonably assured, providers estimate the effects of such potential adjustments. This is occasionally done by preparing a cost report based on alternative assumptions to help estimate contractual allowances required by generally accepted accounting principles. The existence of reserves or a reserve cost report does not by itself mean that a cost report was incorrectly or fraudulently filed.

fact that an entity currently is not subject to a governmental investigation does not mean that a recorded valuation allowance for potential billing adjustments is not warranted. Nor do these emerging industry trends necessarily indicate that an accrual for a specific entity is warranted.

29. In evaluating valuation allowances, the auditor may consider the entity's historical experience and potential future adjustments in the aggregate. For example, assume that over the past few years after final cost report audits were completed, a hospital's adjustments averaged 3 percent to 5 percent of total filed reimbursable costs. Additionally, the hospital is subject to potential billing adjustments, including errors (for example, violations of the three-day window, discharge and transfer issues, and coding errors). Even though specific incidents are not known, it may be reasonable for the hospital to estimate and accrue a valuation allowance for such potential future retrospective adjustments, both cost-based and non-cost-based. Based on this and other information obtained, the auditor may conclude that a valuation allowance for the year under audit of 3 percent to 5 percent of reimbursable costs plus additional amounts for potential non-cost-based program billing errors is reasonable.

30. 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 (for example, differing application of payment rules by fiscal intermediaries, legal interpretations of courts, local enforcement initiatives, timeliness of reviews, and quality of documentation). 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

31. 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.

32. 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*.

33. The auditor should be alert for valuation allowances not associated with any particular program, issue, or time period (for example, cost-report year or year the service was rendered). Such a reserve may indicate measurement bias. The auditor also considers the possibility of bias resulting in distorted earnings trends over time (for example, building up specific or unallocated valuation allowances in profitable years and drawing them down in unprofitable years).

Inadequate Disclosure

34. 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.

35. 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 example, regulatory actions reflecting local or national audit or enforcement initiatives). 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.

36. Differences between original estimates and subsequent revisions might arise due to final settlements, ongoing audits and investigations, or passage of time in relation to the statute of limitations. The Guide (paragraph 5.07) requires that these differences be included in the statement of operations in the period in which the revisions are made and disclosed, if material. Such differences are not treated as prior period adjustments unless they meet the criteria for prior period adjustments as set forth in FASB Statement No. 16, *Prior Period Adjustments*.

37. Disclosures such as the following may be appropriate:

General Hospital (the Hospital) is a (not-for-profit, for-profit, or governmental hospital or health care system) located in (City, State). The Hospital provides health care services primarily to residents of the region.

Net patient service revenue is reported at estimated net realizable amounts from patients, third-party payors, and others for services rendered and includes estimated retroactive revenue adjustments due to future audits, reviews, and investigations. Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period the related services are rendered, and such amounts are adjusted in future periods as adjustments become known or as years are no longer subject to such audits, reviews, and investigations.

Revenue from the Medicare and Medicaid programs accounted for approximately 40 percent and 10 percent, respectively, of the Hospital's net patient revenue for the year ended 1999. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. The 1999 net patient service revenue increased approximately $10,000,000 due to removal of allowances previously estimated that are no longer necessary as a result of final settlements and years that are no longer subject to audits, reviews, and investigations. The 1998 net patient service revenue decreased approximately $8,000,000 due to prior-year retroactive adjustments in excess of amounts previously estimated.

Appendix

Other Considerations Related to Government Investigations

In recent years, the federal government and many states have aggressively increased enforcement efforts under Medicare and Medicaid anti-fraud and abuse legislation. Broadening regulatory and legal interpretations have significantly increased the risk of penalties for providers; for example, broad interpretations of "false claims" laws are exposing ordinary billing mistakes to scrutiny and penalty consideration. In such circumstances, evaluating the adequacy of accruals for or disclosure of the potential effects of illegal acts in the financial statements of health care organizations is a matter that is likely to require a high level of professional judgment.

As previously discussed in this SOP, the far-reaching nature of alleged fraud and abuse violations creates an uncertainty with respect to the valuation of revenues, because future allegations of illegal acts could, if proven, result in a subsequent reduction of revenues. In addition, management makes provisions in the financial statements and disclosures for any contingent liabilities associated with fines and penalties due to violations of such laws. FASB Statement No. 5, *Accounting for Contingencies*, provides guidance in evaluating contingent liabilities, such as fines and penalties under applicable laws and regulations. Estimates of potential fines and penalties are not accrued unless their payment is probable and reasonably estimable.

The auditor's expertise is in accounting and auditing matters rather than operational, clinical, or legal matters. Accordingly, the auditor's procedures focus on areas that normally are subject to internal controls relevant to financial reporting. However, the further that potential illegal acts are removed from the events and transactions ordinarily reflected in the financial statements, the less likely the auditor is to become aware of the act, to recognize its possible illegality, and to evaluate the effect on the financial statements. For example, determining whether a service was medically necessary, obtained through a legally appropriate referral, properly performed (including using only approved devices, rendered in a quality manner), adequately supervised, accurately documented and classified, or rendered and billed by nonsanctioned individuals typically is not within the auditor's professional expertise. As a result, an audit in accordance with generally accepted auditing standards (GAAS) is not designed to detect such matters.

Further, an audit conducted in accordance with GAAS does not include rendering an opinion or any form of assurance on an entity's compliance with laws and regulations.[1] Nor does an audit under GAAS include providing any assurance on an entity's billings or cost report. In fact, cost reports typically are not prepared and submitted until after the financial statement audit has been completed.

Certain audit procedures, although not specifically designed to detect illegal acts, may bring possible illegal acts to an auditor's attention. When a potentially illegal act is detected, the auditor's responsibilities are addressed in SAS

[1] Even when auditors undertake a special engagement designed to attest to compliance with certain provisions of laws, regulations, contracts, and grants (for example, an audit in accordance with OMB Circular A-133), the auditor's procedures do not extend to testing compliance with laws and regulations related to Medicare and Medicaid fraud and abuse.

No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317). Disclosure of an illegal act to parties other than the client's senior management and its audit committee or board of directors is not ordinarily part of the auditor's responsibility, and such disclosure would be precluded by the auditor's ethical or legal obligation of confidentiality, unless the matter affects the auditor's opinion on the financial statements.[2]

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[2] Statement on Auditing Standards No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317.23), discusses circumstances in which a duty to notify parties outside the client of detected illegal acts may exist.

Appendix F

Statement of Position 02-2

Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator

December 27, 2002

Amendment to
AICPA Audit and Accounting Guide
Health Care Organizations

Issued by the Accounting
Standards Executive Committee

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

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SUMMARY

This Statement of Position (SOP) amends the AICPA Audit and Accounting Guide *Health Care Organizations* (Guide) to address how nongovernmental not-for-profit health care organizations should report gains or losses on hedging and nonhedging derivative instruments under Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended. This SOP requires the following:

- Not-for-profit health care organizations should apply the provisions of FASB Statement No. 133 (including the provisions pertaining to cash flow hedge accounting) in the same manner as for-profit enterprises.
- Not-for-profit health care organizations should provide all the disclosures required by paragraph 45 of FASB Statement No. 133, including disclosures related to reclassifications into earnings of gains and losses that are reported in accumulated other comprehensive income. Although those organizations are not otherwise required to report changes in the components of comprehensive income pursuant to paragraph 26 of FASB Statement No. 130, *Reporting Comprehensive Income*, such organizations should separately disclose the beginning and ending accumulated derivative gain or loss that has been excluded from the performance indicator (earnings measure), the related net change associated with current period hedging transactions, and the net amount of any reclassifications into the performance indicator in a manner similar to that described in paragraph 47 of FASB Statement No. 133.

The SOP also amends the Guide to clarify that the performance indicator (earnings measure) reported by not-for-profit health care organizations is analogous to income from continuing operations of a for-profit enterprise.

The provisions of the SOP are effective for fiscal years beginning after June 15, 2003. Earlier application of this SOP is encouraged but is permitted only as of the beginning of any fiscal quarter that begins after issuance of this SOP. The provisions of the SOP should be applied prospectively. Not-for-profit health care organizations that reported derivative gains or losses in a manner inconsistent with the conclusions of the SOP in financial statements issued prior to adoption of the SOP are not permitted to reclassify those gains or losses upon adoption.

FOREWORD

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least 10 of AcSEC's 15 members, and (3) a final document that has been approved by at least 10 of AcSEC's 15 members. The document is cleared if at least four of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the document.

Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator

Introduction

1. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, establishes accounting and reporting standards for derivative instruments and hedging activities. If certain conditions are met, a derivative may be specifically designated as a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment (fair value hedge), a hedge of the exposure to variable cash flows of an existing recognized asset or liability or a forecasted transaction (cash flow hedge), or a hedge of foreign currency exposure.[1]

2. The accounting for derivative gains and losses depends on the intended use of the derivative and the resulting designation.

- For a fair value hedge, the gain or loss on the derivative is recognized in earnings in the period of change together with the offsetting loss or gain on the hedged item attributable to the risk being hedged.
- For a cash flow hedge, the effective portion of the derivative's gain or loss is initially reported as a component of other comprehensive income (outside earnings) and subsequently reclassified into earnings when the forecasted transaction affects earnings. Any ineffective portion of the gain or loss is reported in earnings immediately.
- For a derivative not designated as a hedging instrument, the gain or loss is recognized in earnings in the period of change.

3. The application of FASB Statement No. 133 to entities that do not report earnings as a separate caption in a statement of financial performance (for example, a not-for-profit organization) is described in paragraph 43 of that Statement. Paragraph 43 indicates that such organizations shall recognize the gain or loss on hedging and nonhedging derivative instruments, and changes in the carrying amount of the hedged item in a fair value hedge, as a change in net assets in the period of change. Paragraph 43 also indicates that cash flow hedge accounting is not available to a not-for-profit or other entity that does not report earnings as a separate caption in a statement of financial performance. Consistent with the provisions of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, FASB Statement No. 133 does not prescribe how a not-for-profit organization should determine the components of an operating measure, if one is presented.

4. Many health care entities are organized as not-for-profit organizations, and thus would appear to be subject to the provisions of paragraph 43 of FASB Statement No. 133. The thrust of the guidance in paragraph 43 appears to be directed at the fact that FASB Statement No. 117 does not require not-for-profit entities to report earnings. However, not-for-profit health care organizations must report a defined measure of earnings (performance indicator) as a

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[1] Not-for-profit health care organizations do not frequently enter into foreign currency hedges. Therefore, this SOP focuses on matters pertaining to fair value and cash flow hedges.

separate caption in the statement of operations, based on requirements contained in paragraph 10.17 and 10.18 of the AICPA Audit and Accounting Guide *Health Care Organizations* (the Guide). Consequently, some not-for-profit health care organizations believed that paragraph 43 of FASB Statement No. 133 (including its provisions related to cash flow hedge accounting) did not affect them. Those entities applied the provisions of FASB Statement No. 133 in the same manner as for-profit enterprises. Other not-for-profit health care organizations believed they were subject to the guidance in paragraph 43, but interpreted that guidance in different ways. As a result, diversity in practice arose among not-for-profit health care organizations with respect to their accounting for derivatives.

5. This SOP addresses how not-for-profit health care organizations should report gains or losses on hedging and nonhedging derivative instruments under FASB Statement No. 133 and clarifies certain matters with respect to the performance indicator (earnings measure) reported by such organizations.

Scope

6. This SOP applies to not-for-profit health care organizations that are within the scope of the Guide. It does not apply to governmental entities that are within the scope of the Guide.

Conclusions

Application of FASB Statement No. 133

7. Except as provided in paragraph 8 of this SOP, not-for-profit health care organizations should apply the provisions of FASB Statement No. 133 (including the provisions pertaining to cash flow hedge accounting) in the same manner as for-profit enterprises. That is, the gain or loss items that affect a for-profit enterprise's income from continuing operations similarly should affect the not-for-profit health care organization's performance indicator, and the gain or loss items that are excluded from a for-profit enterprise's income from continuing operations (such as items reported in other comprehensive income) similarly should be excluded from the performance indicator by the not-for-profit health care organization.

8. Paragraph 47 of FASB Statement No. 133 discusses requirements to report changes in the components of comprehensive income pursuant to paragraph 26 of FASB Statement No. 130, *Reporting Comprehensive Income.* Although not-for-profit health care organizations are not subject to the requirements of FASB Statement No. 130, this SOP requires those organizations to separately disclose the beginning and ending accumulated derivative gain or loss that has been excluded from the performance indicator (also see paragraph 10 of this SOP), the related net change associated with current period hedging transactions, and the net amount of any reclassifications into the performance indicator in a manner similar to that described in paragraph 47 of FASB Statement No. 133. Similarly, this SOP requires not-for-profit health care organizations to provide disclosures that are analogous to those required by paragraph 45 of FASB Statement No. 133 for for-profit enterprises, including the disclosure of anticipated reclassifications into the performance indicator of gains and losses that have been excluded from that measure and reported in accumulated derivative gain or loss as of the reporting date.

Performance Indicator

9. Paragraph 10.17 and 10.18 of the Guide are amended as follows. The following text is added after the first sentence of paragraph 10.17:

> This performance indicator and the income from continuing operations reported by for-profit health care enterprises generally are consistent, except for transactions that clearly are not applicable to one kind of entity (for example, for-profit health care enterprises typically would not receive contributions, and not-for-profit health care organizations would not award stock compensation). That is, the performance indicator is analogous to income from continuing operations of a for-profit enterprise.

In paragraph 10.18, item *e* is eliminated, item *f* is renumbered *e*, and item *g* is deleted and replaced with the following two subpoints:

f. Items that are required to be reported in or reclassified from other comprehensive income, such as minimum pension liabilities in accordance with paragraph 37 of FASB Statement No. 87, *Employers' Accounting for Pensions*; foreign currency translation adjustments; and the effective portion of the gain or loss on derivative instruments designated and qualifying as cash flow hedging instruments.

g. Items that are required to be reported separately under specialized not-for-profit standards. These include extraordinary items, the effect of discontinued operations, and the cumulative effect of accounting changes pursuant to the provisions of FASB Statement No. 117; and unrealized gains and losses on investments not restricted by donors or by law (except for those investments classified as trading securities) and investment returns restricted by donors or by law, as required by paragraphs 4.07 through 4.10 of this Guide.

Effective Date and Transition

10. The provisions of this SOP are effective for fiscal years beginning after June 15, 2003. Earlier application of this SOP is encouraged but is permitted only as of the beginning of any fiscal quarter that begins after issuance of this SOP. This SOP should be applied prospectively for all contracts existing on the initial date of application of this SOP and for transactions after that date. Derivative gains or losses reported in a manner inconsistent with the provisions of this SOP in financial statements for periods prior to the initial date of application of this SOP should not be reclassified upon adoption. Any derivative gains and losses excluded from the performance indicator in the financial statements issued for periods ended before the initial date of application of this SOP that did not meet the cash flow hedging criteria of FASB Statement No. 133 should not be reclassified and included as a component of the performance indicator in any period subsequent to the initial date of application of this SOP. In addition, the derivative gains and losses referred to in the preceding sentence should not be included in the disclosure of the accumulated derivative gain or loss (as described in paragraph 8 of this SOP). However, to the extent that derivative gains or losses on cash flow hedges qualifying under FASB Statement No. 133 had been reported in a manner consistent with the provisions of this SOP in financial statements for periods prior to the initial date of application of this SOP, such amounts should be included in that disclosure and should be reclassified and included in the performance indicator when the hedged transaction affects the performance indicator. When the financial statements of the year of adoption are presented separately or included in comparative financial statements, the notes to the financial statements should

disclose (*a*) the fact that this SOP has been adopted and the effective date of adoption, and (*b*) the nature of any differences in accounting principles or financial statement presentation applicable to the financial statements presented that resulted from adoption of the SOP. Disclosure of pro forma amounts is not required.

11. Entities initially applying hedge accounting upon adoption of this SOP are reminded that all the hedge accounting criteria in FASB Statement No. 133 must be met for the entire period to which hedge accounting is being applied. Derivative instruments should not be retroactively designated as hedges if appropriate contemporaneous documentation of the election and periodic assessment of effectiveness[2] did not occur in conformity with FASB Statement No. 133.

The provisions of this SOP need not be applied to immaterial items.

Background

12. Issues surrounding the reporting of derivatives by not-for-profit health care organizations and the resulting diversity in practice were brought to the attention of the planning subcommittee of the AICPA's Accounting Standards Executive Committee (AcSEC) in December 2000. Specifically, questions had been raised about whether the guidance in paragraph 43 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, applied to not-for-profit health care organizations that are required under industry-specific generally accepted accounting principles (GAAP) to report a performance indicator.

13. The planning subcommittee discussed the paragraph 43 issue and concluded that, because not-for-profit health care organizations are required to report a standardized performance indicator that is considered analogous to income from continuing operations reported by for-profit enterprises, they should apply the provisions of FASB Statement No. 133 in the same manner as do for-profit enterprises. Because that conclusion was not considered controversial, the planning subcommittee directed the AICPA staff to draft clarifying guidance in the form of a proposed AICPA Technical Practice Aid (TPA).

14. The planning subcommittee also discussed a footnote that had been added as a conforming change to paragraph 10.18 of the Guide in May 2000. That footnote contained the following statement:

> 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.

In light of the planning subcommittee's conclusion that the provisions of FASB Statement No. 133 should be applied to not-for-profit health care organizations

[2] FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, establishes the general requirement that, to use hedge accounting, an entity should assess a hedge's effectiveness at the time it enters into a hedge and at least every three months thereafter, unless the hedge qualifies for use of the short-cut method. The requirement to assess hedge effectiveness at least every three months applies to entities that issue financial statements only on an annual basis as well as to entities that issue quarterly financial statements.

in the same manner as for-profit enterprises, it was decided that the May 2000 conforming change should be deleted from future editions of the Guide.

15. In January 2001, the planning subcommittee discussed a letter received by AcSEC's Chair from The Bond Market Association (TBMA). The letter indicated TBMA's awareness of the planning subcommittee's discussions and expressed concern that the proposed guidance would be issued in the form of a nonauthoritative TPA. TBMA was concerned that not-for-profit health care organizations and their independent auditors would not be aware of such guidance, resulting in the inconsistent application of derivative accounting among organizations in the sector. TBMA also wanted to ensure that all affected parties would have an opportunity to review and comment on the proposed guidance, because it could represent a significant change in reporting for some not-for-profit health care organizations.

16. In March 2001, after further discussing the draft TPA and considering input received from various sources, the planning subcommittee and AcSEC decided that an SOP should be issued to amend the Guide to address these issues. Although the planning subcommittee and AcSEC did not disagree with the conclusions in the draft TPA, it was concluded that an SOP subject to due process would be the most appropriate vehicle for communicating the guidance. AcSEC issued an exposure draft of a proposed SOP on June 14, 2002 and received four comment letters.

Views on the Issue

17. Some believed that because not-for-profit health care organizations are required by the AICPA Audit and Accounting Guide *Health Care Organizations* to report a performance indicator that is analogous to income from continuing operations of a for-profit enterprise, they should apply the provisions of FASB Statement No. 133 (including the cash flow hedge accounting provisions) in the same manner as for-profit enterprises. That is, the gain or loss items that under FASB Statement No. 133 would affect a for-profit enterprise's earnings similarly should affect the not-for-profit health care organization's performance indicator, and the gain or loss items that under FASB Statement No. 133 are reported in other comprehensive income by the for-profit enterprise similarly should be excluded from the performance indicator by the not-for-profit health care organization. They interpreted paragraph 43 of FASB Statement No. 133 as applying only to organizations that are not required to report an earnings measure.

18. Others believed that paragraph 43 precludes the use of cash flow hedge accounting by not-for-profit health care organizations because the FASB has not defined the performance indicator to be used by those organizations. They cited the following sentence in paragraph 501 of FASB Statement No. 133 as support for their position:

> For this Statement to permit a not-for-profit entity, for example, to apply cash flow hedge accounting, the Board would first have to define a subcomponent of the total change in net assets during a period that would be analogous to earnings for a business enterprise.

They believed that the definition of *performance indicator* used by not-for-profit health care organizations does not qualify as earnings for FASB Statement No. 133 purposes because it was promulgated by AcSEC, rather than the FASB. Opponents of that view pointed to paragraph 49 of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, which allows AICPA industry Audit and Accounting Guides to provide implementing guidance with

respect to that Statement that, if cleared by the FASB, should be adopted by users of those guides. The FASB did not object to the definition of *performance indicator* promulgated in the Guide.

19. Others acknowledged that not-for-profit health care organizations report a performance indicator that is analogous to income from continuing operations of a for-profit enterprise, but believed that the cash flow hedge accounting prohibitions in paragraph 43 should apply because the concept of other comprehensive income is limited to for-profit enterprises that are subject to FASB Statement No. 130, *Reporting Comprehensive Income*. Opponents of that view responded that not-for-profit health care organizations employ other comprehensive income reporting concepts in their statement of operations and their definition of a performance indicator. They pointed to the fact that among the exclusions from the performance indicator listed in paragraph 10.18 of the Guide are the items that for-profit organizations are required to include in other comprehensive income under FASB Statement No. 130 (foreign currency items, minimum pension liability adjustments, and unrealized gains and losses on certain investments in debt and equity securities). Further, they pointed to paragraphs 500 and 501 of FASB Statement No. 133, which indicate that the total change in net assets of a not-for-profit organization is analogous to the total comprehensive income of a for-profit enterprise.

20. Still others believed that, although not-for-profit health care organizations conceptually are capable of applying the mechanics of cash flow hedge accounting in their financial statements, they are precluded from doing so because the list in paragraph 10.18 of the Guide of items to be excluded from the performance indicator does not explicitly include "the effective portion of the gain or loss on derivative instruments designated and qualifying as cash flow hedging instruments." They believed that all transactions except those explicitly listed in paragraph 10.18 should be included in the performance indicator.

21. Among those who believed that paragraph 43 prohibits not-for-profit health care organizations from applying cash flow hedge accounting, some believed that all hedging and nonhedging derivative gains and losses should be included in the performance indicator. Others interpreted paragraph 43 as requiring all hedging and nonhedging derivative gains and losses to be excluded from the performance indicator and reported in "other changes in net assets." Still others employed a hybrid approach to reporting derivative gains and losses based on guidance provided in a conforming change (that subsequently was rescinded[3] contained in a footnote to paragraph 10.18 of the May 2000 edition of the Guide.

Basis for Conclusions

Scope

Other Not-for-Profit Organizations

22. AcSEC discussed whether the scope of the SOP should extend to other types of not-for-profit organizations (that is, not-for-profit organizations other than health care organizations) in situations in which those organizations voluntarily choose to provide a performance indicator. Those organizations are subject to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*, rather than the Audit and Accounting Guide *Health Care Organizations.*

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[3] See paragraph 14 of this SOP.

AcSEC chose not to address similar issues for those organizations in the context of this SOP because, unlike health care organizations, other types of not-for-profit organizations are not subject to a standardized or prescribed performance measure.

Governmental Health Care Enterprises

23. Because the concept of reporting "other comprehensive income" conflicts with the reporting requirements of Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, cash flow hedge accounting is not available to governmental health care enterprises that are within the scope of the Guide. Therefore, governmental health care enterprises are excluded from the scope of the SOP. FASB Statement No. 133 applies to governmental enterprises only to the extent that provisions in that Statement do not conflict with the provisions of GASB pronouncements (see paragraph 94 of GASB Statement No. 34).

Reporting a Separate Component of Equity

24. Pursuant to paragraph 26 of FASB Statement No. 130, for-profit entities report *accumulated other comprehensive income* as a component of equity that is displayed separately from retained earnings and additional paid-in capital in a statement of financial position. When FASB Statement No. 130 was issued, the FASB considered whether not-for-profit organizations should also be included within the scope of that Statement. The FASB decided to exclude those organizations, noting that not-for-profit organizations' financial statements already were displaying the equivalent of comprehensive income as a result of the requirements of FASB Statement No. 117. Thus, not-for-profit organizations are not required to report accumulated other comprehensive income as a separate component of equity.

25. AcSEC discussed whether the absence of a requirement to report accumulated other comprehensive income as a separate component of equity was a significant enough difference to preclude not-for-profit health care organizations from being able to use cash flow hedge accounting under FASB Statement No. 133. AcSEC determined that the concept of reporting accumulated other comprehensive income as a separate component of equity is unique to for-profit enterprises that report retained earnings and additional paid-in capital and that, further, the concept primarily appears to be a carryforward of the reporting practices followed by such entities before the issuance of FASB Statement No. 130. Moreover, AcSEC was concerned that such reporting may conflict with the provisions of FASB Statement No. 117 requiring not-for-profit organizations to report three classes of net assets (unrestricted, temporarily restricted, and permanently restricted). Therefore, AcSEC concluded that the absence of a requirement to report a separate component of equity in the balance sheet of not-for-profit health care organizations should not preclude those organizations from using comprehensive income reporting for qualifying gains and losses on cash flow hedges. Although accumulated other comprehensive income will inherently be carried forward in a not-for-profit health care organization's net assets, there is no compelling need for it to be reported separately in the balance sheet.

Income Statement Classification of Derivative Gains and Losses

26. Although FASB Statement No. 133 provides comprehensive disclosure guidance for derivatives, it does not explicitly address or prescribe the

income statement classification for derivative gains and losses that are included in earnings.

27. Paragraph 45 of FASB Statement No. 133 requires an entity to disclose where in the income statement it has chosen to report the net gain or loss on fair value and cash flow hedges (and the related hedged transaction or item), but the paragraph does not specify where or in what captions such gains and losses should be displayed. That allows for flexibility in reporting based on an entity's economic rationale for entering into the hedge. For derivatives that are not designated as hedges, FASB Statement No. 133 does not require disclosure of where gains and losses are reported in the income statement, nor does it specify where within the income statement those gains and losses should be reported. AcSEC decided not to provide more specific guidance regarding income statement classification in this SOP because it did not want to prescribe more restrictive guidance for not-for-profit health care organizations than that applicable to other organizations subject to FASB Statement No. 133.

Definition of Performance Indicator

28. The term *performance indicator* was introduced in 1996 when the AICPA issued the Audit and Accounting Guide *Health Care Organizations*.[4] The 1996 revision of the industry Guide was necessitated largely by the issuance of FASB Statements No. 116, *Accounting for Contributions Received and Contributions Made*, and No. 117, which (among other things) changed the financial statement display requirements for not-for-profit organizations. The 1995 exposure draft of the Guide had referred to the earnings measure using terms such as *net income* and *operating income*. The FASB subsequently objected to that terminology, deeming it inappropriate for describing an earnings measure of a not-for-profit organization. Accordingly, the final Guide used the generic term *performance indicator* to denote the earnings measure.

29. Paragraph 1.04 of the Guide states, in part:

> The financial reporting for not-for-profit, business-oriented organizations and investor-owned health care enterprises generally is consistent except for transactions that clearly are not applicable. For example, not-for-profit business organizations would have nothing to report for shareholders' equity. On the other hand, investor-owned health care enterprises typically would not have anything to report for contributions.

Consequently, in developing the definition of *performance indicator* (paragraph 10.17 and 10.18 of the Guide), AcSEC intended that the linkage between the new performance indicator measure and the earnings measure previously reported by not-for-profit health care organizations be preserved to the greatest extent possible, due to its importance to users of health care organizations' financial statements. The phrase "other items that are required by GAAP to be reported separately" was included in paragraph 10.18*g* of the Guide to enable the performance indicator to remain "evergreen," that is, to permit it to be updated by conforming changes to incorporate the issuance of future accounting standards.

30. Subsequent to issuance of the Guide, AcSEC determined that the provisions of paragraph 10.17 and 10.18 were not being interpreted by some readers of the Guide in the manner intended by AcSEC. In addition, when new accounting standards have been issued, some readers of the Guide have been

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[4] *Health Care Organizations* replaced the AICPA Industry Audit Guide *Audits of Providers of Health Care Services*.

uncertain how to apply them with respect to the performance indicator. Consequently, paragraph 9 of this SOP revises the definition of *performance indicator* to state explicitly that the performance indicator should be regarded as the functional equivalent of income from continuing operations of a for-profit enterprise. Additionally, this SOP amends paragraph 10.18 of the Guide to clarify that the reference to "other items that are required by GAAP to be reported separately" refers to GAAP applicable to for-profit enterprises (for example, items that are required under existing accounting standards to be reported in other comprehensive income[5] as well as GAAP specific to not-for-profit organizations, and that additional items may result from issuance of future accounting standards.

Transition

31. Paragraph 515 of FASB Statement No. 133 states, in part:

> Because hedge accounting is based on an entity's intent at the time a hedging relationship is established, the Board decided that retroactive application of the provisions of this Statement was not appropriate.

Similarly, Derivatives Implementation Group (DIG) Issue No. K5, *Transition Provisions for Applying the Guidance in Statement 133 Implementation Issues*, indicates that when an entity has applied "the recognition and measurement of derivatives differently than required by subsequently issued cleared implementation guidance, [the entity] should account for the effects of initially complying with that implementation guidance prospectively for all existing contracts and future transactions, as of the effective date for that guidance." Consequently, AcSEC determined that the effects of initially complying with the guidance in this SOP should also be accounted for prospectively.

32. AcSEC also considered whether to allow an alternative for retroactive application of this SOP. Although this SOP does not change the "recognition and measurement of derivatives," it may change an entity's accounting policy and thus may affect certain actions taken by an entity. For example, based on their interpretation of authoritative literature, certain health care entities may have had economic hedges that they did not designate as cash flow hedges because they did not believe that cash flow hedging derivatives were accounted for differently from non-hedging derivatives. AcSEC recognized that the historical actions undertaken to document, designate, or assess effectiveness by entities that, in prior periods, had adopted accounting policies inconsistent with those set forth in this SOP may have differed had this SOP been effective during those prior periods. In recognition of this fact, and because hedging relationships cannot be documented retroactively under FASB Statement No. 133, AcSEC decided that retroactive application of the provisions of this SOP was not appropriate.

33. Because the effect of an entity's hedging activities on its financial statements in the initial year of adoption of this SOP may not be comparable to the preceding year, AcSEC discussed whether pro forma disclosures in the year of adoption would address concerns related to consistency and comparability of financial information. Disclosure of the pro forma effects of retroactive application of hedge accounting for prior periods (in a manner similar to the requirements of paragraph 19(d) of Accounting Principles Board Opinion No.

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[5] For example, in June 1997 the phrase "minimum pension liabilities in accordance with paragraph 37 of FASB Statement No. 87, *Employers' Accounting for Pensions*, or foreign currency translation adjustments" was added to paragraph 10.18(g) as a conforming change necessitated by the issuance of FASB Statement No. 130, *Reporting Comprehensive Income*.

20, *Accounting Changes*) was considered and rejected for the same reasons that AcSEC rejected retroactive restatement as a transition option, as described in paragraph 32. The exposure draft solicited comments on an alternative pro forma measure that would require entities to disclose the effect on their performance indicator for the year of adoption of continuing to apply their prior year's reporting practices, if such practices differed from those required by the SOP. One commenter stated that such a requirement was inappropriate and would not provide users of the financial statements with meaningful comparative information. For example, for an entity that prior to adoption of the SOP believed that paragraph 43 of Statement No. 133 prohibited cash flow hedge accounting but that upon adoption of the SOP adopted cash flow hedge accounting, the information derived from disclosing what the performance indicator would have been had the entity continued to not take advantage of hedge accounting has little (if any) meaning for users of financial statements. Similarly, for an entity that prior to adoption of the SOP was excluding gains and losses from the performance indicator in a manner other than that allowed by this SOP, disclosing what the performance indicator would have been had the entity continued to exclude those derivative gains/losses from the performance indicator subsequent to its adoption of the SOP does not provide meaningful information and, further, results in comparing a performance indicator derived in accordance with GAAP with a measure that is no longer considered to be in accordance with GAAP. Therefore, although acknowledging that the usefulness of financial information about an entity increases if that information can be compared with similar information in prior periods, AcSEC concluded that the potential usefulness of that information is diminished or eliminated if the information has no comparative value. Additionally, AcSEC considered this SOP's guidance as similar in nature to the guidance provided in Statement No. 133 and DIG Issue No. K5. Neither Statement No. 133 nor Issue No. K5 requires disclosure of any pro forma information. Consequently, AcSEC concluded that pro forma disclosures of any type would not be appropriate for the year of adoption of this SOP. However, when the financial statements of the year of adoption are presented separately or included in comparative financial statements, the entity should disclose in the notes to the financial statements (*a*) the fact that the SOP has been adopted and the effective date of adoption (for example, beginning of a year or beginning of a quarter), and (*b*) the nature of any differences in accounting principles or financial statement presentation applicable to the financial statements presented that resulted from adoption of the SOP (for example, "The effective portion of unrealized gains and losses on cash flow hedges, which prior to adoption of SOP 02-2 were included in the performance indicator, are now reported below the performance indicator").

34. The exposure draft would have required entities to adopt the SOP as of the beginning of a fiscal year. Several respondents to the exposure draft objected to precluding entities from early adopting this SOP, based on their understanding that a number of entities had already been applying the provisions of FASB Statement No. 133 pertaining to cash flow hedge accounting prior to issuance of the exposure draft. They also were concerned about allowing diversity in practice to continue over the extended period that would result from requiring adoption as of the beginning of a fiscal year. AcSEC concluded that in the interest of remedying diversity in practice as quickly as possible, entities should be allowed to early adopt the SOP.

35. AcSEC observed that some not-for-profit health care organizations may have employed a methodology that excluded derivative gains and losses from the performance indicator until those gains or losses were realized. Upon realization, those organizations would have recognized the derivative's gain or

loss in the performance indicator. Consistent with its decision to require prospective application of this SOP, AcSEC decided that upon initial application of this SOP, any prior gains or losses on derivative instruments recognized by those not-for-profit health care organizations that had been excluded from the performance indicator in years before adoption and that did not meet the hedging criteria of FASB Statement No. 133 (including the requirements of contemporaneous documentation and testing of effectiveness) should not subsequently be reclassified and included as a component of the performance indicator. Rather, any such derivative gains and losses should be permanently excluded from the performance indicator.

36. AcSEC did agree, however, that to the extent that a not-for-profit health care organization had reported derivative gains or losses in a manner consistent with the provisions of this SOP (including compliance with the documentation and designation requirements of FASB Statement No. 133) in financial statements for periods prior to the initial application of this SOP, such amounts should be reclassified and included in the performance indicator when the hedged item affects the performance indicator.

37. For entities that initially apply hedge accounting upon adoption of this SOP or thereafter, paragraph 11 states that all the hedge accounting criteria in FASB Statement No. 133 must be met for the entire period to which hedge accounting is being applied in order for hedge accounting to be used. AcSEC noted that when an organization designates an existing derivative as a hedging instrument upon adoption of the SOP or thereafter, the fair value of the derivative instrument typically will not be zero at the inception of the hedging relationship. Because paragraph 68(b) of FASB Statement No. 133 requires that the fair value of the hedging instrument at the inception of the hedging relationship be zero in order for the short-cut method to be used, application of the short-cut method will not be possible and hedge ineffectiveness for cash flow hedges must be measured under either the hypothetical derivative method or the change in fair value method as described in DIG Issue No. G7, *Cash Flow Hedges: Measuring the Ineffectiveness of a Cash Flow Hedge under Paragraph 30(b) When the Shortcut Method is Not Applied*. For cash flow hedging relationships that were designated and accounted for pursuant to the hedge accounting criteria in FASB Statement No. 133 prior to the adoption of this SOP, the adoption of this SOP will not affect how hedge effectiveness is assessed or hedge ineffectiveness is measured for such relationships.

Appendix G

Information Sources

Further information on matters addressed in this Guide is available through various publications and services listed in the table that follows. Many non-government and some government publications and services involve a charge or membership requirement.

Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow the user to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

All telephone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines.

Information Sources

Organization	General Information	Fax Services	Available Publications
Health Care Investment Analysts, Inc. (HCIA)	*Order Department* 300 East Lombard Street Baltimore, MD 21200 Attn: Customer Service (800) 568-3282		*Comparative Performance of U.S. Hospitals: The Sourcebook* *Profile of U.S. Hospitals* *Guide to the Managed Care Industry* *Guide to the Nursing Home Industry*
American Association of Homes and Services for the Aging (AAHSA)	*Order Department* AAHSA Publications Dept. 5119 Washington, DC 20061-5119 (301) 490-0677		*Continuing Care Retirement Communities: An Industry in Action*
Center for Health Care Industry Performance Studies (CHIPS)	*Order Department* 1550 Old Henderson Road, Suite S277 Columbus, OH 43220-3626 (800) 859-2447		*Almanac of Hospital Financial & Operating Indicators*
American Hospital Association (AHA)	*Order Department* P.O. Box 92683 Chicago, IL 90673-2683 (800) AHA-2626	Fax-on-Demand (312) 422-2020	*Hospital Statistics* *National Hospital Panel Survey Report*
Group Health Association of America, Inc. (GHAA)	*Order Department* 1129 20th Street, NW, Suite 600 Washington, DC 20036 (202) 778-3200	Fax-on-Demand (202) 331-7487	*HMO Industry Profile*
Interstudy Publications	*Order Department* 2901 Metro Drive, Fourth Floor Minneapolis, MN 55425 (612) 858-9291	Fax-on-Demand (612) 854-5698	*Competitive Edge Industry Report for HMOs*
American Medical Association (AMA)	*Order Department* 515 N. State Street Chicago, IL 60610 (800) 621-8335	Information-on-Request Fax Line (800) 621-8335	*Socioeconomics of the Medical Practice*
Medical Group Management Association	*Order Department* Denver, CO 80256-0444 (303) 397-7888	Fax-on-Demand (800) FAX-4MED	*Cost Survey* *Academic Practice Management Survey*
Health Care Financial Management Association (HFMA)	*Order Department* Two Westbrook Corporate Center, Suite 700 Westchester, IL 60154 (202) 296-2920	Fax-on-Demand (800) 839-HFMA	*Health Care Financial Management (monthly publication)* Issue Analysis 98-1, *Compliance with Laws and Regulations for Health Care Organizations*

Organization	General Information	Fax Services	Web Site Address	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (888) 777-7077	*24 Hour Fax Hotline* (201) 938-3787	www.aicpa.org	
Financial Accounting Standards Board	*Order Department* 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10 (800) 748-0659	*24 Hour Fax on Demand* (203) 847-0700 menu item 14	www.fasb.org	*Action Alert Telephone Line* (203) 847-0700 (ext. 444)
Governmental Accounting Standards Board	*Order Department* 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10 (800) 748-0659	*24 Hour Fax on Demand* (203) 847-0700 menu item 14	www.gasb.org	
U.S. Government Accountability Office	*GAO Document Distribution Center* (202) 512-6000 *Superintendent of Documents* U.S. Government Printing Office (202) 512-1800		www.gao.gov	
U.S. Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4040 *SEC Public Reference Room* (202) 942-8090	*Information Line* (202) 942-8088, ext. 4 TTY (202) 942-7114	www.sec.gov	
U.S. Office of Management and Budget	725 17th Street NW Washington, DC 20503 (202) 395-3080 *OMB Information Line* (202) 395-3080		www.omb.gov	

Appendix H

Schedule of Changes Made to Health Care Organizations

As of May 2004

Beginning May 2001, all schedules of changes reflect only current year activity for improved clarity.

Reference	Change
General	Deleted "Audits of" in all references to all applicable Guide titles.
Preface	Revised to reflect the issuance of GASB Statement No. 34 and related pronouncements, the Audit and Accounting Guide *State and Local Governments*, and the Audit Guide Government Auditing Standards *and Circular A-133 Audits* and to clarify guidance; Updated to reflect the applicability and requirements of the Sarbanes-Oxley Act, related SEC regulations, and Standards of the PCAOB; Footnotes 1, 3, and 4 added; Former footnote 4 deleted; Subsequent footnotes renumbered.
Chapter 1 (title)	Note deleted.
Paragraph 1.01 (footnote 1)	Revised to reflect the issuance of GASB Statement No. 34.
Paragraph 1.03 (heading)	Revised since guidance for governmental health care organizations formerly contained under this heading has been transferred to a new section in the chapter entitled "Financial Reporting of Governmental Health Care Organizations."
Paragraphs 1.04 and 1.05	Revised to delete guidance for governmental healthcare organizations.
Paragraph 1.06 (footnote 4)	Deleted; Subsequent footnotes renumbered.
Paragraphs 1.07 and 1.08	Revised to delete guidance for governmental healthcare organizations.
Former paragraphs 1.09 (and heading), 1.10, and 1.11	Deleted; Subsequent paragraphs renumbered.
Paragraphs 1.09, 1.10, 1.11, 1.12, 1.13, 1.14, 1.15, 1.16, 1.17, 1.18, 1.19, 1.20, 1.21, 1.22, 1.23, and 1.24	Added to include new section entitled "Financial Reporting of Governmental Health Care Organizations" with guidance for governmental healthcare organizations transferred from paragraphs 1.03 through 1.08 as well as to reflect the issuance of GASB Statement No. 34 and related pronouncements, GASB Staff document *Comprehensive Implementation Guide—2003*, and Audit and Accounting Guide *State and Local Governments*; Footnotes 4 and 5 added; Subsequent paragraphs and footnotes further renumbered.

Reference	Change
Renumbered paragraph 1.51	Revised to delete reference to FASB Statement No. 4; Footnotes * and ** deleted.
Renumbered paragraph 1.52 (heading)	Footnote *** deleted.
Renumbered paragraphs 1.52 and 1.53	Revised to reflect the issuance of GASB Statement No. 34 and to clarify guidance by adding a cross-reference to paragraph 1.16.
Renumbered paragraphs 1.55, 1.56, 1.57, 1.58, 1.59, and 1.60	Revised to reflect the issuance of recent authoritative or proposed guidance; Footnotes CON, footnote **, and footnotes * deleted.
Chapter 2 (title)	Footnote * and note deleted.
Paragraph 2.01	Added to reflect the issuance of the Audit and Accounting Guide *State and Local Governments*.
Paragraph 2.02	Added discussion of regulatory developments for registered public accounting firms; Subsequent paragraphs renumbered.
Renumbered paragraphs 2.03 and 2.09	Revised to reflect the issuance of SAS No. 96 and the Audit and Accounting Guide *State and Local Governments;* Footnotes ** and *, respectively, deleted.
Renumbered paragraph 2.14	Revised to reflect the issuance of SAS No. 99; Footnote * deleted.
Former paragraphs 2.13 and 2.14	Deleted; Subsequent paragraphs further renumbered.
Paragraphs 2.15, 2.16, 2.17, 2.18, 2.19, 2.20, 2.21, 2.22, 2.23, 2.24, 2.25, 2.26, and 2.27	Added to reflect the issuance of SAS No. 99; Subsequent paragraphs further renumbered.
Paragraph 2.27 (heading)	Footnote * added to reflect the issuance of PCAOB Auditing Standard No. 2.
Paragraphs 2.28, 2.29, 2.30, 2.31, 2.32, 2.33 (and footnotes 1 and 2), 2.34, 2.35, 2.36	Added to reflect the issuance of SAS No. 99; Subsequent paragraphs and footnotes further renumbered; Footnotes 1 and 2 added.
Paragraph 2.37	Added to reflect the release of the Practice Aid, *Fraud Detection in a GAAS Audit—Revised Edition*; Subsequent paragraphs further renumbered.
Renumbered paragraph 2.38 (heading)	Footnote † added to reflect the issuance of PCAOB Auditing Standard No. 2 and release of proposed PCAOB auditing standard; Subsequent footnotes redesignated.
Renumbered paragraphs 2.41 and 2.51	Revised to reflect the issuance of SAS No. 96; Footnotes * deleted.

Reference	Change
Paragraph 2.52	Added to reflect the issuance of SAS No. 96; Subsequent paragraphs further renumbered; Footnote ‡ added to reflect the issuance of PCAOB Auditing Standard No. 2 and release of proposed PCAOB auditing standard; Subsequent footnotes further redesignated.
Renumbered paragraph 2.53 (footnote **)	Deleted.
Renumbered paragraph 2.72	Revised to reflect the issuance of SAS No. 96; Footnote * deleted.
Renumbered paragraph 2.74	Revised to reflect the issuance of SAS No. 96; Footnote ** deleted; Footnote ‖ added to reflect the issuance of PCAOB Auditing Standard No. 2, release of proposed PCAOB auditing standard, and release of ASB exposure draft; Subsequent footnotes further redesignated.
Renumbered paragraph 2.75	Revised to reflect the issuance of SAS No. 99; Former footnote * deleted.
Renumbered paragraph 2.76	Revised to reflect the issuance of SAS No. 99 and to discuss guidance in SAS No. 52; Footnote ** deleted.
Renumbered paragraph 2.79	Revised to reflect recent regulatory developments; Footnote # added; Subsequent footnotes further redesignated.
Renumbered paragraph 2.83	Revised to reflect the issuance of the Audit Guide Government Auditing Standards *and Circular A-133 Audits*; Footnote 4 deleted.
Chapter 3 (title)	Note deleted.
Paragraph 3.01	Revised to reflect the issuance of GASB Statement No. 34.
Paragraph 3.04 (footnote *)	Added to reflect the issuance of GASB Statement No. 40; Subsequent footnotes redesignated.
Chapter 4 (title)	Note deleted.
Paragraph 4.02 (footnote *)	Deleted.
Paragraphs 4.04, 4.05, 4.07, and 4.11	Footnotes 2, 3, 5, and 7 added, respectively, to reflect the issuance of EITF Issue No. 03-1; Subsequent footnotes renumbered.
Paragraph 4.12	Revised to reflect the issuance of GASB Statement No. 34.
Paragraph 4.13 (footnote *)	Added to reflect the issuance of GASB Statement No. 40; Subsequent footnotes redesignated.
Paragraph 4.18	Revised to reflect the issuance of FASB Statement No. 149, SOP 02-2, and GASB Technical Bulletin 2003-1; Renumbered footnote 11 revised to reflect the issuance of FASB Statement No. 149; Footnotes * deleted; Footnote * added to reflect the issuance of GASB Statement No. 40; Footnote ** added to reflect the issuance of GASB Technical Bulletin 2003-1; Subsequent footnotes further redesignated.

Reference	Change
Exhibit 4-1 (renumbered footnote 13)	Revised to reflect the issuance of SAS No. 101.
Chapter 5 (title)	Note deleted.
Paragraphs 5.04 and 5.22 (footnotes *)	Deleted.
Paragraph 5.23	Added to reflect the issuance of GASB Statement No. 38; Subsequent paragraphs renumbered.
Renumbered paragraph 5.25 (footnote *)	Deleted.
Renumbered paragraph 5.26	Revised to reflect the issuance of SOP 02-2 and GASB Technical Bulletin 2003-1; Footnote ** deleted; Footnote † added; Subsequent footnotes redesignated.
Renumbered paragraph 5.27	Revised to reflect the issuance of GASB Statement No. 34; Footnote 14 added.
Chapter 6 (title)	Note deleted.
Paragraph 6.05	Footnote * revised to reflect the issuance of GASB Statement No. 42; Footnote ** deleted.
Paragraph 6.09	Added to reflect the issuance of GASB Statement No. 34; Subsequent paragraphs renumbered.
Renumbered paragraph 6.14	Footnote * deleted; Footnote † added to reflect the issuance of GASB Statement No. 42; Subsequent footnotes redesignated.
Exhibit 6-1 (footnote 3)	Added to reflect the issuance of SAS No. 101.
Chapter 7 (title)	Note deleted.
Paragraph 7.04 (footnote *)	Added to reflect release of GASB exposure draft and issuance of GASB Statement No. 45; Subsequent footnotes redesignated.
Paragraph 7.13	Added to reflect the issuance of GASB Statement No. 34 and related pronouncements; Subsequent paragraphs renumbered.
Renumbered paragraph 7.20	Revised to reflect the issuance of FASB Statement No. 145; Footnote * deleted.
Chapter 8 (title)	Note deleted.
Paragraph 8.02	Revised to reflect the issuance of FASB Interpretation No. 45; Footnote * deleted.
Paragraph 8.16 (footnote *)	Revised to reflect the issuance of FASB Interpretation No. 46 and FASB Interpretation No. 46 (revised December 2003).
Paragraphs 8.21 and 8.23	Revised to reflect the issuance of GASB Statement No. 34.
Chapter 9 (title)	Note deleted.

Reference	Change
Paragraph 9.02 (heading)	Revised since guidance for governmental health care entities formerly contained under this heading has been transferred to a new section in the chapter entitled "Governmental Health Care Organizations."
Paragraph 9.06	Deleted; Subsequent paragraphs renumbered.
Paragraphs 9.07 (and heading), 9.08, 9.09, 9.10, and 9.11	Added to include new section entitled "Governmental Health Care Organizations" with guidance for governmental healthcare organizations transferred from paragraphs 9.02 through 9.07, and to reflect the issuance of GASB Statement No. 34 and related pronouncements; Footnote * added; Subsequent footnotes renumbered; Subsequent paragraphs further renumbered.
Chapter 10 (title)	Note deleted.
Paragraph 10.03 (heading)	Revised to reflect the issuance of GASB Statement No. 34.
Paragraphs 10.03 and 10.09	Revised to reflect the issuance of GASB Statement No. 34; Footnote 2 added; Subsequent footnotes renumbered.
Paragraph 10.12	Revised to reflect the issuance of GASB Statements No. 33 and No. 34.
Paragraphs 10.15 and 10.16	Added to reflect the issuance of GASB Statement No. 34 and GASB Staff Document *Comprehensive Implementation Guide—2003*; Subsequent paragraphs renumbered.
Renumbered paragraphs 10.19 and 10.20	Revised to reflect the issuance of SOP 02-2; Footnotes * and 5 deleted; Subsequent footnotes redesignated and renumbered.
Paragraphs 10.22, 10.23, 10.24, and 10.26	Added to reflect the issuance of GASB Statement No. 34; Subsequent paragraphs further renumbered.
Renumbered paragraph 10.28	Revised to reflect the issuance of GASB Statement No. 34 and related pronouncements; Footnote 6 deleted; Subsequent footnote renumbered.
Paragraphs 10.29, 10.30, and 10.31	Added to reflect the issuance of GASB Statement No. 34 and related pronouncements; Subsequent paragraphs renumbered.
Chapter 11 (title)	Note deleted.
Paragraph 11.01	Deleted; Discussion of GASB Statement No. 14 transferred to paragraph 11.03 (a new section in the chapter entitled "Financial Reporting of Governmental Health Care Entities"); Footnotes * and ** deleted; Subsequent paragraphs and footnotes renumbered.
Paragraph 11.03 and heading	Added; Discussion of GASB Statement No. 14 transferred from former paragraph 11.01 and revised to reflect the issuance of GASB Statement No. 39.

Reference	Change
Paragraph 11.04 (heading)	Added "Financial Reporting of Nongovernmental Health Care Entities;" Footnote * from paragraph 11.05 moved to the new heading and revised to reflect the issuance of FASB Interpretation No. 46 and FASB Interpretation No. 46 (revised December 2003).
Paragraph 11.05 (heading)	Deleted; Footnote * moved to new heading at paragraph 11.04.
Paragraphs 11.07 and 11.08 (footnote 2)	Revised to reflect the issuance of FASB Interpretation No. 46 and FASB Interpretation No. 46 (revised December 2003).
Paragraph 11.10	Footnote 5 revised to clarify guidance; Footnote † added to reflect the release of AcSEC exposure draft; Subsequent footnotes redesignated.
Paragraph 11.14	Added to reflect the issuance of FASB Interpretation No. 46 and FASB Interpretation No. 46 (revised December 2003); Footnote ‡ added; Subsequent footnotes further redesignated; Subsequent paragraphs renumbered.
Renumbered paragraph 11.17 (footnote ‖)	Added to reflect the release of AcSEC exposure draft; Subsequent footnotes further redesignated.
Renumbered paragraph 11.20 (footnote 13)	Revised to reflect the issuance of GASB Statement No. 34 and add cross-reference to paragraphs 1.12 and 10.12.
Renumbered paragraph 11.37	Revised to reflect the issuance of FASB Interpretation No. 46 and FASB Interpretation No. 46 (revised December 2003); Footnote * added; Subsequent footnotes further redesignated.
Chapter 12 (title)	Note deleted.
Paragraph 12.01	Revised to reflect the issuance of the Audit and Accounting Guide *State and Local Governments;* Footnote * added to discuss proposed Audit Interpretations.
Paragraph 12.02	Added discussion of regulatory developments for registered public accounting firms and PCAOB Auditing Standard No. 1; Subsequent paragraphs renumbered.
Paragraphs 12.07, 12.08, and 12.09	Added to reflect the issuance of GASB Statement No. 34 and to discuss guidance in SAS No. 8, SAS No. 29, and SAS No. 52; Footnote 2 added to clarify guidance; Subsequent footnotes renumbered; Subsequent paragraphs further renumbered.
Renumbered paragraph 12.10	Revised to reflect the issuance of the Audit Guide Government Auditing Standards *and Circular A-133 Audits.*

Reference	Change
Paragraph 13.02	Revised to reflect the issuance of FASB Statement No. 146; Footnote * deleted; Footnote 1 added; Subsequent footnotes renumbered.
Paragraph 13.08 (footnote *)	Added to reflect the issuance of GASB Statement No. 42.
Appendix A	Introductory paragraphs revised to reflect the issuance of GASB pronouncements and EITF Issue No. 03-1; *Illustrative Financial Statements for Sample Not-for-Profit Hospital:* Revised to reflect the release of Technical Practice Aids 6400.36 through 6400.42, the issuance of FASB Statements No. 145, No. 132 (revised 2003), and FASB Staff Positions No. FAS 106-1 and No. FAS 106-2, and delete effective date information for SOP 01-6; *Illustrative Financial Statements for Sample Governmental Hospital Authority:* Replaced with Illustrative Management's Discussion and Analysis and Financial Statements from former Appendix F that have been revised to reflect the issuance of recent authoritative and proposed guidance; *Illustrative Financial Statements for Sample Ambulatory Care Organization:* Revised to reflect the issuance of FASB Interpretation No. 45, and delete effective date information for SOP 01-6. Illustrative financial statements for Sample For-Profit Nursing Home, Inc., Sample Not-for-Profit Continuing Care Retirement Community, Sample Not-for-Profit Home Health Agency, and Sample Not-for-Profit Health Maintenance Organization revised to delete effective date information for SOP 01-6.
Appendix F	Deleted (transferred Illustrative Management's Discussion and Analysis and Financial Statements to Appendix A); SOP 02-2 added.
Appendix G	Updated.

Glossary

acquisition costs. Marketing costs that are (*a*) directly related to the acquisition of specific subscriber contracts and member enrollment and (*b*) incremental to general marketing activities.

acute care. Inpatient general routine care provided to patients who are in a phase of illness that does not require the concentrated and continuous observation and treatment provided in intensive-care units.

advance fee. A payment required to be made by a continuing care retirement community (CCRC) resident prior to, or at the time of, admission to the CCRC for future services and the use of facilities specified in a contract that remains in effect for as long as the resident resides in the CCRC.

advance refunding. A transaction in which refunding debt is issued to pay the refunded debt at a specified future date(s), with the proceeds placed in trust or otherwise restricted to pay the refunded debt.

affiliate. A party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an enterprise (FASB Statement No. 57, *Related Party Disclosures*, paragraph 24(a))

agent. An entity that acts for and on behalf of another. A recipient organization acts as an agent for and on behalf of a donor if it receives 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 a specified beneficiary. A recipient organization acts as an agent for and on behalf of a beneficiary if it agrees to solicit assets from potential donors specifically for the beneficiary's use and to distribute those assets to the beneficiary. A recipient organization also acts as an agent if a beneficiary can compel the organization to make distributions on its behalf. (FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, paragraph 10)

allocated loss adjustment expense (ALAE). Claim expense that can be assigned to individual claims (for example, attorney's fees, claim adjusting service fees, or court costs).

ambulatory care organization. A partnership, association, corporation, or other legal entity organized to deliver health care services to patients that come or are brought to a health care facility for a purpose other than admission as an inpatient (for example, emergency room services, clinic services, or outpatient surgery).

ancillary services. Services performed for diagnostic or therapeutic purposes. Ancillary services generally are those special services for which charges in addition to routine charges customarily are made (for example, laboratory, radiology, surgical, or other services).

anticipated revenues. Amounts including third-party payments (for example, those from Blue Cross), contractually or statutorily committed investment income from sources related to the activities of a continuing care retirement community (CCRC), contributions pledged by donors to support CCRC activities, periodic fees expected to be collected, or the balance of deferred nonrefundable advance fees.

asserted claim. A claim made against a health care organization by or on behalf of a patient alleging improper professional service.

assets limited as to use. Assets that are segregated and limited either by the Board or management (for example, designated for expenditure in the acquisition of property and equipment or for the liquidation of long-term debt) or by outside third parties other than a donor or grantor (for example, funds under bond agreements or malpractice arrangements) as to how the assets may be used.

associated entity. An individual practice association, hospital, medical group, or similar health care organization that contracts with a prepaid health care provider to provide health care services.

bad-debt expense. The current period charge for actual or expected doubtful accounts resulting from the extension of credit.

capitation fee. A fixed amount per individual that is paid periodically (usually monthly) to a provider as compensation for providing comprehensive health care services for the period. The fee is set by contract between a prepaid health care plan and the provider. These contracts are generally with medical groups, independent practice associations (IPAs), hospitals, and other similar providers. Capitation fees may be determined actuarially or negotiated based on expected costs to be incurred.

charity care. Health care services that never were expected to result in cash inflows. Charity care results from a provider's policy to provide health care services free of charge to individuals who meet certain financial criteria.

claims-made insurance policy. A policy that covers only malpractice claims reported to the insurance carrier during the policy term, regardless of the date of the incident giving rise to the claim.

clinic. A freestanding facility or part of another health care organization used for diagnosis and treatment of outpatients.

commercial paper. Short-term, unsecured promissory notes that represent a flexible and low-cost form of short-term financing. Taxable commercial paper is sold on a discount basis, rather than on an interest-bearing basis, with the discount determined by the maturity of the notes, the creditworthiness of the issuer or its credit support, and general market demand. The primary risk is the variable interest rate exposure. Issuance often requires some form of credit enhancement or liquidity support.

comprehensive medical plan (CMP). A health plan option that may be available to Medicare beneficiaries and provides a more limited range of services than health maintenance organizations but includes physician services, laboratory, radiology, emergency, preventive, and inpatient services. A CMP assumes the financial risk for the provision of services and for out-of-area coverage.

conditional promise to give. A promise to give that depends on the occurrence of a specified future or uncertain event to bind the promisor.

continuing-care contract. An agreement between a resident and a CCRC specifying the services and facilities to be provided by the CCRC to a resident over an established period of time (usually the remaining life of the resident).

continuing care retirement community (CCRC). A legal entity sponsoring or guaranteeing residential facilities, meals, and health care services for a community of retired persons who may reside in apartments, other living units, or in some cases a nursing center. (Also referred to as a residential care facility or a life-care retirement community.)

contract period. The period (typically one year) for which premium rates are fixed by contract.

contractual adjustments. The differences between revenue at established rates and the amounts realizable from third-party payors under contractual agreements.

contribution. An unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner.

costs of acquiring initial continuing-care contracts. Costs incurred to originate a contract that result from and are essential to the acquisition of the initial contracts and are incurred through the date of substantial occupancy but no later than one year from the date of completion of construction.

These costs include—

- The costs of processing the contract, such as evaluating the prospective resident's financial condition; evaluating and recording guarantees, collateral, and other security arrangements; negotiating contract terms; preparing and processing contract documents; and closing the transaction.
- The costs from activities in connection with soliciting potential initial residents (such as model units and their furnishings, sales brochures, semipermanent signs, tours, grand openings, and sales salaries). These costs do not include advertising, interest, administrative costs, rent, depreciation, or any other occupancy or equipment costs.
- The portion of an employee's compensation and benefits that relates to the initial contract acquisitions.

courtesy and policy discounts. The differences between revenue recorded at established rates and amounts realizable for services provided to specific individuals such as employees, medical staff, and clergy.

credibility. A measure of the statistical significance of a provider's own data, dependent on its stability and volume in relation to the stability and volume of the industry data. Actuaries use credibility to blend an estimate from a provider's own experience with a broader estimate based on the experience of similar institutions. A provider's own experience may be assigned a credibility weight less than 100 percent due to year-to-year volatility. Such volatility is often a function of the size of the provider. Large providers generally have less volatility than small providers. In such an instance, a broader and more stable body of experience of similar providers would be used to supplement the specific provider's experience.

credit enhancement. Typically, a bank letter of credit that guarantees investors will receive principal and interest in the event of an issuer default. A line of credit provides liquidity support to an issuer but does not provide a guarantee of the repayment of principal and interest in the event of issuer default. The liquidity support provides a loan to issuers in the event the issuer is unable to place large amounts of maturing commercial paper with investors.

crossover refunding (also called a *delayed defeasance*). A type of advance refunding in which the old debt is not immediately replaced. The proceeds from the new debt, additional cash deposits (if any), and the income earned on the related investments are sufficient to pay the principal and any call premium of the old debt and the interest on the new debt until the date of crossover. Until the crossover, the proceeds from the new debt serve as collateral for that debt. The old debt is serviced by the entity until the date of crossover, at which time the proceeds from the new debt are used to retire the old debt and the entity becomes obligated to service the new debt. The old debt remains as a liability on the issuer's books until the crossover, when it is called in accordance with the call provisions of its indenture.

deductions from revenue. Reductions in gross revenue arising from contractual adjustments, courtesy and policy discounts, or other adjustments and deductions.

defeasance. Legal satisfaction of refunded debt without the debt necessarily being retired.

development factor. A computed factor used to project future changes in estimated losses from the date of the occurrence of the incident to the date-of-claim payment resulting from inflation, claimed cost growth, industry trends, and court awards. The development factor can be applied to incurred losses, paid losses, claim counts, and average values.

diagnosis-related group (DRG). A patient classification scheme that categorizes patients who are related medically with respect to primary and secondary diagnosis, age, or complications.

donor-imposed condition. A donor stipulation that specifies a future and uncertain event whose occurrence or failure to occur gives the promisor a right of return of the assets it has transferred or releases the promisor from its obligation to transfer its assets.

donor-imposed restriction. A donor stipulation that specifies the use for a contributed asset that is more specific than broad limits resulting from the nature of the organization, the environment in which it operates, and the purposes specified in its articles of incorporation or bylaws of comparable documents for an unincorporated association. A restriction on an organization's use of the asset contributed may be temporary or permanent.

endowment fund. An established fund of cash, securities, or other assets used to provide income for the maintenance of a not-for-profit organization. The use of the assets of the fund may be permanently restricted, temporarily restricted, or unrestricted. Endowment funds generally are established by donor-restricted gifts and bequests to provide a permanent endowment (to provide a permanent source of income) or a term endowment (to provide income for a specific period). The principal of a permanent endowment must be maintained permanently, that is, not used up, expended, or otherwise exhausted—and is classified as permanently restricted net assets. The principal of a term endowment must be maintained for a specified term and is classified as temporarily restricted net assets. An organization's governing board may earmark a portion of its unrestricted net assets as a board-designated endowment (sometimes called *funds functioning as endowment* or *quasi-endowment funds*) to be invested to provide income for a long but unspecified period. The principal of a board-designated endowment, which results from an internal designation, is not donor restricted and is classified as unrestricted net assets.

enrollee. An individual who is a subscriber or an eligible dependent of a subscriber in a prepaid health care plan.

estimated costs of future services. Amounts that are expected to be incurred to provide services and the use of facilities to individuals over their remaining lives under continuing-care contracts. Examples include resident care, dietary, health care, facility, general and administrative, interest, depreciation, and amortization costs.

exposure. The amount of potential claim risk. The basis for reflecting differences in the claim potential among providers' bases for charging insurance premiums or allocating member contributions to a captive. Exposure bases for hospital professional liability include number of occupied beds, outpatient visits, emergency room visits, and number of residents by specialty.

floating rate note (FRN). A debt instrument that allows issuers to borrow at a floating short-term rate with a long-term stated maturity without some of the risks traditionally associated with commercial paper. The investor is subject to principal risk to the degree the issuer's credit deteriorates or investor demand for FRNs decreases. Most health care issuers of FRNs require credit enhancement and a bank liquidity facility in conjunction with an FRN program.

functional classification. A method of grouping expenses according to the purpose for which costs are incurred. The primary functional classifications are program services and supporting activities.

fund. A self-contained accounting entity set up to account for a specific activity or project.

gross service revenues. All revenues from the provision of health care services excluding charity care.

health care services. Services provided to individuals related to the diagnosis or treatment of physical or mental illness.

health maintenance organization (HMO). A generic group of medical care entities organized to provide defined health care services to members in return for fixed, periodic premiums (usually paid monthly) that are paid in advance.

home health agency. An agency organized to provide health and supportive services in a person's home. These services may include nursing, nutritional, and therapeutic aid (such as physical therapy and dialysis) and the rental, as well as sale of medical equipment.

increased limit factor. The relationship between losses limited to a per-occurrence limit at which the provider's own experience is meaningful to losses limited to the provider's total retained limit per occurrence.

incremental costs. Costs that vary with and are directly attributable to changes in business, such as an additional employer or HMO contract. Fixed costs such as building depreciation or general overhead that do not change with the addition or loss of a contract are not incremental costs.

incurred but not reported (IBNR) costs. Costs associated with health care services incurred during a financial reporting period but not reported to the health care organization until after the financial reporting date.

indenture. An agreement between two or more persons specifying the reciprocal rights and duties of the parties under a contract (such as a lease, mortgage, or contract between bondholders and the issuer of the bond).

individual practice association (IPA). A partnership, association, corporation, or other legal entity organized to provide or arrange for the delivery of health care services to members of a prepaid health care plan and nonmember patients. In return, the IPA receives either a capitation fee or a specified fee for services rendered.

inpatient. Under most circumstances, a patient who is provided with room, board, and general nursing service and is expected to remain in the health care facility at least overnight and occupy a bed.

in-substance defeasance. A form of advance refunding in which the debtor places into an irrevocable trust an amount of assets estimated to be sufficient to satisfy all future principal and interest payments of a specific obligation. In such cases, the debt is not considered extinguished because the debtor is not legally released from being the primary obligor.

integrated delivery system. A provider or group of providers that is organized to deliver and finance acute and preventive health care services. An integrated delivery system generally will provide (or arrange to provide) a complete continuum of health care services (inpatient acute care, ambulatory care, outpatient surgery, home health care, including long-term care) to an enrolled population, generally for fixed prepaid fees called premiums.

interest rate swaps. An agreement to exchange interest payments without actually exchanging the underlying principal. The two parties each agree to make interest payments based on the calculation formula for the other's debt. Swaps can be used for a variety of purposes, such as to reduce the overall cost of borrowing, lock in forward rates, reduce interest rate risk, or adjust the ratio of variable and fixed-rate debt liabilities. Interest rate swaps do not change the amount or type of debt outstanding, but they do affect the issuer's debt portfolio and risk profile.

intermediary. An entity that acts as a facilitator for the transfer of assets between a potential donor and a potential beneficiary (donee) but is neither an agent or trustee nor a donee and donor as contemplated by FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*. (*FASB Statement No. 136, Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, paragraph 8)

intermediate care facility (ICF). A facility that provides care to individuals whose mental or physical conditions require services that are above the level of room and board and that can be made available only through institutional facilities. The care provided at an ICF does not require hospitals or skilled nursing facilities.

maintenance costs. Costs associated with maintaining enrollment records and processing premium collections and payments.

margin for risk of adverse deviation. Actuarially determined estimate of the additional funding requirement to obtain a specific confidence level that losses will not exceed the amount paid into the self-insurance fund. Margins are determined using statistical simulation techniques.

medical group. An association of physicians and other licensed health care professionals organized on a group basis to practice medicine.

medium-term notes. An intermediate-term security offered on a continuous basis providing flexibility for an issuer to vary the amount of outstanding notes as its funding requirements change. The broad range of possible maturities enables an issuer to borrow at the most attractive yield at the time of each issuance. They can be issued domestically or abroad.

member. An individual who is enrolled as a subscriber or as an eligible dependent of a subscriber in a prepaid health care plan.

multiprovider captive. An insurance company owned by two or more health care organizations that underwrites malpractice insurance for its owners.

natural classification. A method of classifying expenditures according to the nature of the expense such as salaries and wages, employee benefits, supplies, and purchased services.

net advance refunding. A type of advance refunding in which the proceeds from the new debt, additional cash deposits (if any) and the income earned on the related investments are sufficient to pay the interest, principal, and call premium on the old debt. After the advance refunding, the old debt is serviced by the investments in trust and the new debt is serviced by the entity.

net service revenue. Gross service revenue less provisions for contractual adjustments with third-party payors.

nonexchange transaction. An external transaction in which a government gives (or receives) value without directly receiving (or giving) equal value in exchange.

nonfinancial assets. Nonmonetary assets such as inventories or property, plant, and equipment.

not-for-profit organization. An entity that possesses the following characteristics that distinguish it from a business enterprise: (*a*) contributions of significant amounts of resources from resource providers that do not expect commensurate or proportionate pecuniary return, (*b*) operating purposes other than to provide goods or services at a profit, and (*c*) absence of ownership interests like those of business enterprises. Not-for-profit organizations possess these characteristics in varying degrees.

nursing center. A facility that provides nursing care to residents with a variety of needs or medical conditions. A nursing center may be a component of a continuing care retirement community. (Also called a health center, skilled-nursing facility, intermediate-care facility, continuing-care facility, or basic-care home.)

occurrence-basis policy. A policy that covers claims resulting from incidents that occur during the policy term, regardless of when the claims are reported to the insurance carrier.

outliers. In referring to the Medicare Prospective Payment System, additional payments that are made for cases that either have unusually long lengths of stay or have charges in excess of the cost outlier threshold.

outpatient. A patient who is not confined overnight in a health care institution.

peer review organization (PRO). Under federal statutory provision, PROs are required in each state to monitor hospital activity under the prospective payment system. Each hospital must contract with a PRO, which will review (*a*) the validity of diagnostic information, which establishes the diagnosis-related group; (*b*) the appropriateness of admissions; (*c*) the appropriateness of care to outliers; and (*d*) the adequacy of care provided.

periodic fees. Amounts paid to a continuing care retirement community by a resident at periodic intervals for continuing-care services. Such fees may be fixed or adjustable. (Also called *maintenance fees* or *monthly fees*.)

periodic interim payment (PIP). A plan under which the health care organization receives cash payments from a third-party payor (usually Medicare) in constant amounts periodically.

permanent restriction. A donor-imposed restriction that stipulates that resources be maintained permanently but permits the organization to use up or expend part or all of the income (or other economic benefits) derived from the donated assets.

permanently restricted net assets. The part of the net assets of a not-for-profit organization resulting from (*a*) contributions and other inflows of assets whose use by the organization is limited by donor-imposed stipulations that neither expire by the passage of time nor can be fulfilled or otherwise removed by the actions of the organization, (*b*) other asset enhancements and diminishments subject to the same kind of stipulations, and (*c*) reclassification from (or to) other classes of net assets as a consequence of donor-imposed stipulations.

premium. The consideration paid for providing contract coverage. (Also called a *subscriber fee.*)

premium period. The period to which a premium payment applies (generally one month) that entitles a member to health care services according to the contract provisions.

prepaid health care plan. A plan in which the provider is compensated in advance by the sponsoring organization. The sponsoring organization pays or compensates the provider based on either a fixed sum or a per-enrollee amount. Prepaid health care plans include health maintenance organizations, preferred provider organizations, eye care plans, dental care plans, and similar plans. Under such plans, the financial risk of delivering the health care is transferred to the provider of services.

prepaid health care services. Any form of health care service provided to a member in exchange for a scheduled payment (or payments) established before care is provided, regardless of the level of service subsequently provided.

prevailing charge. A charge that falls within the range of charges most frequently used in a locality for a particular service or procedure.

primary care. Care that is rendered in an ambulatory fashion, such as in an emergency room, an outpatient clinic, or other outpatient department.

prospective payment system (PPS). Medicare payment made at a predetermined, specific rate for each Medicare discharge, based on the patient's diagnosis. Each discharge is classified according to a series of diagnosis-related groups. (See also *diagnosis-related group.*)

provider. A person or entity that undertakes to provide health care services.

providers of prepaid health care services (prepaid health care providers). Organizations that provide or arrange for the delivery of health care services in accordance with the terms and provisions of a prepaid health care plan. Providers assume the financial risk of the cost of delivering health care services in excess of preestablished fixed premiums. However, some or all of the financial risk may be contractually transferred to other providers (affiliated entities) or by purchasing stop-loss insurance. Other providers of prepaid health care services may include comprehensive medical plans, physicians groups (for example, independent practice associations), and hospitals.

refundable advance fees. The portion of an advance fee that is payable to a resident of a continuing care retirement community or the resident's estate.

refunded debt. Debt for which payment at a specified future date has been provided by the issuance of refunding debt.

refunding debt. Debt issued to provide funds to pay for refunded debt at a specified future date.

reported incident. An occurrence identified by a health care organization as one in which improper professional service may be alleged at a future time that would result in a malpractice claim.

retrospectively rated insurance policy. An insurance policy with a premium that is adjustable based on the experience of the insured health care organization or group of health care organizations during the policy term.

risk contract. A contract between a provider of health care services and a prepaid health care plan that exposes the provider to the uncertainty of financial gain or loss by obligating the provider to provide specified health care services to enrollees of the plan for a negotiated price, which may be an amount per case, service, or day. The price may vary based on the volume of services furnished during the contract period.

secondary care. Care that is rendered to inpatients in hospitals that offer short-term, acute-care services of either a general or a specialized nature.

self-insurance. That portion of risk or loss assumed by a health care organization. There is no external insurance coverage.

skilled nursing facilities (SNF). These facilities provide services on a daily, inpatient basis. The services provided by an SNF are ordered by a physician and require the skilled services of technical or professional personnel.

stop-loss (or reinsurance) insurance. A contract in which a company agrees to indemnify providers for certain health care costs incurred by members.

subscriber. The person who is responsible for the payment of premiums or whose employment is the basis for eligibility for membership in a prepaid health care plan.

tail coverage. Insurance designed to cover malpractice claims incurred before, but reported after, cancellation or expiration of a claims-made insurance policy.

taxable variable rate demand notes. Issuers may call the notes on any monthly interest payment date, which provides issuers the opportunity to refinance short-term obligations with long-term bonds if market conditions make this alternative attractive.

temporarily restricted net assets. The part of the net assets of a not-for-profit organization resulting (*a*) from contributions and other inflows of assets whose use by the organization is limited by donor-imposed stipulations that either expire with the passage of time or can be fulfilled and removed by actions of the organization pursuant to those stipulations, (*b*) from other asset enhancements and diminishments subject to the same kinds of stipulations, or (*c*) from reclassification to (or from) other classes of net assets as a consequence of donor-imposed stipulations, their expiration by passage of time, or their fulfillment and removal by actions of the organization pursuant to those stipulations.

tertiary care. Care that is rendered in hospitals that possess the personnel, equipment, and expertise to handle complex cases.

third-party payor. Any agency (such as Blue Cross, Medicare, or commercial insurance companies) that contracts with health care organizations and patients to pay for the care of covered patients.

trend factor. A factor used in actuarial methodology to adjust ultimate losses from historical experience periods to the loss cost levels of the projection period, due to the impact of economic, jurisdictional, and social changes affecting hospital professional liability loss costs.

trust fund. A fund established with an outside entity to be used for a specific purpose, such as to pay malpractice claims and related expenses as they arise.

trustee. An entity that has a duty to hold and manage assets for the benefit of a specified beneficiary in accordance with a charitable trust agreement. (FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, paragraph 9)

ultimate cost. Total claims payments, including costs associated with litigating or setting claims.

unasserted claim. A medical malpractice claim that has not been asserted formally against a health care provider by or on behalf of a patient alleging improper professional service. It may relate to either reported incidents or to unreported incidents.

unreported incident. An occurrence in which improper professional service may have been administered by a health care provider, which may result in a malpractice claim of which the provider is not yet aware.

unrestricted net assets. The part of net assets of a not-for-profit organization that is neither permanently restricted nor temporarily restricted by donor-imposed stipulations.

voluntary health and welfare organizations. Organizations formed for the purpose of performing voluntary services for various segments of society. They are tax-exempt (organized for the benefit of the public), supported by the public, and operated on a not-for-profit basis. Most voluntary health and welfare organizations concentrate their efforts and expend their resources in an attempt to solve health and welfare problems of society and, in many cases, those of specific individuals. As a group, voluntary health and welfare organizations include not-for-profit organizations that derive their revenue primarily from voluntary contributions from the general public to be used for general or specific purposes connected with health, welfare, or community services.

wholly owned captive. An insurance company subsidiary of a health care organization that provides malpractice insurance primarily to its parent corporation.

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