



Audit and Accounting Guide

Health Care Entities

September 1, 2017

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Preface

Prepared by the Health Care Committee and the Health Care Audit Guide Task Force



(Updated as of September 1, 2017)

About AICPA Guides

This AICPA Guide has been developed by the AICPA Health Care Expert Panel and the AICPA Health Care Audit and Accounting Guide Overhaul Task Force to assist management in the preparation of their financial statements in conformity with U.S. generally accepted accounting principles (GAAP) and to assist auditors in performing and reporting on their audit engagements.

AICPA Guides may include certain content presented as "Supplement," "Appendix," or "Exhibit." A supplement is a reproduction, in whole or in part, of authoritative guidance originally issued by a standard setting body (including regulatory bodies) and applicable to entities or engagements within the purview of that standard setter, independent of the authoritative status of the applicable AICPA Guide. Both appendixes and exhibits are included for informational purposes and have no authoritative status.

The Financial Reporting Executive Committee (FinREC) is the designated senior committee of the AICPA authorized to speak for the AICPA in the areas of financial accounting and reporting. Conforming changes made to the financial accounting and reporting guidance contained in this guide are approved by the FinREC Chair (or his or her designee). Updates made to the financial accounting and reporting guidance in this guide exceeding that of conforming changes are approved by the affirmative vote of at least two-thirds of the members of FinREC.

This guide does the following:

- Identifies certain requirements set forth in FASB *Accounting Standards Codification*® (ASC) and GAAP for governmental entities.
- Describes FinREC's understanding of prevalent or sole industry practice concerning certain issues. In addition, this guide may indicate that FinREC expresses a preference for the prevalent or sole industry practice, or it may indicate that FinREC expresses a preference for another practice that is not the prevalent or sole industry practice; alternatively, FinREC may express no view on the matter.
- Identifies certain other, but not necessarily all, industry practices concerning certain accounting issues without expressing FinREC's views on them.
- Provides guidance that has been supported by FinREC on the accounting, reporting, or disclosure treatment of transactions or events that are not set forth in FASB ASC or GAAP for governmental entities.

Accounting guidance for nongovernmental entities included in an AICPA Guide is a source of nonauthoritative accounting guidance. As discussed later in this preface, FASB ASC is the authoritative source of U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the SEC.

Accounting guidance for governmental entities included in an AICPA Guide, and cleared by GASB, is a source of authoritative GAAP described in category B of the hierarchy of GAAP for state and local governmental entities as defined in GASB Statement No. 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*. The accounting provisions of this guide that have been cleared by GASB are **formatted in orange font** for the reader within the text of the guide and are noted in appendix F, "Category B Guidance." AICPA members should be prepared to justify departures from GAAP, as discussed in the "Accounting Principles Rule" (AICPA, *Professional Standards*, ET sec. 1.320.001 and 2.320.001).

Auditing guidance included in an AICPA Guide is recognized as an interpretive publication, as defined in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Interpretive publications are recommendations on the application of generally accepted auditing standards (GAAS) in specific circumstances, including engagements for entities in specialized industries.

Interpretive publications are issued under the authority of the AICPA Auditing Standards Board (ASB) after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with GAAS. The members of the ASB have found the auditing guidance in this guide to be consistent with existing GAAS.

Although interpretive publications are not auditing standards, AU-C section 200 requires the auditor to consider applicable interpretive publications in planning and performing the audit because interpretive publications are

relevant to the proper application of GAAS in specific circumstances. If the auditor does not apply the auditing guidance in an applicable interpretive publication, the auditor should document how the requirements of GAAS were complied with in the circumstances addressed by such auditing guidance.

The ASB is the designated senior committee of the AICPA authorized to speak for the AICPA on all matters related to auditing. Conforming changes made to the auditing guidance contained in this guide are approved by the ASB Chair (or his or her designee) and the Director of the AICPA Audit and Attest Standards Staff. Updates made to the auditing guidance in this guide exceeding that of conforming changes are issued after all ASB members have been provided an opportunity to consider and comment on whether the guide is consistent with the Statements on Auditing Standards (SASs).

Any auditing guidance in a guide appendix or chapter appendix in a guide, or in an exhibit, while not authoritative, is considered an "other auditing publication." In applying such guidance, the auditor should, exercising professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. Although the auditor determines the relevance of other auditing guidance, auditing guidance in a guide appendix or exhibit has been reviewed by the AICPA Audit and Attest Standards staff and the auditor may presume that it is appropriate.

An AICPA Guide containing attestation guidance is recognized as an interpretive publication as defined in AT-C section 105, *Concepts Common to All Attestation Engagements* (AICPA, *Professional Standards*). Interpretive publications are recommendations on the application of Statements on Standards for Attestation Engagements (SSAEs) in specific circumstances, including engagements for entities in specialized industries. Interpretive publications are issued under the authority of the ASB. The members of the ASB have found the attestation guidance in this guide to be consistent with existing SSAEs.

A practitioner should be aware of and consider the guidance in this AICPA Guide applicable to his or her attestation engagement. If the practitioner does not apply the attestation guidance included in an applicable AICPA Guide, the practitioner should be prepared to explain how he or she complied with the SSAE provisions addressed by such attestation guidance.

Any attestation guidance in a guide appendix or chapter appendix in a guide, or in an exhibit, while not authoritative, is considered an "other attestation publication." In applying such guidance, the practitioner should, exercising professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the engagement. Although the practitioner determines the relevance of other attestation guidance, such guidance in a guide appendix or exhibit has been reviewed by the AICPA Audit and Attest Standards staff and the practitioner may presume that it is appropriate.

The ASB is the designated senior committee of the AICPA authorized to speak for the AICPA on all matters related to attestation. Conforming changes made to the attestation guidance contained in this guide are approved by the ASB Chair (or his or her designee) and the Director of the AICPA Audit and Attest Standards Staff. Updates made to the attestation guidance in this guide exceeding that of conforming changes are issued after all ASB members have been provided an opportunity to consider and comment on whether the guide is consistent with the SSAEs.

Recognition

2017 Guide Edition

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The AICPA gratefully acknowledges those members of the AICPA Health Care Expert Panel who reviewed or otherwise contributed to the development of this edition of the guide: Nicole Blythe, Brian Conner, Martha Garner, John Gaspich, Renee Gravalin, Farlen Halikman, John Hawryluk, Chuck Heimerdinger, Laura Hyland, Norman Mosrie, Andy Mrakovcic, and Mark Ross.

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to the Health Care Expert Panel

Guidance Considered in This Edition

This edition of the guide has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative guidance since the guide was originally issued, and other revisions as deemed appropriate. Relevant guidance issued through September 1, 2017, has been considered in the development of this edition of the guide. However, this guide does not include all audit, accounting, reporting, regulatory, and other requirements applicable to an entity or a particular engagement. This guide is intended to be used in conjunction with all applicable sources of relevant guidance.

Relevant guidance that is issued and effective on or before September 1, 2017, is incorporated directly in the text of this guide. Relevant guidance issued but not yet effective as of September 1, 2017, but becoming effective on or before June 30, 2018, is also presented directly in the text of the guide, but shaded gray and accompanied by a footnote indicating the effective date of the new guidance. The distinct presentation of this content is intended to aid the reader in differentiating content that may not be effective for the reader's purposes (as part of the guide's "dual guidance" treatment of applicable new guidance).

Relevant guidance issued but not yet effective as of the date of the guide and not becoming effective until after June 30, 2018, is referenced in a "guidance update" box that contains summary information on the guidance issued but not yet effective.

In updating this guide, all guidance issued up to and including the following was considered, but not necessarily incorporated, as determined based on applicability:

- FASB Accounting Standards Update (ASU) No. 2017-11, *Earnings Per Share (Topic 260); Distinguishing Liabilities from Equity (Topic 480); Derivatives and Hedging (Topic 815): (Part I) Accounting for Certain Financial Instruments with Down Round Features, (Part II) Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception (a consensus of the Emerging Issues Task Force)*
- GASB statements, interpretations, and technical bulletins issued through September 1, 2017
- GASB Implementation Guidance Update No. 2017-2, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, issued April 2017
- SAS No. 133, *Auditor Involvement With Exempt Offering Documents*, (AICPA, *Professional Standards*, AU-C sec. 945)
- Interpretation No. 3, "Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and International Standards on Auditing" (AICPA, *Professional Standards*, AU-C sec. 9700 par. .08–.13), of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*
- SSAE No. 18, *Attestation Standards: Clarification and Recodification* (AICPA, *Professional Standards*)
- Interpretation No. 1, "Third-Party Due Diligence Services Related to Asset-Backed Securitizations: SEC Release No. 34-72936" (AICPA, *Professional Standards*, AT-C sec. 9215 par. .01–.18), of AT-C section 215, *Agreed-Upon Procedures Engagements*
- PCAOB Staff Guidance, *Staff Guidance—Form AP, Auditor Reporting of Certain Audit Participants and Related Voluntary Audit Report Disclosure Under AS 3101, Reports on Audited Financial Statements (January 26, 2017)*

Users of this guide should consider guidance issued subsequent to those items listed previously to determine their effect on entities covered by this guide. In determining the applicability of recently issued guidance, its effective date should also be considered.

The changes made to this edition of the guide are identified in appendix I, "Schedule of Changes Made to the Text From the Previous Edition." The changes do not include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

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Auditors who perform audits under *Government Auditing Standards*; the Single Audit Act Amendments of 1996; and Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance, effective for audits of fiscal years ending on or after December 25, 2015), should also refer to the AICPA Audit Guide *Government Auditing Standards and Single Audits*.

FASB ASC Pending Content

Presentation of Pending Content in FASB ASC

Amendments to FASB ASC (issued in the form of ASUs) are initially incorporated into FASB ASC in "pending content" boxes, below the paragraphs being amended with links to the transition information. The pending content boxes are meant to provide users with information about how the guidance in a paragraph will change as a result of the new guidance.

Pending content applies to different entities at different times due to varying fiscal year-ends, and because certain guidance may be effective on different dates for public and nonpublic entities. As such, FASB maintains amended guidance in pending content boxes within FASB ASC until the "roll-off" date. Generally, the roll-off date is six months following the latest fiscal year end for which the original guidance being amended could still be applied.

Presentation of FASB ASC Pending Content in AICPA Guides

Amended FASB ASC guidance that is included in pending content boxes in FASB ASC on September 1, 2017, is referenced as "Pending Content" in this guide. Readers should be aware that "Pending Content" referenced in this guide will eventually be subjected to FASB's "roll-off" process and no longer be labeled as "Pending Content" in FASB ASC (as discussed in the previous paragraph).

Terms Used to Define Professional Requirements in This AICPA Guide

Any requirements described in this guide are normally referenced to the applicable standards or regulations from which they are derived. Generally the terms used in this guide describing the professional requirements of the referenced standard setter (for example, the ASB and GASB) are the same as those used in the applicable standards or regulations (for example, *must* or *should*). However, where the accounting requirements are derived from FASB ASC, this guide uses *should*, whereas FASB uses *shall*. In its resource document "About the Codification" that accompanies FASB ASC, FASB states that it considers the terms *should* and *shall* to be comparable terms and to represent the same concept—the requirement to apply a standard.

Readers should refer to the applicable standards and regulations for more information on the requirements imposed by the use of the various terms used

to define professional requirements in the context of the standards and regulations in which they appear.

Certain exceptions apply to these general rules, particularly in those circumstances where the guide describes prevailing and/or preferred industry practices for the application of a standard or regulation. In these circumstances, the applicable senior committee responsible for reviewing the guide's content believes the guidance contained herein is appropriate for the circumstances.

Applicability of Generally Accepted Auditing Standards and PCAOB Standards

Appendix A, "Council Resolution Designating Bodies to Promulgate Technical Standards," of the AICPA Code of Professional Conduct recognizes both the ASB and the PCAOB as standard setting bodies designated to promulgate auditing, attestation, and quality control standards. Paragraph .01 of the "Compliance With Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.310.001 and 2.310.001) requires an AICPA member who performs an audit to comply with the applicable standards.

Audits of the financial statements of those entities subject to the oversight authority of the PCAOB (that is, those audit reports within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended) are to be conducted in accordance with standards established by the PCAOB, a private sector, nonprofit corporation created by the Sarbanes-Oxley Act of 2002. The SEC has oversight authority over the PCAOB, including the approval of its rules, standards, and budget. In citing the auditing standards of the PCAOB, references generally use section numbers within the reorganized PCAOB auditing standards and not the original standard number, as appropriate.

Audits of the financial statements of those entities not subject to the oversight authority of the PCAOB (that is, those audit reports not within the PCAOB's jurisdiction as defined by the Sarbanes-Oxley Act of 2002, as amended)—hereinafter referred to as nonissuers¹—are to be conducted in accordance with GAAS as issued by the ASB, a senior committee of the AICPA. The ASB develops and issues standards in the form of SASs through a due process that includes deliberation in meetings open to the public, public exposure of proposed SASs, and a formal vote. The SASs and their related interpretations are codified in AICPA *Professional Standards*. In citing GAAS and their related interpretations, references generally use section numbers within the codification of currently effective SASs and not the original statement number, as appropriate.

The auditing content in this guide primarily discusses GAAS issued by the ASB and is applicable to audits of nonissuers. Users of this guide may find the tool developed by the PCAOB's Office of the Chief Auditor helpful in identifying comparable PCAOB Standards. The tool is available at <http://pcaobus.org/standards/auditing/pages/findanalogousstandards.aspx>.

Considerations for audits of entities in accordance with PCAOB standards may also be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Audits Performed in Accordance With PCAOB Standards*. PCAOB

¹ See the definition of the term *nonissuer* in the AU-C Glossary (AICPA, *Professional Standards*).

guidance included in an AICPA Guide has not been reviewed, approved, disapproved, or otherwise acted upon by the PCAOB and has no official or authoritative status.

Applicability of Quality Control Standards

QC section 10, *A Firm's System of Quality Control* (AICPA, *Professional Standards*), addresses a CPA firm's responsibilities for its system of quality control for its accounting and auditing practice. A system of quality control consists of policies that a firm establishes and maintains to provide it with reasonable assurance that the firm and its personnel comply with professional standards, as well as applicable legal and regulatory requirements. The policies also ensure reports issued by the firm are appropriate in the circumstances.

QC section 10 applies to all CPA firms with respect to engagements in their accounting and auditing practice. In paragraph .13 of QC section 10, an *accounting and auditing practice* is defined as "a practice that performs engagements covered by this section, which are audit, attestation, compilation, review, and any other services for which standards have been promulgated by the ASB or the AICPA Accounting and Review Services Committee under the "General Standards Rule" (AICPA, *Professional Standards*, ET sec.1.300.001) or the "Compliance With Standards Rule" of the AICPA Code of Professional Conduct. Although standards for other engagements may be promulgated by other AICPA technical committees, engagements performed in accordance with those standards are not encompassed in the definition of an *accounting and auditing practice*.

In addition to the provisions of QC section 10, readers should be aware of other sections within AICPA *Professional Standards* that address quality control considerations, including the following provisions that address engagement level quality control matters for various types of engagements that an accounting and auditing practice might perform:

- AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*)
- AT-C section 105
- AR-C section 60, *General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services* (AICPA, *Professional Standards*)

Because of the importance of engagement quality, this guide includes appendix A, "Overview of Statements on Quality Control Standards." This appendix summarizes key aspects of the quality control standard. This summarization should be read in conjunction with QC section 10, AU-C section 220, AT-C section 105, AR-C section 60, and the quality control standards issued by the PCAOB, as applicable.

Alternatives Within U.S. GAAP

The Private Company Council (PCC), established by the Financial Accounting Foundation's Board of Trustees in 2012, and FASB, working jointly, mutually agree on a set of criteria to decide whether and when alternatives within U.S. GAAP are warranted for private companies. Based on those criteria, the PCC

reviews and proposes alternatives within U.S. GAAP to address the needs of users of private company financial statements. These U.S. GAAP alternatives may be applied to those entities that are not public business entities, not-for-profits, or employee benefit plans.

The FASB ASC Master Glossary defines a *public business entity* as follows:

A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.

- a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
- b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
- c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
- d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
- e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

Considerations related to alternatives for private companies may be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Private Companies That Elect to Use Standards Issued by the FASB as a Consensus of the Private Company Council*.

Limitations and Relationships to Other Authoritative Literature

This guide does not discuss the application of all GAAP and GAAS that are relevant to the preparation and audit of financial statements of health care entities. The guide is directed primarily to those aspects of the preparation and

audit of health care entities' financial statements that may be unique to those entities or that are considered particularly significant to them.

This guide incorporates certain provisions of FASB ASC 954, *Health Care Entities*; FASB ASC 958, *Not-for-Profit Entities*; GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, as amended; and GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, as amended, as well as other authoritative accounting and auditing literature. Not all guidance included in that literature, however, is incorporated, repeated, or summarized in this guide. Accordingly, FASB ASC, GASB statements and interpretations, AICPA *Professional Standards*, and all authoritative guidance should be read in conjunction with this guide.

This guide is not the only industry-specific AICPA Guide that auditors should consider when performing an audit of a governmental health care entity. The AICPA Audit and Accounting Guide *State and Local Governments* includes governmental health care entities in its scope and specific provisions of that guide (as noted in that guide's appendix B) were cleared by GASB. Therefore, certain accounting and financial reporting guidance in that guide constitutes Category B of the hierarchy of GAAP for governmental health care entities. 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 as special-purpose governments engaged only in business-type activities² 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. However, the AICPA Audit and Accounting Guide *State and Local Governments* 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

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 may be component units of another governmental entity, or they may be other stand-alone governments (*component units* and *other stand-alone governments* are also defined in GASB Statement No. 14, as amended). 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

² GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, as amended, 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 in chapter 12, "Special-Purpose and State Governments," of the AICPA Audit and Accounting Guide *State and Local Governments*). Reporting guidance on separate reporting by individual enterprise funds of a government is provided in the AICPA Audit and Accounting Guide *State and Local Governments*.

³ See paragraphs 1.21 and 12.11–13 of the AICPA Audit and Accounting Guide *State and Local Governments*.

for enterprise funds. These financial statements are discussed further in chapter 15, "Unique Considerations of State and Local Government Health Care Entities," of this guide.

The Uniform Guidance sets forth audit requirements for health care entities expending federal awards that are nonfederal entities. Institutions covered by the Uniform Guidance include not-for-profit hospitals, public hospitals, institutions of higher education and their affiliated hospitals, voluntary health and welfare entities, and other community-based organizations.⁴ Auditors of health care entities who perform audits under *Government Auditing Standards*, the Single Audit Act Amendments of 1996, and the Uniform Guidance should also refer to the Audit Guide *Government Auditing Standards and Single Audits*. Note that federal agency implementation regulations for the Uniform Guidance are codified in Title 2 of the *Code of Federal Regulations* (CFR) except for Department of Health and Human Services, which are codified at Title 45 CFR Part 75.

AICPA.org Website

The AICPA encourages you to visit the website at aicpa.org and the Financial Reporting Center at www.aicpa.org/frc. The Financial Reporting Center supports members in the execution of high-quality financial reporting. Whether you are a financial statement preparer or a member in public practice, this center provides exclusive member-only resources for the entire financial reporting process, and provides timely and relevant news, guidance and examples supporting the financial reporting process. Another important focus of the Financial Reporting Center is keeping those in public practice up to date on issues pertaining to preparation, compilation, review, audit, attestation, assurance, and advisory engagements. Certain content on the AICPA's websites referenced in this guide may be restricted to AICPA members only.

Select Recent Developments Significant to This Guide

AICPA's Ethics Codification Project

The AICPA's Professional Ethics Executive Committee (PEEC) restructured and codified the AICPA Code of Professional Conduct (code) so that members and other users of the code can apply the rules and reach appropriate conclusions more easily and intuitively. This is referred to as the *AICPA Ethics Codification Project*.

Although PEEC believes it was able to maintain the substance of the existing AICPA ethics standards through this process and limited substantive changes to certain specific areas that were in need of revision, the numeric citations and titles of interpretations have all changed. In addition, the ethics rulings are no longer in a question and answer format but rather, have been drafted

⁴ The audit requirements of Title 45 U.S. *Code of Federal Regulations* (CFR) Part 75, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for HHS Awards*, are applicable for commercial organizations, including for-profit hospitals, that receive federal awards under Department of Health & Human Services programs. Generally, the organization has two options regarding audits: a financial-related audit of a particular award, in accordance with *Government Auditing Standards*, or an audit that meets the requirements of Subpart F of Part 75. See Title 45, *Public Welfare*, U.S. CFR Part 75.501(i) for further information.

as interpretations, incorporated into interpretations as examples, or deleted where deemed appropriate. For example,

- Rule 101, *Independence* [ET sec. 101 par. .01] is referred to as the "Independence Rule" [ET sec. 1.200.001] in the revised code.
- The content from the ethics ruling entitled "Financial Services Company Client has Custody of a Member's Assets" [ET sec. 191 par. .081–.082] is incorporated into the "Brokerage and Other Accounts" interpretation [ET sec. 1.255.020] found under the subtopic "Depository, Brokerage, and Other Accounts" [ET sec. 1.255] of the "Independence" topic [ET sec. 1.200].

The revised code was effective December 15, 2014 and is available at <http://pub.aicpa.org/codeofconduct/ethics.aspx>. References to the code have been updated in this guide.

To assist users in locating in the revised code content from the prior code, PEEC created a mapping document. The mapping document is available in Excel format in appendix D in the revised code.

FASB's Revenue Recognition

FASB ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, as amended, was issued by FASB to improve the financial reporting of revenue from contracts with customers and related costs and to align the reporting with International Financial Reporting Standards. FASB ASU No. 2014-09 provides a framework for revenue recognition and supersedes or amends several of the revenue recognition requirements in FASB ASC 605, *Revenue Recognition*, as well as guidance within the industry-specific topics, including FASB ASC 954, *Health Care Entities*, and FASB ASC 958, *Not-for-Profit Entities*. The standard applies to any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance or lease contracts).

The AICPA has formed 16 industry task forces to assist in developing a new guide on revenue recognition that will provide insights and illustrative examples on how to apply the new standards. Revenue recognition implementation issues identified by the Health Care Entities Revenue Recognition Task Force will be available at aicpa.org for informal comment, after review by FinREC. Readers are encouraged to submit comments to revrecomments@aicpa.org.

Appendix C, "The New Revenue Recognition Standard: FASB ASC 606," of this guide provides additional discussion of the new standards. The appendix is prepared for informational and reference purposes only. It has not been reviewed, approved, disapproved, or otherwise acted on by any senior committee of the AICPA and does not represent official positions or pronouncements of the AICPA.

FASB's Recognition and Measurement of Financial Assets and Financial Liabilities

FASB ASU No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, was issued by FASB in January 2016 to improve the financial reporting of financial assets and liabilities. For health care entities, FASB ASU No. 2016-01 makes the following changes:

- Expands the scope of the standards for equity investments to all equity securities and other ownership interests in an entity, including investments in partnerships, unincorporated joint ventures, and limited liability companies.
- For not-for-profit (NFP) health care entities, retains the requirement to report equity securities that have readily determinable fair values at fair value, except for those accounted for under the equity method of accounting or those that result in consolidation of the investee. The standards for those investments, however, will move from FASB ASC 958-320 to FASB ASC 958-321.
- For health care entities that are investor-owned entities, expands the use of fair value measures to all equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) with changes in fair value recognized in net income.
- Allows a health care entity to choose, on an investment-by-investment basis, to report an equity investment at its cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issue, provided that the equity investment (a) does not have a readily determinable fair value and (b) does not qualify for the practical expedient to estimate fair value using net asset value per share or its equivalent (in accordance with FASB ASC 820-10-35-59). The ASU requires additional disclosures about those investments.
- Requires the impairment of equity investments without readily determinable fair values to be assessed qualitatively at each reporting period. That impairment assessment will be similar to the qualitative assessment for long-lived assets, goodwill, and indefinite-lived intangible assets. Upon determining that impairment exists, an entity should calculate the fair value of that investment and recognize the impairment in change in net assets. The impairment is measured as the amount by which the carrying value exceeds the fair value of the investment.
- Eliminates the requirement for health care entities to disclose the fair value of financial instruments measured at amortized cost, unless the health care entity is a public business entity. Currently, that information is required of all public entities as well as non-public entities that have assets of \$100 million or more on the date of the financial statements, or that have derivative instruments.
- Eliminates the requirement for health care entities that are public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet. Requires health care entities that are public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes.
- Requires an investor-owned health care entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to

measure the liability at fair value in accordance with the fair value option for financial instruments.

- For NFP health care entities, modifies the requirements for the performance indicator so that that measure includes the changes in the fair values of equity securities and liabilities in the same manner as those changes are reflected in net income (included in the performance indicator) and other comprehensive income (excluded from the performance indicator) of investor-owned health care entities.
- Requires disclosure of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) either on the face of the statement of financial position or in the accompanying notes.
- Clarifies that a health care entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets.

The amendments are effective for public business entities for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is not permitted by public business entities; however, this FASB ASU provides for early application of certain specified amendments as of the beginning of the fiscal year of adoption.

For all other entities, including not-for-profit entities, the amendments in this update are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted by entities other than public business entities as of the fiscal years beginning after December 15, 2017, and interim periods within those fiscal years.

Because the amendments in FASB ASU No. 2016-01 cannot be adopted earlier than for fiscal years beginning after December 15, 2017, this guide will be updated for FASB ASU No. 2016-01 in a future edition. However, because FASB ASU No. 2016-01 allows entities that are not public business entities to elect not to disclose information about fair value of financial instruments measured at amortized cost (paragraphs 10-19 of FASB ASC 825-10-50) in financial statements that have not yet been made available for issuance, this guide no longer includes those disclosures.

FASB's Leases

FASB ASU No. 2016-02 issued February 2016, changes the accounting for leases, primarily by the recognition of lease assets and lease liabilities by lessees for leases classified as operating leases under current GAAP. A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and an asset representing its right to use the underlying asset for the lease term (the right-of-use asset). The right-of-use asset and the lease liability are initially measured at the present value of the lease payments.

Leases will continue to be classified as either operating or finance leases (currently referred to as capital leases). However, in contrast to existing lease standards, there are no percentage tests to apply, and there can be more judgment exercised in applying the criteria that determine whether a lease is a finance

lease. As a practical matter, most existing capital leases are finance leases and most existing operating leases remain operating leases. For finance leases, a lessee is required to recognize interest on the lease liability separately from amortization of the right-of-use asset. For operating leases, a lessee is required to recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term on a generally straight-line basis.

For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and lease liabilities. If a lessee makes this election, it should recognize lease expense for such leases generally on a straight-line basis over the lease term.

The accounting applied by a lessor is largely unchanged from that applied under existing GAAP. Lessors will account for leases using an approach that is substantially equivalent to existing standards for sales-type leases, direct financing leases and operating leases. Leveraged lease accounting is eliminated, except for grandfathering existing leveraged leases during transition.

FASB ASU No. 2016-02 is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, for NFPs that have issued, or are conduit bond obligors for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market. For all other NFPs, the amendments in this ASU are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted.

FASB's Project on Financial Statements of NFPs

On August 18, 2016, the FASB issued FASB ASU No. 2016-14, *Presentation of Financial Statements for Not-for-Profit Entities (Topic 958)*. The new standards are effective for annual financial statements issued for fiscal years beginning after December 15, 2017 (for example, years ending December 31, 2018 and years ending June 30, 2019). Early application of the amendments in the ASU is permitted. The ASU, which is the first phase of a two-phase project, makes significant changes in seven areas:

- Net asset classes
- Liquidity and availability of resources
- Classification and disclosure of underwater endowment funds
- Expense reporting
- Statement of cash flows
- Investment return
- Release of restrictions on capital assets

Appendix H, "The New Not-for-Profit Financial Reporting Model Standards: FASB ASU No. 2016-14," of this guide provides additional discussion of the new standards. The appendix is prepared for informational and reference purposes only. It has not been reviewed, approved, disapproved, or otherwise acted on by any senior committee of the AICPA and does not represent official positions or pronouncements of the AICPA.

The second phase of the project is expected to address the following issues:

- Whether to require a measure of operations
- Whether and how to define a measure of operations

- Realignment of certain items in the statement of cash flows to better align operating cash flows with an operating measure on the statement of activities
- An alternative of segment reporting for NFP health care entities in lieu of an analysis of expenses by both natural and functional classification

FASB's Project on Revenue Recognition of Grants and Contracts by NFPs

In August 2017, FASB issued a proposed ASU, *Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made*, to improve the scope and the accounting guidance for contributions received and contributions made as it relates revenue recognition of grants and contracts by NFPs. For more information, see www.fasb.org.

SAS No. 133

In July 2017, the ASB issued SAS No. 133, which clarifies auditors' responsibilities related to offerings of securities exempt from registration under the Securities Act of 1933 and franchise offerings (collectively, exempt offerings). SAS No. 133 will be effective for exempt offering documents with which the auditor is involved that are initially distributed, circulated, or submitted on or after June 15, 2018. This SAS is included in the auditing section of Chapter 7 as gray shaded text, which is used to identify guidance issued but not yet effective as of the date of this guide, September 1, 2017, but becoming effective on or prior to June 30, 2018.

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H The New Not-for-Profit Financial Reporting Model Standards: FASB ASU No.
2016-14

I Schedule of Changes Made to the Text From the Previous Edition

Glossary

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Subject Index

Chapter 1

Overview and Unique Considerations of Health Care Entities

Purpose

1.01 This guide has been prepared to assist health care entities in preparing financial statements in accordance with generally accepted accounting principles in the United States of America and to assist independent auditors in auditing and reporting on those financial statements. This guide focuses on accounting and auditing issues that are pervasive in, or unique to, health care entities.

Applicability

1.02 This guide applies to the following types of health care entities:

- Investor-owned businesses, both public business entities and private companies. Refer to the preface for further explanation of public business entities and private companies.
- Not-for-profit (NFP) business-oriented entities that have no ownership interest and are essentially self-sustaining from fees charged for goods and services (the term *not-for-profit entity* is used as defined in the FASB *Accounting Standards Codification* [ASC] Master Glossary).
- Governmental entities. See paragraph 1.08 and chapter 15, "Unique Considerations of State and Local Government Health Care Entities," of this guide for further discussion regarding governmental health care entities.

This guide applies to entities 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 entities whose primary activities are the planning, organization, and oversight of such entities, such as parent or holding companies of health care entities.

1.03 This guide does not apply to *voluntary health and welfare entities*, as defined in the FASB ASC Master Glossary. It also does not apply to NFPs that are fund-raising foundations, even if those foundations are included in the consolidated financial statements of a health care entity. Voluntary health and welfare entities and fund-raising foundations follow the AICPA Audit and Accounting Guide *Not-for-Profit Entities*, rather than this guide.

1.04 Thus, this guide applies to the following entities, among others:

- Clinics, medical group practices, individual practice associations, individual practitioners, emergency care providers, laboratories, surgery centers, imaging centers, and other ambulatory care organizations
- Continuing care retirement communities

- Drug and alcohol rehabilitation centers and other rehabilitation facilities
- Health maintenance organizations, or HMOs, and similar prepaid health care plans
- Home health agencies
- Hospice care providers
- Hospitals
- Institutional facilities that provide skilled nursing, intermediate, or less-intensive levels of health care
- Integrated health care delivery systems that include one or more of these entities
- Providers of durable medical equipment and related medical services

1.05 Some entities may have health care as a component of a larger, more diversified operation. For example, some senior independent living facilities are primarily real estate operations with a health care component. The Financial Reporting Executive Committee believes that to the extent such entities have unique transactions of the type covered by this guide, the recognition and measurement guidance of this guide would be applicable. Professional judgment should be exercised in determining the applicability of this guide to transactions entered into by such entities.

1.06 A health care entity may be part of another entity, such as a medical school or university, or a subsidiary of a corporation. The recommendations in this guide apply to the separate financial statements of the health care entity.

Classification of Health Care Entities

1.07 The nature of the entity and its operating structure have a significant effect on the needs of financial statement users. According to paragraph 8 of FASB Concepts Statement No. 4, *Objectives of Financial Reporting by Non-business Organizations*

[s]ome 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 Concepts Statement No. 1 may be more appropriate for those organizations.

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

- a. *Investor-owned health care entities.* According to FASB ASC 954-10-05-2, these entities are owned by investors or others with a private equity interest and provide goods or services with the objective of making a profit. They include public business entities and private

companies. Refer to the preface for further explanation of public business entities and private companies.

- b. *NFP business-oriented entities.* According to FASB ASC 954-10-05-2, these entities are characterized by no ownership interests and are essentially self-sustaining from fees charged for goods and services. The fees charged by such entities generally are intended to help the entity maintain its self-sustaining status, rather than maximize profits for the owner's benefit. Such entities 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.
- c. *Governmental health care entities.* **Public corporations¹ and bodies corporate and politic are governmental organizations. Other organizations are governmental if they have one or more of the following characteristics:**
 - i. Popular election of officers or appointment (or approval) of a controlling majority of the members of the entity's governing body by officials of one or more state or local governments;
 - ii. The potential for unilateral dissolution by a government, with the net assets reverting to a government; or
 - iii. The power to enact and enforce a tax levy.

Furthermore, organizations are presumed to be governmental if they have the ability to directly issue (rather than through a state or municipal authority) debt that pays interest that is 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. *NFP nonbusiness-oriented entities.* According to FASB ASC 954-10-15-3, these are *voluntary health and welfare entities*, as defined in the FASB ASC Master Glossary. Such entities are within the scope of FASB ASC 958, *Not-for-Profit Entities*. Additional accounting guidance may be obtained in the AICPA Audit and Accounting Guide *Not-for-Profit Entities*, rather than this guide, as discussed in paragraph 1.03.

Regulatory Environment

1.09 Health care entities operate in a highly regulated environment. These regulations affect the provider's operations, as well as certain estimates in the financial statements, such as patient service revenue, third-party payor

¹ *Black's Law Dictionary* defines a *public corporation* as: "An artificial person (for example, [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.

settlements, and general and professional liabilities. The Department of Health and Human Services (HHS) is the government's principal agency for protecting the health of all Americans and providing essential human services. The following are some of the more significant agencies operating under the HHS that impact health care entities:

- Administration for Community Living
- Centers for Medicare and Medicaid Services
- Food and Drug Administration
- Health Resources and Services Administration
- National Institutes of Health
- Office of Inspector General

1.10 Some other important agencies include the Civil and Criminal Divisions of the Department of Justice, each state's Office of the Attorney General, the Centers for Medicare & Medicaid Services, the IRS, the Drug Enforcement Administration, the Occupational Safety and Health Administration, the Food and Drug Administration, state insurance agencies or departments, and state and federal health benefit exchanges.

1.11 Some significant regulations affecting health care are the following:

- False Claims Act
- The antikickback statute of the Medicare and Medicaid Patient and Program Protection Act of 1987
- Stark I, II, and III
- Emergency Medical Treatment and Active Labor Act
- The Privacy Rule of the Health Insurance Portability and Accountability Act of 1996
- The State Children's Health Insurance Program of 1997
- The Medicare Prescription Drug Improvement and Modernization Act of 2003
- Health Information Technology for Economic and Clinical Health Act enacted as part of the American Recovery and Reinvestment Act of 2009
- Patient Protection and Affordable Care Act (ACA)
- Health Care and Education Reconciliation Act of 2010

Health Care Reform

1.12 In March 2010, Congress passed two pieces of legislation designed to reform the U.S. health care system. The ACA was enacted on March 23 and was quickly followed by the Health Care and Education Reconciliation Act of 2010, which amended several portions of the first act and added new provisions of its own. One of the goals of the legislation is to reform the health care delivery system to improve its quality while lowering its overall cost. In order to meet this goal, among other things, the ACA

- requires states to create health benefit exchanges, competitive marketplaces where individuals and small businesses can compare policies and premiums, and buy insurance (with a government subsidy if eligible).

- establishes state-based reinsurance and risk adjustment programs and a federal risk corridors program. The overall goal of these programs is to provide certainty and protect against adverse selection in the market while stabilizing premiums in the individual and small group markets as market reforms and health benefit exchanges began in 2014. Two of these programs—the risk corridor and reinsurance programs—ended in 2016 because they failed to collect enough money to cover payments owed.
- authorizes Center for Medicare and Medicaid Services to create the Medicare Shared Savings Program, which encourages accountable care organizations to facilitate cooperation among providers to improve the quality of care provided to Medicare beneficiaries and reduce unnecessary costs.
- adds new requirements for tax-exempt hospitals. To address these requirements for hospitals that want to qualify for tax exemption under IRC Section 501(c)(3), the IRS issued IRC Section 501(r) that provides requirements for charitable hospitals on a facility-by-facility basis. These four general requirements are to
 - establish written financial assistance and emergency medical care policies,
 - limit amounts charged for emergency or other medically necessary care to individuals eligible for assistance under the hospital's financial assistance policy,
 - make reasonable efforts to determine whether an individual is eligible for assistance under the hospital's financial assistance policy before engaging in extraordinary collection actions against the individual, and
 - conduct a community health needs assessment (CHNA) and adopt an implementation strategy at least once every three years. (These CHNA requirements are effective for tax years beginning after March 23, 2012).
- establishes other requirements, such as employer mandates, that will further affect provider reimbursement for the current uninsured population.

1.13 Health reform measures may affect the way health care entities deliver services to their patients and how they are compensated for those services. The AICPA has dedicated a section on its website to health care reform legislation and its implementation; see www.aicpa.org/research/hcr/pages/default.aspx.

1.14 President Donald Trump and the Republican leadership have promised to repeal and replace the ACA. During 2017, both the House of Representatives and the Senate introduced bills that would repeal many of its provisions, although no bill has passed both houses of Congress. Uncertainty about whether reform will take place and what it will look like if it does makes planning complicated for health care entities. This guide will be updated as further regulations are issued.

Chapter 2

General Auditing Considerations

Gray shaded text in this chapter reflects guidance issued but not yet effective as of the date of this guide, September 1, 2017, but becoming effective on or prior to June 30, 2018, exclusive of any option to early adopt ahead of the mandatory effective date. Unless otherwise indicated, all unshaded text reflects guidance that was already effective as of the date of this guide.

Overview

2.01 AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), addresses the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with generally accepted auditing standards (GAAS). Specifically, it sets out the overall objectives of the independent auditor (the auditor) and explains the nature and scope of an audit designed to enable the auditor to meet those objectives. It also explains the scope, authority, and structure of GAAS and includes requirements establishing the general responsibilities of the auditor applicable in all audits, including the obligation to comply with GAAS.

2.02 Paragraph .12 of AU-C section 200 states that the overall objectives of the auditor, in conducting an audit of financial statements, are to

- a. obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with an applicable financial reporting framework; and
- b. report on the financial statements, and communicate as required by GAAS, in accordance with the auditor's findings.

This section of the guide provides guidance to the auditors of health care entities primarily on the unique application of GAAS in health care entity audits.

An Audit of Financial Statements

2.03 Consistent with the guidance presented in paragraph .04 of AU-C section 200, the purpose of an audit of a health care entity's financial statements is to provide financial statement users with an opinion by the auditor on whether the financial statements are fairly presented, in all material respects, in accordance with an applicable financial reporting framework, which enhances the degree of confidence that intended users can place in the financial statements. An audit conducted in accordance with GAAS and relevant ethical requirements enables the auditor to form that opinion. As the basis for the auditor's opinion, paragraph .06 of AU-C section 200 states that GAAS require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high, but not absolute, level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence

to reduce *audit risk* (for purposes of GAAS, that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level.

2.04 Paragraphs .08 and .10 of AU-C section 200 state that GAAS contain objectives, requirements, and application and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. GAAS require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things,

- identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control.¹
- obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
- form an opinion on the financial statements, or determine that an opinion cannot be formed, based on an evaluation of the audit evidence obtained.

The auditor also may have certain other communication and reporting responsibilities to users, management, those charged with governance, or parties outside the entity, regarding matters arising from the audit. These responsibilities may be established by GAAS or by applicable law or regulation.

Audit Risk

2.05 Paragraph .A36 of AU-C section 200 explains that audit risk is a function of the risks of material misstatement and detection risk. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

2.06 Paragraphs .A38–.A40 of AU-C section 200 provide further explanation on the two levels of the risks of material misstatement. The risks of material misstatement exist at the overall financial statement level and the assertion level for classes of transactions, account balances, and disclosures. Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk.

2.07 Paragraph .05 of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), requires the auditor to perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and relevant assertion levels. Paragraph

¹ In May 2013, the Committee of Sponsoring Organizations of the Treadway Commission issued its updated *Internal Control–Integrated Framework* and related illustrative documents.

.A44 of AU-C section 200 explains that the assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages or in nonquantitative terms (for example, high, medium, or low).

2.08 Paragraphs .A41–.A44 and .A46–.A47 of AU-C section 200 provide further guidance on the two components of the risk of material misstatement (inherent risk and control risk) and characteristics of detection risk.

2.09 In many health care entities, assertions for certain significant accounts may have inherent risk assessed as relatively low. Such assertions typically have characteristics such as (a) a low volume of transactions, (b) transactions that are not complex, or (c) transactions that do not require the use of significant accounting estimates or other judgments. Examples of such relatively low risk assertions may include completeness and existence of inventories, valuation of certain marketable securities and assets whose use is limited, and completeness of long-term debt. However, assertions for certain other significant accounts may have higher inherent risk due to various factors such as (a) complex transactions, (b) transactions involving the use of significant accounting estimates or other judgments, or (c) transactions involving the use of experts. Examples of such higher risk assertions may include the valuation of patient accounts receivable, goodwill, certain marketable securities and derivative financial instruments, or the completeness and accuracy of medical malpractice, pension, or third-party settlement liabilities.

Terms of Engagement

2.10 The scope of services rendered by auditors generally depends on the types of reports to be issued as a result of the engagement. Paragraphs .09–.10 of AU-C section 210, *Terms of Engagement* (AICPA, *Professional Standards*), state that the auditor should agree upon the terms of the audit engagement with management or those charged with governance, as appropriate. The agreed-upon terms of the audit engagement should be documented in an audit engagement letter or other suitable form of agreement. Paragraph .10 of AU-C section 210 provides a listing of agreed-upon terms that should be included. As explained in paragraph .A22 of AU-C section 210, both management and the auditor have an interest in documenting the agreed-upon terms of the audit engagement before the commencement of the audit to help avoid misunderstandings with respect to the audit. In some cases, the auditor is engaged to perform an audit of internal control over financial reporting (ICFR) that is integrated with the audit of financial statements (integrated audit); if so, AU-C section 940, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements* (AICPA, *Professional Standards*), establishes requirements for and includes special considerations for performing an integrated audit.

Considerations for Audits Performed in Accordance With PCAOB Standards²

² The auditing content in this guide focuses primarily on generally accepted auditing standards issued by the Auditing Standards Board and is applicable to audits of nonissuers. These standards are codified in AICPA *Professional Standards* and referenced by "AU-C" section numbers within the codification. Considerations for audits of issuers in accordance with PCAOB standards may be discussed within this guide's chapter text. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Audits Performed in Accordance With PCAOB Standards*.

Paragraphs .05–.07 of PCAOB AS 1301, *Communications with Audit Committees* (AICPA, *PCAOB Standards and Related Rules*), includes requirements related to an auditor's understanding when performing an integrated audit of financial statements and internal control over financial reporting and requirements related to an audit of the financial statements in accordance with PCAOB standards.

PCAOB AS 2201, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*), and PCAOB Staff Audit Practice Alert No. 11, *Considerations for Audits of Internal Control Over Financial Reporting* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.11) establish requirements and provide direction that applies when an auditor is engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting ("the audit of internal control over financial reporting") that is integrated with an audit of the financial statements.

2.11 The auditor may consider certain health-care-specific matters in establishing the terms of engagement. For example, when auditing the financial statements of a hospital, with respect to third-party payment matters, language such as the following may be included if appropriate:

An audit conducted in accordance with auditing standards generally accepted in the United States of America does not include audit procedures specifically designed to detect noncompliance with laws and regulations that does not have a material effect on the financial statements (for example, noncompliance with fraud and abuse statutes that result in fines or penalties being imposed on the company). The auditors' procedures do not include testing compliance with laws and regulations in any jurisdiction related to Medicare and Medicaid antifraud and abuse. It is the responsibility of management of the company, with the oversight of those charged with governance, to ensure that the company's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provision of laws and regulations that determine the reported amounts and disclosures in the company's financial statements. Therefore, management's responsibilities for compliance with laws and regulations applicable to its operations, include, but are not limited to, those related to Medicare and Medicaid antifraud and abuse statutes.

With respect to cost reports that may be filed with a third party (such as federal and state regulatory agencies), the auditors have not been engaged to test in any way, or render any form of assurance on, the propriety or allowability of the specific costs to be claimed on, or charges to be reported in, a cost report. Management is responsible for the accuracy and propriety of all cost reports filed with Medicare, Medicaid, or other third parties.

The auditors have not been engaged to provide any services with respect to confirming the tax-exempt status of any outstanding bond issue, including testing in any way or rendering any form of assurance that the bonds are in compliance with the requirements as specified in the Internal Revenue Code (IRC) and regulations thereunder.

Management is responsible for monitoring the post-issuance compliance with these requirements.

2.12 In addition to reporting on the entity's basic financial statements, the independent auditor may be engaged to report on the following special reports: (a) cost reports for third-party payors;³ (b) cost reports related to research grants; (c) reports for local, state, or federal authorities; (d) reports related to bond indentures and other debt instruments; and (e) other special-purpose reports. The nature, timing, and extent of procedures to be performed and the type of reports to be issued are based on the scope of services required by the entity and applicable professional standards. AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*; AU-C section 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*; and AU-C section 806, *Reporting on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements* (AICPA, *Professional Standards*), and Statements on Standards for Attestation Engagements (AT-C sections in *AICPA Professional Standards*) are useful for these engagements.

2.13 The auditor may consider including a provision in the engagement letter requiring the client to obtain consent from the auditor before including the auditor's report in an official statement related to a bond offering. If the auditor and client agree not to include such a provision, the auditor considers including in the engagement letter a requirement that if the client issues any official statement, and the auditor is not associated with that statement, the client will include therein a comment that the auditor is not associated with the contents of such official statement. For example, the official statement might include a comment such as the following: "[Name of firm], our independent auditor, has not been engaged to perform and has not performed, since the date of its report included herein, any procedures on the financial statements addressed in that report. [Name of firm] also has not performed any procedures relating to this official statement."

Business Associate Agreements

2.14 The Privacy Standards of the Health Insurance Portability and Accountability Act of 1996 (HIPAA), as amended by the Health Information Technology for Economic and Clinical Health (HITECH) Act, require a covered entity to have written agreements with business associates in place. Many health care entities, including health care providers and payors and certain not-for-profit (NFP) and governmental entities, are considered covered entities under HIPAA. A *business associate* is a person or an entity who performs or assists in the performance of a function or an activity on behalf of a covered entity that involves access to, or use or disclosure of, protected health information (PHI). Independent auditors and advisory and tax professionals may be considered business associates. The HITECH Act also requires business associates to comply with the HIPAA Security Rule's administrative, technical, and physical safeguard requirements and to implement security policies and procedures

³ See Technical Questions and Answers section 9110.15, "Reporting on Medicaid/Medicare Cost Reports" (AICPA, *Technical Questions and Answers*), for additional guidance regarding auditor association with cost reports in certain jurisdictions.

in the same manner as a covered entity. This will require a business associate to implement written policies and procedures that address each Security Rule standard; implement a security awareness and training program for workforce members; designate a security official; and conduct an accurate and thorough security risk analysis, along with a security management process. Business associates are subject to potentially significant civil and criminal penalties for violation of data privacy and security rules governing the protection of PHI. Business associate agreements generally are an addendum to, or incorporated into, the audit engagement letter. Auditors may need to work with management to tailor the form of the business associate agreement, so that it is consistent with the requirements of the privacy regulations of HIPAA and the HITECH Act while recognizing the various rules and regulations applicable to CPAs.

Audit Planning

2.15 Auditors of health care entities should refer to auditing standards, including AU-C section 300, *Planning an Audit* (AICPA, *Professional Standards*), which addresses the auditor's responsibilities to plan an audit of financial statements. AU-C section 300 is written in the context of recurring audits. This section addresses planning considerations and other auditing considerations that are relevant to audits of health care entities.

2.16 Planning activities include performing preliminary engagement activities; establishing an overall audit strategy and communicating with those charged with governance an overview of the planned scope and timing of the audit; developing a detailed, documented audit plan; determining direction and supervision of engagement team members, and review of their work; and determining the extent of involvement of professionals with specialized skills. Industry-specific examples of these procedures include the following:

- Review the relationship of affiliated entities to the health care entity, and determine the extent to which their financial information will be included in the financial statements of the entity. See the related discussion in chapter 12, "The Reporting Entity and Related Entities," of this guide.
- Review the status of unsettled cost (reimbursement) reports for prior periods filed with third-party payors.
- Identify situations for which accounting estimates, such as third-party contractual allowances, allowances for doubtful accounts, and medical malpractice liabilities, are required and identify relevant factors that may affect those estimates.
- Review periodic reports from and to third-party payors or other regulatory bodies.
- Consider entity and industry-specific factors, including the organizational structure of the entity, when establishing materiality for the financial statements as a whole as well as performance materiality.
- Review relevant state or federal regulatory changes, including changes in reimbursement arrangements or mechanisms.

2.17 The independent auditor may find it helpful to maintain audit documentation that includes copies of the following documents specifically relating to the health care entity:

- Specific documents concerning restrictions on donor gifts and bequests
- Contracts and agreements, including leases, agreements with physicians, agreements with third-party payors, and agreements with affiliated entities
- Third-party correspondence related to cost report settlements, third-party audits such as Recovery Audit Contractor and Risk Assessment Data Validation audits and other significant correspondence from third-party payers
- Loan agreements, bond indentures, and other debt instruments
- IRS determination letter (for tax-exempt entities)

2.18 In accordance with paragraph .09 of AU-C section 300, the auditor should develop an audit plan that includes a description of the nature and extent of planned risk assessment procedures, as determined under AU-C section 315; the nature, timing and extent of planned further audit procedures at the relevant assertion level as determined under AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*); and other planned audit procedures that are required to be carried out so that the engagement complies with GAAS. Paragraph .A2 of AU-C section 300 explains that planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement.

Group Audits

2.19 Group audits involve an audit of financial statements that include the financial information of more than one component group (group financial statements). AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*), includes terms, concepts, and requirements related to group audit engagements.

2.20 The concept of group financial statements is broader than consolidated or combined financial statements as it encompasses business activities in addition to separate entities. Additionally, AU-C section 600 applies in all audits of group financial statements regardless of whether or not different auditors are involved in an audit. A *component* is defined as an entity or business activity for which group or component management prepares financial information that is required to be included in the group financial statements. A component may include, but is not limited to, subsidiaries, geographical locations, divisions, investments, products or services, functions, processes, or component units of state or local governments.

2.21 AU-C section 600 addresses special considerations that apply to group audits, in particular those that involve component auditors. Accordingly, a critical aspect of AU-C section 600 is the identification of the components that are included in group financial statements. The requirements in paragraphs .51–.65 of AU-C section 600 are applicable to all components except those for

which the auditor of the group financial statements is making reference to the work of a component auditor. All other requirements of AU-C section 600 apply regardless of whether or not the auditor of the group financial statements is assuming responsibility for the work of component auditors.

2.22 AU-C section 600 provides guidance for situations when the auditor of the group financial statements assumes responsibility for the work of a component auditor and when the auditor does not assume responsibility for the work of a component auditor (that is, the auditor makes reference to the audit of the component auditor in the auditor's report on the group financial statements). An audit of group financial statements involves establishing an overall group audit strategy and group audit plan (including identifying the components and the extent to which the group engagement team will use the work of component auditors). The decision regarding whether the auditor's report on the group financial statements will make reference to the audit of a component auditor should be made by the group engagement partner. When the auditor of the group financial statements assumes responsibility for the work of a component auditor, no reference is made to the component auditor in the auditor's report on the group financial statements. Alternatively, paragraph .28 of AU-C section 600 states when the group engagement partner decides to make reference to the audit of a component auditor in the auditor's report on the group financial statements, the auditor's report on the group financial statements should clearly indicate that the component was not audited by the auditor of the group financial statements but was audited by the component auditor, and should include the magnitude of the portion of the financial statements audited by the component auditor. Reference in the auditor's report on the group financial statements to the fact that part of the audit was conducted by a component auditor is not to be construed as a qualification of the opinion. Rather, such reference is intended to communicate

- a. that the auditor of the group financial statements is not assuming responsibility for the work of the component auditor and
- b. the source of the audit evidence with respect to those components for which reference to the audit of component auditors is made.

Multi-Location Audits Versus Group Audits

2.23 A multi-location audit is different from a group audit. For example, a multi-location audit is performed when a single health care entity has multiple locations, and none of the business activities at the individual locations are components. As another example, a group audit exists when a health care entity has two or more components regardless of the number of locations. As noted previously, each component is an entity or business activity for which group or component management prepares financial information that should be included in the group financial statements. In this situation, there is a group engagement team, and component auditors who perform work on the financial information of a component. AU-C section 600 addresses considerations related to group audits.

Complex Transactions

2.24 Health care entities may enter into complex transactions with other providers and patients. This may require the use of specialists in accordance

with AU-C section 620, *Using the Work of an Auditor's Specialist* (AICPA, *Professional Standards*), legal inquiry, and detailed reviews of contracts.

Materiality

2.25 AU-C section 320, *Materiality in Planning and Performing an Audit* (AICPA, *Professional Standards*), addresses the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements. AU-C section 450, *Evaluation of Misstatements Identified During the Audit* (AICPA, *Professional Standards*), explains how materiality is applied in evaluating the effect of identified misstatements on the audit and the effect of uncorrected misstatements, if any, on the financial statements. AU-C section 600 explains how materiality is established in the context of a group audit, for which materiality is established not only for the group financial statements as a whole, but also for the financial information of those components on which the group engagement team will perform, or request a component auditor to perform, an audit or review.

2.26 Paragraphs .04 and .06 of AU-C section 320 state that the auditor's determination of materiality is a matter of professional judgment and is influenced by the auditor's perception of the financial information needs of users of financial statements. In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material.

2.27 In accordance with paragraphs .10 and .A5 of AU-C section 320, the auditor should determine materiality for the financial statements as a whole when establishing the overall audit strategy. Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. If, in the specific circumstances of the entity, one or more particular classes of transactions, account balances, or disclosures exist for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users, then taken on the basis of the financial statements, the auditor also should determine the materiality level or levels to be applied to those particular classes of transactions, account balances, or disclosures. See paragraphs .A12–.A13 of AU-C section 320 for further guidance. If the auditor is engaged to perform an audit of internal control over financial reporting (ICFR) that is integrated with the audit of financial statements (integrated audit); AU-C section 940 states that the auditor should use the same materiality for planning and performing the audit of ICFR and the financial statement audit.

Considerations for Audits Performed in Accordance With PCAOB Standards

PCAOB AS 2105, *Consideration of Materiality in Planning and Performing an Audit* (AICPA, *PCAOB Standards and Related Rules*), provides guidance for determining materiality for audits of the financial statements of entities subject to the oversight authority of the PCAOB. When conducting an integrated audit, paragraph .20 of PCAOB AS 2201 states that the auditor should use the same materiality considerations he or she would use in planning the audit of the company's annual financial statements.

2.28 In determining an appropriate benchmark, the auditor may consider whether items exist on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance, users may tend to focus on profit, revenue or net assets). For a for-profit entity, net income and earnings per share are typically the major concern of financial statement users, and operating results may be the most relevant measurement basis for materiality. On the other hand, for most NFPs, expenditures are often tightly controlled and based on the concept of a balanced budget. Examples of appropriate benchmarks for NFPs include total assets, various net asset classes, changes in net assets, total revenues, and total expenses. However, other factors also may be relevant such as compliance with its debt covenants (for example, a debt service coverage ratio); and the stability of its operating results (for example, as measured by operating income or the performance indicator).

Performance Materiality

2.29 Paragraph .A14 of AU-C section 320 explains that planning the audit solely to detect individual material misstatements overlooks the fact that the aggregation of individually immaterial misstatements may cause the financial statements to be materially misstated and leaves no margin for possible undetected misstatements. Therefore, in accordance with paragraph .11 of AU-C section 320, the auditor should determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. *Performance materiality*, for purposes of GAAS, is defined in AU-C section 320 as the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, *performance materiality* also refers to the amount or amounts set by the auditor at less than materiality level or levels for particular classes of transactions, account balances or disclosures. Performance materiality is to be distinguished from tolerable misstatement, which is the application of performance materiality to a particular sampling procedure. AU-C section 530, *Audit Sampling* (AICPA, *Professional Standards*), defines tolerable misstatement and provides further application guidance about the concept.

2.30 Paragraph .A14 of AU-C section 320 goes on to explain that the determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures, and the nature and extent of misstatements identified in previous audits and, thereby, the auditor's expectations regarding misstatements in the current period.

Qualitative Aspects of Materiality

2.31 As previously indicated, judgments about materiality include both quantitative and qualitative information. Qualitative considerations include the following:

- The nature of the client's business and industry sector (for example, hospital, managed care, or assisted living)

- Operating results (for example, stable earnings, consistently near break-even, low-margin industry, or volatile results)
- Financial position (for example, concerns regarding liquidity, debt covenants, and capital adequacy)

As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements. For example, an error of an otherwise immaterial amount could be material if a reasonable possibility exists that it could lead to a violation of the entity's debt covenants that would cause the debt to be classified as current.

2.32 Qualitative considerations also influence the auditor in reaching a conclusion about whether misstatements are material. Paragraph .A23 of AU-C section 450 provides qualitative factors that the auditor may consider relevant in determining whether misstatements are material. Although it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature (that is, qualitative considerations), the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements, as described in paragraph .06 of AU-C section 320.

Use of Assertions in Assessment of Risks of Material Misstatement

2.33 Paragraphs .A113–.A118 of AU-C section 315 discuss the use of assertions in assessment of risks of material misstatement. In representing that the financial statements are presented in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation, and disclosure of the various elements of financial statements and related disclosures. Assertions used by the auditor to consider the different types of potential misstatements fall into the following categories and may take the following forms:

Categories of Assertions

	<i>Description of Assertions</i>		
	<i>Classes of Transactions and Events During the Period</i>	<i>Account Balances at the End of the Period</i>	<i>Presentation and Disclosure</i>
Occurrence or existence	Transactions and events that have been recorded have occurred and pertain to the entity.	Assets, liabilities, and equity interests exist.	Disclosed events and transactions have occurred.

(continued)

Categories of Assertions—continued

	Description of Assertions		
	<i>Classes of Transactions and Events During the Period</i>	<i>Account Balances at the End of the Period</i>	<i>Presentation and Disclosure</i>
Rights and obligations	—	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.	Disclosed events and transactions pertain to the entity.
Completeness	All transactions and events that should have been recorded have been recorded.	All assets, liabilities, and equity interests that should have been recorded have been recorded.	All disclosures that should have been included in the financial statements have been included.
Accuracy or valuation and allocation	Amounts and other data relating to recorded transactions and events have been recorded appropriately.	Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments are recorded appropriately.	Financial and other information is disclosed fairly and at appropriate amounts.
Cut-off	Transactions and events have been recorded in the correct reporting period.	—	—
Classification and understandability	Transactions and events have been recorded in the proper accounts.	—	Financial information is appropriately presented and described, and information in disclosures is expressed clearly.

2.34 Examples of industry-specific assertions for classes of transactions, account balances, and presentation and disclosures are reflected in the individual chapters of this guide.

Risk Assessment Procedures

2.35 AU-C section 315 addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through the understanding of the entity and its environment, including the entity's internal control.

2.36 Obtaining an understanding of the entity and its environment, including the entity's internal control (referred to hereafter as an *understanding of the entity*), is a continuous, dynamic process of gathering, updating and analyzing information throughout the audit. As stated in paragraph .A1 of AU-C section 315, the understanding of the entity establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit when, for example,

- assessing risks of material misstatement of the financial statements;
- determining materiality in accordance with AU-C section 320;
- considering the appropriateness of the selection and application of accounting policies and the adequacy of financial statement disclosures;
- identifying areas for which special audit consideration may be necessary (for example, related party transactions, the appropriateness of management's use of the going concern assumption, considering the business purpose of transactions, or the existence of complex and unusual transactions);
- developing expectations for use when performing analytical procedures;
- responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence; and
- evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and management's oral and written representations.

Risk Assessment Procedures and Related Activities

2.37 As described in paragraph .05 of AU-C section 315, the auditor should perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and relevant assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. For purposes of GAAS, risk assessment procedures are defined in AU-C section 315 as audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels.

2.38 Paragraph .A3 of AU-C section 315 states that the auditor is required to exercise professional judgment to determine the extent of the required understanding of the entity. The auditor's primary consideration is whether the understanding of the entity that has been obtained is sufficient to meet the objectives of AU-C section 315. The depth of the overall understanding that is

required by the auditor is less than that possessed by management in managing the entity.

2.39 Paragraph .06 of AU-C section 315 states that the risk assessment procedures should include the following:

- Inquiries of management, appropriate individuals within the internal audit function (if such function exists), and others within the entity
- Analytical procedures
- Observation and inspection

Analytical Procedures

2.40 Paragraphs .A14–.A17 of AU-C section 315 provide additional explanation for analytical procedures performed during the risk assessment process. Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures may enhance the auditor's understanding of the entity's business and the significant transactions and events that have occurred since the prior audit and help to identify the existence of unusual transactions or events and amounts, ratios, and trends that might indicate matters that have audit implications.

2.41 Analytical procedures performed as risk assessment procedures may include both financial and nonfinancial information. Examples of sources of information for analytical procedures include prior-period financial information, budgets, and health care financial and statistical ratios. Comparative analytical information is available from various health care industry associations.

2.42 The following are examples of analytical procedures that 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 or resident 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
- Contractual discounts as a percentage of gross amounts by major payor classes for both accounts receivable and revenues
- 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
- Comparison of operating expenses as a percentage of operating revenue
- Relationship between periods of the liability for claims incurred but not reported (IBNR) to the related expense

Discussion Among the Audit Team

2.43 In accordance with paragraph .11 of AU-C section 315, the engagement partner and other key engagement team members should discuss the susceptibility of the entity's financial statements to material misstatement and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner should determine which matters are to be communicated to engagement team members not involved in the discussion. Paragraph .A21 of AU-C section 315 states this discussion may be held concurrently with the discussion among the engagement team that is required by AU-C section 240, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), to discuss the susceptibility of the entity's financial statements to fraud.

The Entity and Its Environment

2.44 Paragraph .12 of AU-C section 315 states that the auditor should obtain an understanding of the following:

- a. Relevant industry, regulatory, and other external factors, including the applicable financial reporting framework.
- b. The nature of the entity, including
 - i. its operations;
 - ii. its ownership and governance structures;
 - iii. the types of investments that the entity is making and plans to make, including investments in entities formed to accomplish specific objectives; and
 - iv. the way that the entity is structured and how it is financed, to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.
- c. The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor should evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.
- d. The entity's objectives and strategies and those related business risks that may result in risks of material misstatement.
- e. The measurement and review of the entity's financial performance.

2.45 Appendix A, "Understanding the Entity and Its Environment," of AU-C section 315 provides additional guidance on matters the auditor may consider when obtaining an understanding of the industry and regulatory and other external factors that affect the entity, the nature of the entity, objectives and strategies and related business risks, and the measurement and review of the entity's financial performance. Appendix B, "Internal Control Components," of AU-C section 315 contains a detailed explanation of the internal control components. The following table includes some unique characteristics of health care entities that the auditor may consider, in addition to the factors listed in appendix A of AU-C section 315, when obtaining an understanding of the entity and its environment in order to assess the risks of material misstatement. Some of these factors are discussed in more detail following the table.

<i>Aspects of the Auditor's Understanding of the Entity and Its Environment</i>	<i>Considerations for Health Care Entities</i>
Industry, regulatory, and other external factors	<ul style="list-style-type: none"> • Regulatory requirements unique to entities receiving Medicare; Medicaid; or other federal or state payments, including federal financial assistance. • Healthcare reform initiatives brought on by government efforts (for example, Patient Protection and Affordable Care Act, including its possible repeal and replacement, and the Health Care and Education Reconciliation Act of 2010), consumer demands, the current economic environment, and changes in reimbursement structures (for example bundled payments or reimbursement tied to quality indicators). • Increased competition in reaction to the issues noted previously. • Service delivery regulations (for example, antidumping, Emergency Medical Treatment and Active Labor Act, use of devices approved by the Food and Drug Administration, Hill-Burton charity care, and so on). • Billing and coding regulations, including being subject to peer reviews and governmental intermediary audits. • Factors arising from an entity's tax-exempt status (for example, prohibited activities, unrelated business income, bond arbitrage rules, and so on). • Insurance-related industry regulations (for example, minimum capital requirements, statutory reporting requirements, and so on).
Nature of the entity	<ul style="list-style-type: none"> • The existence of related-party transactions. • The entity's experience with payment denials and other matters subject to review by medical review entities. • The nature of reports expected to be rendered. Examples include reports on consolidated or consolidating financial statements, reports on financial statements filed with the SEC, reports filed with third-party payors or other regulatory bodies, reports on compliance with debt covenants, and other special reports. • Recognition of liabilities for costs incurred by providers of prepaid health care services (see paragraph 2.46). • Contingencies for medical malpractice losses (see paragraph 2.47). • Obligations under continuing care contracts. • Revenue recognition practices (see paragraphs 2.48–.57). • Minimum loss issues.

<i>Aspects of the Auditor's Understanding of the Entity and Its Environment</i>	<i>Considerations for Health Care Entities</i>
Objectives and strategies and related business risks	<ul style="list-style-type: none"> • Changing strategies to create more viable healthcare entities to respond to the regulatory and market dynamics noted previously. Examples include development of accountable care organizations and other strategies to increase clinical integration, expand market share, and take on risk sharing arrangements. • Limitations on the initiation of new services or construction (for example, certificate of need). • Required federal certification prior to billing (for example, Medicare certification). • Recognition of retrospective billing adjustments from third-party payors. • Limitations on physician arrangements, such as ones related to patient referrals.
Measurement and review of the entity's financial performance	<ul style="list-style-type: none"> • Financial covenants required by bond or other financing agreements • Risk-based capital requirements (see the "Statutory Reporting Considerations for Health Plans" section).

Cost of Prepaid Health Care Services

2.46 Risks are associated with recognizing the liability for costs incurred by providers of prepaid health care services (for example, health maintenance organizations) because such costs may have been incurred but not yet reported to the providers. Therefore, it is necessary for the providers to estimate the liability for those costs. These estimates often necessitate a high degree of management judgment. Management considers historical experience, as well as the effects of any changes in conditions, such as seasonality trends and changes in subscriber population and the services and benefits provided. Costs of prepaid health care services are discussed further in chapter 13, "Financial Accounting and Reporting for Managed Care Services," of this guide.

Medical Malpractice Losses and Obligations

2.47 Risks also are associated with contingencies for medical malpractice losses and similar contingencies. Obligations to provide services under continuing care contracts can also result in a significant contingency. (See chapter 14, "Financial Accounting and Reporting by Continuing Care Retirement Communities.") A high degree of management judgment and complex analyses usually are involved in evaluating the related financial statement assertions. The measurement of estimates is inherently uncertain and depends on the outcome of future events. Because no one accounting estimate that involves a degree of management judgment can be considered accurate with certainty, material changes in such estimates do not indicate that the audit was not performed in accordance with professional standards. Medical malpractice losses and other contingencies are discussed further in chapter 8, "Contingencies and Other Liabilities," of this guide.

Revenue Recognition**© Update 2-1 Accounting and Reporting: FASB Accounting Standards Codification (ASC) 606, Revenue from Contracts with Customers**

FASB ASU No. 2014-09, *Revenue from Contracts with Customers*, as amended, provides a framework for revenue recognition and supersedes or amends several of the revenue recognition requirements in FASB ASC 605, *Revenue Recognition*, as well as guidance within the industry-specific topics, including FASB ASC 954, *Health Care Entities*, and FASB ASC 958, *Not-for-Profit Entities*. The standards apply to any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance or lease contracts).

The effective date of the new revenue standards for health care entities is dependent on the type of reporting entity, as follows:

- Health care entities that are either public business entities or NFPs that have issued, or are conduit bond obligors for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market are required to apply the standards for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Earlier application by those entities is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.
- All other health care entities are required to apply the guidance in FASB ASU No. 2014-09 to annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. Earlier application by those health care entities is permitted only as of an annual reporting period beginning after December 15, 2016, including interim reporting periods within that reporting period, or an annual reporting period beginning after December 15, 2016, and interim reporting periods within annual reporting periods beginning one year after the annual reporting period in which an entity first applies the guidance in FASB ASU No. 2014-09.

Readers are encouraged to consult the full text of FASB ASU No. 2014-09 on FASB's website at www.fasb.org.

The AICPA has formed 16 industry task forces to assist in developing a new accounting guide on revenue recognition that will provide helpful hints and illustrative examples for how to apply the new standard. Revenue recognition implementation issues identified by the Health Care Entities Revenue Recognition Task Force will be available for informal comment, after review by the AICPA Financial Reporting Executive Committee, at www.aicpa.org/interestareas/frc/accountingfinancialreporting/revenuerecognition/pages/rrtf-healthcare.aspx.

Readers are encouraged to submit comments to revrecomments@aicpa.org.

For more information, see appendix C, "The New Revenue Recognition Standard: FASB ASC 606," of this guide.

This edition of the guide has not been updated to reflect changes as a result of FASB ASC 606, however, the section that follows will be updated in a future edition.

2.48 Because of the large monetary amounts and complexity of determining health care service revenue and receivables, risks are associated with health care service revenue recognition and the valuation of the related receivables. A significant portion of services is usually paid 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. Statement of Position (SOP) 00-1, *Auditing Health Care Third-Party Revenues and Related Receivables* (AICPA, *Professional Standards*, AUD sec. 20), provides guidance to auditors regarding uncertainties inherent in health care third-party revenue recognition. SOP 00-1 is included as Supplement A, "Statement of Position 00-1, Auditing Health Care Third-Party Revenues and Related Receivables," of this guide.

Considerations for Audits Performed in Accordance With PCAOB Standards

PCAOB Staff Audit Practice Alert No. 12, *Matters Related to Auditing Revenue in an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.12), highlights certain requirements of PCAOB standards related to aspects of auditing revenue. PCAOB Staff Audit Practice Alerts are neither rules of the PCAOB nor have they been approved by the PCAOB.

2.49 Typically, a number of clinicians (for example, 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-10-CM or CPT-4) to the record. The provider prepares and submits a bill that includes, among other things, the assigned ICD-10-CM or CPT-4 code. The Medicare fiscal intermediary or other third-party payor typically reviews the bill and assigns a specific payment code, such as a diagnosis related group (DRG) number. Payment is based on the assigned DRG number or other payment code. The provider may check the assigned payment code and follow up on any identified discrepancies. However, the final assignment of the payment code is generally determined by the third-party payor.

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

2.51 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 a potential misstatement is removed from the events and transactions ordinarily reflected in the financial statements, the less likely the auditor is to become aware of the misstatement and 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 from a clinical perspective, and so on); adequately supervised; accurately documented and classified; or rendered and billed by non-sanctioned individuals typically is not within the auditor's professional expertise. As a result, an audit in accordance with GAAS is not designed to detect such matters.

2.52 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.⁴ 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.

2.53 Due to the higher inherent risk associated with revenue recognition, including the clinical coding process, the independent auditor may consider obtaining an understanding of internal controls over documentation of the services rendered; clinical coding, including the use of groupers and supervisory reviews; and billing procedures (for example, admission, payor verification, and discharge). The auditor also may consider the results of the internal compliance program; the internal audit; and external reviews (consulting or regulator or payor), including denials.

2.54 For reasons previously discussed, an auditor 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 paragraph .17 of AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* (AICPA, *Professional Standards*), states that if the auditor becomes aware of information concerning an instance of noncompliance or suspected noncompliance with laws and regulations, the auditor should obtain (a) an understanding of the nature of the act and the circumstances in which it has occurred and (b) further information to evaluate the possible effect on the financial statements. In accordance with paragraph .18 of AU-C section 250, if the auditor suspects noncompliance may exist, the auditor should discuss the matter with management (at a level above those involved with the suspected noncompliance, if possible) and, when appropriate, those charged with governance. If management or, as appropriate, those charged with governance do not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor's professional judgment, the effect of the suspected noncompliance may be material to the financial statements, the auditor should consider the need to obtain legal advice. If sufficient information about suspected noncompliance cannot be obtained, paragraph .19 of AU-C section 250 requires the auditor to evaluate the effect of the lack of sufficient appropriate audit evidence on the auditor's opinion. For example, after being informed about a special regulatory review that was performed, the

⁴ 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 Office of Management and Budget *Uniform Administrative Requirements, Cost Principles, and Audit Requirements*, the auditor's procedures do not extend to testing compliance with laws and regulations related to Medicare and Medicaid fraud and abuse. AT-C section 315, *Compliance Attestation* (AICPA, *Professional Standards*), provides guidance to practitioners in conducting and reporting on an agreed-upon procedures engagement performed pursuant to the AICPA Statements on Standards for Attestation Engagements (SSAEs) to assist a health care provider in evaluating the effectiveness of its corporate compliance program consistent with the requirements of a Corporate Integrity Agreement (CIA) entered into with the Office of Inspector General (OIG) of the U.S. Department of Health and Human Services.

auditor inquires about the results and considers whether performance of additional substantive audit procedures is necessary to evaluate the contingency, including the need for possible recognition or disclosure pursuant to FASB ASC 450, *Contingencies*.

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

2.56 Among other duties, the Medicare fiscal intermediary is responsible for evaluating the propriety of submitted claims before processing them for payment. Absent the client committing an illegal act, the payment of a claim provides evidence that billed amounts were correct. As a result, the auditor generally obtains an understanding of the entity's billing and collection history, paying particular attention to the entity's historical denial rate or the significance of coding changes.

2.57 Generally, the notes to the financial statements disclose that amounts recognized as revenues are subject to retrospective review and laws and regulations that are extremely complex and subject to interpretation; as a result, a reasonable possibility exists that recorded estimates will change by a material amount in the near term. Therefore, the adequacy of the financial statement disclosures regarding the inherent risk relating to revenue recognition is an important consideration for health care entities and their auditors.

Additional Audit Considerations

Analytical Procedures

2.58 As discussed in paragraph 2.40, AU-C section 315 describes the use of analytical procedures as risk assessment procedures (which may be referred to as analytical procedures used to plan the audit). AU-C section 520, *Analytical Procedures* (AICPA, *Professional Standards*), addresses the auditor's use of analytical procedures as substantive procedures and the auditor's responsibility to perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements.

2.59 According to paragraph .05 of AU-C section 520, when designing and performing analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with AU-C section 330, the auditor should

- a. determine the suitability of particular substantive analytical procedures for given assertions, taking into account the assessed risks of material misstatement and tests of details, if any, for these assertions;
- b. evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking into account the source, comparability, and nature and relevance of information available and controls over preparation;
- c. develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise (taking into

account whether substantive analytical procedures are to be performed alone or in combination with tests of details) to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and

- d. determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation as required by paragraph .07 of AU-C section 520 and compare the recorded amounts, or ratios developed from recorded amounts, with the expectations.

Accounting Estimates

2.60 Certain areas of a health care entity's operations include accounting estimates that may be material in the preparation and presentation of financial statements. FASB ASC 275, *Risks and Uncertainties*, requires entities to include in their financial statements information about the use of estimates in the preparation of financial statements. In addition, if specified disclosure criteria in FASB ASC 275-10-50-8 are met, entities are required to include the disclosures about certain significant estimates described in paragraphs 6–15 of FASB ASC 275-10-50 in their financial statements. AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (AICPA, *Professional Standards*), addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates and related disclosures, in an audit of financial statements. Specifically, it expands on how AU-C sections 315 and 330, and other relevant AU-C sections are to be applied with regard to accounting estimates. It also includes requirements and guidance related to misstatements of individual accounting estimates and indicators of possible management bias.

Considerations for Audits Performed in Accordance With PCAOB Standards

Paragraph .10 of PCAOB AS 2501, *Auditing Accounting Estimates* (AICPA, *PCAOB Standards and Related Rules*), provides that for an integrated audit, auditors are required to obtain an understanding of the process that management used to develop estimates and to test controls over all relevant assertions related to the estimate.

2.61 SOP 00-1 (Supplement A to this guide) provides guidance for auditors regarding the sufficiency of audit evidence supporting accounting estimates recorded for the proper valuation of health care third-party revenues and related receivables.

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

- The provision for third-party payor contractual adjustments and allowances and the provision for estimated receivables and payables for final settlements with those payors and any other valuation allowances for revenue recognition matters, as discussed further in chapter 10, "Health Care Service Revenue and Related Receivables," of this guide
- The valuation of investments and derivative financial instruments

- The accruals for income taxes
- The provision for uncollectible accounts, notes, or pledges receivable
- Accruals for medical malpractice liabilities and other similar liabilities
- Accruals for obligations under continuing care contracts
- Accruals by providers of prepaid health care services for IBNR costs
- Accruals for loss contracts
- Obligations under defined benefit retirement plans or other postemployment benefits

Transactions Processed by Service Organizations

2.63 Health care entities may engage outside service organizations to perform services that are part of the health care provider's information system.

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

- Investment managers that invest and service assets for health care entities
- Service organizations that process payroll, provide IT services, and perform other administrative functions
- 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

2.65 Paragraphs .13–.14 of AU-C section 315 states that the auditor should obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. When obtaining an understanding of controls that are relevant to the audit, the auditor should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel. This understanding may encompass controls placed in operation by the health care entity and service organizations whose services are part of the health care entity's information system.

2.66 AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization* (AICPA, *Professional Standards*), addresses the user auditor's responsibility for obtaining sufficient appropriate audit evidence in an audit of the financial statements of a user entity that uses one or more service organizations. Specifically, it expands on how the user auditor applies AU-C sections 315 and 330, in obtaining an understanding of the user entity, including internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement and in designing and performing further audit procedures responsive to those risks.

Considerations for Audits Performed in Accordance With PCAOB Standards

PCAOB AS 2201 provides guidance regarding the use of service organizations for an integrated audit.

Compliance With Laws and Regulations

2.67 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 anti-kickback statute of the Medicare and Medicaid Patient and Program Protection Act of 1987 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.

Responsibility for Compliance With Laws and Regulations

2.68 The requirements of AU-C section 250 are designed to assist the auditor in identifying material misstatement of the financial statements due to noncompliance with laws and regulations. However, the auditor is not responsible for preventing noncompliance and cannot be expected to detect noncompliance with all laws and regulations.

Responsibility of Management

2.69 In accordance with paragraph .03 of AU-C section 250, it is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements.

Responsibility of the Auditor

2.70 As stated in paragraph .05 of AU-C section 250, the auditor is responsible for obtaining reasonable assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Because of the inherent limitations of an audit, an unavoidable risk exists that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with GAAS. In the context of laws and regulations, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for the following reasons:

- Many laws and regulations relating principally to the operating aspects of an entity typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.
- Noncompliance may involve conduct designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, management override of controls, or intentional misrepresentations made to the auditor.

- Whether an act constitutes noncompliance is ultimately a matter for legal determination, such as by a court of law.

Ordinarily, the further removed noncompliance is from the events and transactions reflected in the financial statements, the less likely the auditor is to become aware of, or recognize, the noncompliance.

2.71 Paragraph .06 of AU-C section 250 distinguishes the auditor's responsibilities regarding compliance with the following two categories of laws and regulations:

- a. The provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements, such as tax and pension laws and regulations.
- b. The provisions of other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements but compliance with which may be
 - i. fundamental to the operating aspects of the business,
 - ii. fundamental to an entity's ability to continue its business, or
 - iii. necessary for the entity to avoid material penalties

(for example, compliance with the terms of an operating license, regulatory solvency requirements, or environmental regulations); therefore, noncompliance with such laws and regulations may have a material effect on the financial statements.

2.72 Differing requirements are specified for each of the previously mentioned categories of laws and regulations are set forth in paragraph .07 of AU-C section 250. For the category referred to in paragraph 2.71a, the auditor's responsibility is to obtain sufficient appropriate audit evidence regarding material amounts and disclosures in the financial statements that are determined by the provisions of those laws and regulations. For the category referred to in paragraph 2.71b, the auditor's responsibility is limited to performing specified audit procedures that may identify noncompliance with those laws and regulations that may have a material effect on the financial statements.

2.73 The auditor is required by paragraph .08 of AU-C section 250 to remain alert to the possibility that other audit procedures applied for the purpose of forming an opinion on financial statements may bring instances of identified or suspected noncompliance with laws and regulations to the auditor's attention. Maintaining professional skepticism throughout the audit, as required by AU-C section 200, is important in this context, given the extent of laws and regulations that affect the entity.

2.74 Examples of laws and regulations, described in paragraph 2.71a, that are generally recognized by auditors to have a direct and material effect on the determination of amounts in financial statements of health care entities 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 reporting period, such as those concerning the submission of bills for fictitious patients.

2.75 Health care entities also may be affected by many other laws and regulations as described in paragraph 2.71b, such as those related to Medicare and

Medicaid fraud and abuse, discrimination related to patients or residents, violation of patient or resident rights, 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 its financial and accounting aspects, and they may not have a direct effect on the determination of material amounts and disclosures in the financial statements. An auditor ordinarily does not have a sufficient basis for recognizing possible noncompliance with such laws and regulations. Their effect is normally the result of the need to disclose a contingent liability because of the allegation or determination of noncompliance. For example, patients may be obtained based on noncompliant arrangements with physicians or other providers. Although the direct effects of the services rendered may be appropriately recorded, other effects, such as the possible contingent liability for noncompliance with Medicare and Medicaid fraud and abuse statutes, may not be appropriately disclosed. Even when noncompliance with such laws and regulations has material consequences to the financial statements, auditors may not become aware of the existence of the noncompliance, unless they are informed by the client or evidence exists of a governmental agency investigation or enforcement proceeding in the records, documents, or other information normally inspected in an audit of financial statements.

2.76 As required in paragraph .14 of AU-C section 250, the auditor should perform the following audit procedures that may identify instances of noncompliance with other laws and regulations described in paragraph 2.71*b* that may have a material effect on the financial statements:

- a.* Inquiring of management and, when appropriate, those charged with governance about whether the entity is in compliance with such laws and regulations
- b.* Inspecting correspondence, if any, with the relevant licensing or regulatory authorities

2.77 Paragraph .A5 of AU-C section 250 states whether an act constitutes noncompliance with laws and regulations is a matter for legal determination, which ordinarily is beyond the auditor's professional competence to determine. 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. Nevertheless, the auditor's training, experience, and understanding of the entity and its industry or sector may provide a basis to recognize that some acts coming to the auditor's attention may constitute noncompliance with laws and regulations.

Going-Concern Considerations

2.78 The "Pending Content" in FASB ASC 205-40-50 requires that, in connection with preparing financial statements, an entity's management evaluate whether there are conditions and events, considered in the aggregate, that raise substantial doubt about an entity's ability to continue as a going concern within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued, when applicable) and to provide related disclosures. AU-C section 570A, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*), establishes requirements and provides guidance to auditors in conducting an audit of financial statements in accordance

with GAAS with respect to evaluating whether there is substantial doubt about the entity's ability to continue as a going concern. This section applies to all audits, regardless of which financial reporting framework, as defined in AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*), and AU-C section 800, was used to prepare the financial statements.

The "Pending Content" in FASB ASC 205-40-50 requires that, in connection with preparing financial statements, an entity's management evaluate whether there are conditions and events, considered in the aggregate, that raise substantial doubt about an entity's ability to continue as a going concern within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued, when applicable) and to provide related disclosures. AU-C section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*), addresses the auditor's responsibilities in the audit of financial statements relating to the entity's ability to continue as a going concern and the implications for the auditor's report. This section applies to all audits of a complete set of financial statements, regardless of which financial reporting framework, as defined in AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*), and AU-C section 800, was used to prepare the financial statements.⁵

Considerations for Audits Performed in Accordance With PCAOB Standards

PCAOB AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *PCAOB Standards and Related Rules*), provides guidance to the auditor in conducting an audit of financial statements in accordance with the standards of the PCAOB with respect to evaluating whether there is substantial doubt about the entity's ability to continue as a going concern.

PCAOB Staff Audit Practice Alert No. 13, *Matters Related to the Auditor's Consideration of a Company's Ability to Continue as a Going Concern* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.13), discusses the professional standards applicable to the auditor's evaluation of going concern. PCAOB Staff Audit Practice Alerts are neither rules of the PCAOB nor have they been approved by the PCAOB.

The Auditor's Responsibility

2.79 In accordance with paragraph .03 of AU-C section 570A, the auditor should evaluate whether there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time, based on the auditor's knowledge of relevant conditions or events that exist at or have occurred prior to the date of the auditor's report. The auditor should consider whether the results of the procedures performed during the course of the audit identify conditions or events that, when considered in the aggregate, indicate there

⁵ Statement on Auditing Standards No. 132, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, (AICPA, *Professional Standards*, AU-C sec. 570), issued in February 2017, is effective for audits of financial statements for periods ending on or after December 15, 2017.

could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time and consider the need to obtain additional information about such conditions or events, as well as the appropriate audit evidence to support information that mitigates the auditor's doubt.

In accordance with paragraph .10 of AU-C section 570, the auditor's objectives are:

- a. To obtain sufficient appropriate audit evidence regarding, and to conclude on, the appropriateness of management's use of the going concern basis of accounting, when relevant, in the preparation of the financial statements
- b. To conclude, based on the audit evidence obtained, whether substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time exists
- c. To evaluate the possible financial statement effects, including the adequacy of disclosure regarding the entity's ability to continue as a going concern for a reasonable period of time
- d. To report in accordance with AU-C section 570.

2.80 Paragraphs .01–.10 of AU-C section 9570A, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern: Auditing Interpretation of AU-C Section 570* (AICPA, *Professional Standards*), provides definitions for the terms *substantial doubt about an entity's ability to continue as a going concern* and *reasonable period of time*, which are both used in AU-C section 570A. AU-C section 9570A also provides interpretations regarding interim financial information and the possible effects on the financial statements and the adequacy of the related disclosure in situations when the auditor concludes there is a substantial doubt about an entity's ability to continue as a going concern.

AU-C section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*), does not define *substantial doubt*. However, the "Pending Content" in the FASB ASC Master Glossary states that *substantial doubt about an entity's ability to continue as a going concern* "exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due."

Paragraph .11 of AU-C section 570 defines *reasonable period of time* as "the period of time required by the applicable financial reporting framework or, if no such requirement exists, within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued, when applicable)." As explained in paragraph .A6 of AU-C section 570, most financial reporting frameworks requiring an explicit management evaluation of the entity's ability to continue as a going concern specify the period of time to be evaluated. For example, the FASB ASC glossary definition of *substantial doubt* specifies the period as within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued, when applicable) and GASB specifies the period as 12 months beyond the date of the financial statements, and further requires that, if a governmental entity currently knows information that may raise substantial doubt

shortly thereafter (for example, within an additional three months), such information should also be considered (paragraph 16 of GASB Statement No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards*).

Audit Procedures

2.81 Pursuant to paragraph .08 of AU-C section 570A, the auditor should evaluate whether there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time based on the results of the audit procedures performed. The following are examples of procedures that may identify such conditions or events:

- Analytical procedures
- Review of subsequent events
- Review of compliance with the terms of debt and loan agreements
- Reading of minutes of meetings of board of directors and important committees of the board
- Inquiry of an entity's legal counsel about litigation, claims, and assessments
- Confirmation with related and third parties of the details of arrangements to provide or maintain financial support

Pursuant to paragraph .12 of AU-C section 570, when performing risk assessment procedures as required by AU-C section 315, the auditor should consider whether there are conditions or events, considered in the aggregate, that raise substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. In doing so, the auditor should determine whether management has performed a preliminary evaluation of whether such conditions or events exist. If management has performed that evaluation, the auditor should discuss the evaluation with management and determine whether management has identified conditions or events that raise substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time and, if so, understand management's plans to address them. If management has not performed that evaluation, the auditor should discuss with management the basis for the intended use of the going concern basis of accounting and inquire of management whether conditions or events exist that raise substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time.

Consideration of Conditions and Events

2.82 When performing audit procedures such as those described in paragraph 2.81, the auditor may identify information about certain conditions or events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. The significance of such conditions or events will depend on the circumstances, and some conditions or events may have significance only when viewed in conjunction with others. The following are examples of such conditions and events that may be encountered in audits of health care entities:

- Insufficient cash inflows to provide services
- Increased competition resulting in a decrease in patient volume
- A high ratio of expenses to revenues
- Insufficient resources (for example, medical expertise) to provide services and finance operations in a particular geographic location
- Loss of physicians or inability to recruit new physicians
- Activities that could jeopardize tax-exempt status, if a tax exempt entity
- Violation of debt covenants that allow the lender to accelerate payment of debt
- Concerns expressed by governmental authorities regarding alleged violations of relevant laws and regulation
- A loss of key governing board members or volunteers
- A loss of a major payor contract or major funding sources

Pursuant to paragraph .13 of AU-C section 570, the auditor should remain alert throughout the audit for audit evidence of conditions or events that raise substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. The following are examples of such conditions and events in audits of health care entities that, when considered in the aggregate, could indicate that there is substantial doubt:

- Insufficient cash inflows to provide services
- Increased competition resulting in a decrease in patient volume
- A high ratio of expenses to revenues
- Insufficient resources (for example, medical expertise) to provide services and finance operations in a particular geographic location
- Loss of physicians or inability to recruit new physicians
- Activities that could jeopardize tax-exempt status, if a tax exempt entity
- Violation of debt covenants that allow the lender to accelerate payment of debt
- Concerns expressed by governmental authorities regarding alleged violations of relevant laws and regulation
- A loss of key governing board members or volunteers
- A loss of a major payor contract or major funding sources

Consideration of Financial Statement Effects

2.83 If, after considering the identified conditions or events in the aggregate, the auditor believes there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, paragraphs .10 and .14 of AU-C 570A require the auditor to

- a. obtain written representations from management
 - i. regarding its plans that are intended to mitigate the adverse effects of conditions or events that indicate there is substantial doubt about the entity's ability to continue as a

- going concern for a reasonable period of time and the likelihood that those plans can be effectively implemented, and
- ii. that the financial statements disclose all the matters of which management is aware that are relevant to the entity's ability to continue as a going concern, including principal conditions or events and management's plans.
- b. obtain information about management's plans that are intended to mitigate the adverse effects of such conditions or events. The auditor should
- i. assess whether it is likely that the adverse effects would be mitigated by management's plans for a reasonable period of time;
 - ii. identify those elements of management's plans that are particularly significant to overcoming the adverse effects of the conditions or events and plan and perform procedures to obtain audit evidence about them, including, when applicable, considering the adequacy of support regarding the ability to obtain additional financing or the planned disposal of assets; and
 - iii. assess whether it is likely that such plans can be effectively implemented.

Pursuant to paragraph .16 of AU-C section 570, the auditor should obtain sufficient appropriate audit evidence to determine whether conditions and events identified, considered in the aggregate, raise substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time by performing additional audit procedures, including consideration of mitigating factors. These procedures should include the following:

- a. Requesting management to make an evaluation when management has not yet performed an evaluation
- b. Evaluating management's plans in relation to its going concern evaluation, with regard to whether it is probable that
 - i. management's plans can be effectively implemented and
 - ii. the plans would mitigate the relevant conditions or events that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time
- c. When the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in evaluating management's plans,
 - i. evaluating the reliability of the underlying data generated to prepare the forecast and
 - ii. determining whether there is adequate support for the assumptions underlying the forecast, which includes considering contradictory audit evidence
- d. Considering whether any additional facts or information have become available since the date on which management made its evaluation.

2.84 When prospective financial information is particularly significant to management's plans, the auditor should refer to paragraph .11 of AU-C section 570A, which provides guidance on the assessment of such information.

Paragraphs .A28.A38 of AU-C section 570 include other audit procedures that may be relevant to performing the requirements in paragraph .16 of AU-C section 570.

Consideration of the Effects on the Auditor's Report When Substantial Doubt Has Been Alleviated

2.85 FASB ASC 205-40-50-12 requires certain disclosures when substantial doubt about an entity's ability to continue as a going concern is alleviated as a result of consideration of management's plans. The auditor's assessment of the financial statement effects under AU-C section 570 would be based on those disclosure requirements. When the auditor concludes, primarily because of the auditor's consideration of management's plans, that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time has been alleviated, the auditor should consider the need for, and evaluate the adequacy of, disclosure of the principal conditions or events that initially caused the auditor to believe there was substantial doubt. The auditor's consideration of disclosure should include the possible effects of such conditions or events, and any mitigating factors, including management's plans.

Consideration of the Effects on the Auditor's Report When Substantial Doubt Remains

2.86 If the substantial doubt is not alleviated, paragraphs 13–14 of FASB ASC 205-40-50 require a statement in the notes to financial statements indicating that there is substantial doubt about the NFP's ability to continue as a going concern within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable), as well as additional information. The auditor's assessment of the financial statement effects under AU-C section 570 would be based on those disclosure requirements. If, after considering identified conditions or events and management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the auditor should include an emphasis-of-matter paragraph in the auditor's report to reflect that conclusion and includes the terms *substantial doubt* and *going concern*. Additionally, the auditor's opinion should be modified if the auditor determines that the entity's disclosures with respect to the ability to continue as a going concern are inadequate.

2.87 Additionally, if, after considering identified conditions or events in the aggregate and after considering management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the auditor should communicate the following to those charged with governance:

- a. The nature of the conditions or events identified
- b. The possible effect on the financial statements and the adequacy of related disclosures in the financial statements
- c. The effects on the auditor's report

Documentation

2.88 Paragraph .22 of AU-C section 570A states that if the auditor believes, before consideration of management's plans, there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, the auditor should document the following:

- a. The conditions or events that led the auditor to believe that there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.
- b. The elements of management's plans that the auditor considered to be particularly significant to overcoming the adverse effects of the conditions or events.
- c. The audit procedures performed to evaluate the significant elements of management's plans and evidence obtained.
- d. The auditor's conclusion regarding whether substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains or is alleviated. If substantial doubt remains, the auditor also should document the possible effects of the conditions or events on the financial statements and the adequacy of the related disclosures. If substantial doubt is alleviated, the auditor also should document the auditor's conclusion as to the need for, and, if applicable, the adequacy of, disclosure of the principal conditions or events that initially caused the auditor to believe there was substantial doubt.
- e. The auditor's conclusion with respect to the effects on the auditor's report.

Paragraph .32 of AU-C section 570 states that if conditions or events are identified that, when considered in the aggregate, raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time before consideration of management's plans, the auditor should document the following:

- a. The conditions or events that led the auditor to believe that there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.
- b. The elements of management's plans that the auditor considered to be particularly significant to overcoming the conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern, if applicable.
- c. The audit procedures performed to evaluate the significant elements of management's plans and evidence obtained, if applicable.
- d. The auditor's conclusion regarding whether substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains or is alleviated. If substantial doubt remains, the auditor should also document the possible effects of the conditions or events on the financial statements and the adequacy of the related disclosures. If substantial doubt is alleviated, the auditor should also document the auditor's

conclusion regarding the need for, and, if applicable, the adequacy of, disclosure of the principal conditions or events that initially caused the auditor to believe there was substantial doubt and management's plans that alleviated the substantial doubt.

- e. The auditor's conclusion with respect to the effects on the auditor's report.

In addition, paragraph .18 of AU-C section 570 states that if the auditor believes, before consideration of management's plans, that substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time, the auditor should request written representations from management that (a) describe management's plans that are intended to mitigate the adverse effects of conditions or events that indicate there is substantial doubt, and the probability that those plans can be effectively implemented and (b) represent that the financial statements disclose all the matters of which management is aware that are relevant to the entity's ability to continue as a going concern for a reasonable period of time, including principal conditions or events and management's plans. Further, paragraph .17 of AU-C section 570 states that when management's plans include financial support by third parties or the entity's owner-manager (hereinafter referred to as "supporting parties") and such support is necessary in supporting management's assertions about the entity's ability to continue as a going concern for a reasonable period of time, the auditor should obtain sufficient appropriate audit evidence about (a) the intent of such supporting parties to provide the necessary financial support, including written evidence of such intent, and (b) the ability of such supporting parties to provide the necessary financial support. The failure to obtain the written evidence required by item (a) constitutes a lack of sufficient appropriate audit evidence regarding the intent of the supporting parties to provide financial support.

2.89 If the going concern issue arises from imminent liquidation that does not follow a plan for liquidation that was specified in the entity's governing documents at the entity's inception, then the entity should apply FASB ASC 205-30 on the liquidation basis of accounting. This requires the remeasurement of assets in the entity's financial statements. It also requires the entity to accrue and separately present the costs that it expects to incur and the income that it expects to earn during the expected duration of the liquidation, including any costs associated with sale or settlement of those assets and liabilities. In addition, the entity should disclose its plan for liquidation, the methods and assumptions used to measure assets and liabilities, the type and amount of costs and income accrued, and the expected duration of the liquidation process. Interpretation No. 1, "Reporting on Financial Statements Prepared on a Liquidation Basis of Accounting" (AICPA, *Professional Standards*, AU-C sec. 9700 par. .01–.05), of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*, contains applicable guidance regarding the auditor's reporting responsibilities when using the liquidation basis of accounting.

Written Representations

2.90 AU-C section 580, *Written Representations* (AICPA, *Professional Standards*), addresses the auditor's responsibility to obtain written representations from management and, when appropriate, those charged with governance in an audit of financial statements.

Written Representations as Audit Evidence

2.91 According to paragraphs .03–.04 of AU-C section 580, written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence. Although written representations provide necessary audit evidence, they complement other auditing procedures and do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, obtaining reliable written representations does not affect the nature or extent of other audit procedures that the auditor applies to obtain audit evidence about the fulfillment of management's responsibilities or about specific assertions.

Management From Whom Written Representations Are Requested

2.92 As explained in paragraph .A2 of AU-C section 580, written representations are requested from those with overall responsibility for financial and operating matters whom the auditor believes are responsible for, and knowledgeable about, directly or through others in the organization, the matters covered by the representations, including the preparation and fair presentation of the financial statements. As such, in accordance with paragraph .09 of AU-C section 580, the auditor should request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned.

2.93 Paragraph .A2 of AU-C section 580 further states that those individuals with overall responsibility may vary depending on the governance structure of the entity; however, management (rather than those charged with governance) is often the responsible party. Written representations may therefore be requested from the entity's chief executive officer and chief financial officer or other equivalent persons in entities that do not use such titles. In some circumstances, however, other parties, such as those charged with governance, also are responsible for the preparation and fair presentation of the financial statements.

Written Representations About Management's Responsibilities and Other Written Representations

2.94 Paragraphs .10–.18 of AU-C section 580 discuss matters the auditor should request management to provide written representation about such as preparation and fair presentation of the financial statements, information provided and completeness of transactions, fraud, laws and regulations, uncorrected misstatements, litigation and claims, estimates, related party transactions, and subsequent events. If, in addition to such required representations and those addressed in other AU-C sections the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, paragraph .19 of AU-C section 580 states that the auditor should request such other written representations.

2.95 The auditor may consider the following examples of specific representations for receivables, cost reports filed with third parties, and contingencies related to health care third-party revenue recognition:

- For receivables, consider the following:

- Adequate consideration has been given to, and appropriate provision made for, estimated adjustments to revenue, such as for denied claims and changes to home health resource group, resource utilization group, ambulatory payment classification, and 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.
- For cost reports filed with third parties, auditors may consider the following:
 - All required Medicare, Medicaid, and similar reports have been properly filed.
 - Management is responsible for the accuracy and propriety of all filed cost reports.
 - 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 employed reimbursement methodologies and principles 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. Although management believes that the entity is entitled to all amounts claimed on the cost reports, management also believes the amounts of these differences are appropriate.
- For contingencies, auditors may consider the following:
 - There are no instances of noncompliance with laws or regulations, such as those related to Medicare and Medicaid antifraud and abuse statutes, in any jurisdiction, whose effects are 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. This is including, but not limited to, the antikickback statute of the Medicare and Medicaid Patient and Program Protection Act of 1987, limitations on

certain physician referrals (the Stark law), and the False Claims Act.

- Billings to third-party payors comply in all material respects with applicable coding guidelines (for example, ICD-10 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 internal or external investigations relating to compliance with applicable laws and regulations, including investigations in progress that would have an effect on the amounts reported in the financial statements or on the disclosure in the notes to the financial statements.
- There have been no oral or written communications 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 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.
- Adequate consideration has been given to, and appropriate provision made for, a continuing care retirement community's obligation to provide future services and the use of facilities to current residents.
- Adequate consideration has been given to, and appropriate provision made for, a prepaid health care provider's obligation to provide future health care services.
- Guarantees, whether written or oral, under which the health care entity is contingently liable, including guarantee contracts and indemnification agreements pursuant to FASB ASC 460, *Guarantees*, have been properly recorded or disclosed in the financial statements.

2.96 The auditor of the health care entity also may obtain specific representations, if applicable, of the following items that are unique or pervasive in the health care industry:

- The health care entity is in compliance with the provisions of IRC Section 501(c)(3) and is exempt from federal income tax under IRC Section 501(a), as evidenced by a determination letter, and from state income tax.
- Information returns (Form 990) have been filed on a timely basis.
- The health care entity is in compliance with the requirements of the provisions of IRC Section 501(r)(1), as established by the Patient Protection and Affordable Care Act, in order to be treated as an entity described in IRC Section 501(c)(3).

- 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.
- For each of its outstanding bond issues, the health care entity is in compliance with post-issuance requirements, as specified in the IRC, including, but not limited to, the areas of arbitrage and private business use.
- 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 entity is in compliance with contractual agreements, grants, and donor restrictions.
- The health care entity has maintained an appropriate composition of net assets in amounts needed to comply with all donor restrictions.
- The internal controls over the receipt and recording of received contributions are adequate.
- The allocation of expenses reported in the notes to the financial statements is reasonable based on the health care entity's current operations.
- The health care entity has properly classified equity securities with readily determinable fair values and all debt securities as either trading or other-than-trading securities and reported these investments at fair value.
- The health care entity has reported to its risk management department all known asserted and unasserted claims and incidents. Adequate and reasonable provision has been made for losses related to asserted and unasserted malpractice, health insurance, worker's compensation, and any other claims.
- The health care entity is (or is not) subject to the requirements of Office of Management and Budget Title 2 U.S. *Code of Federal Regulations* (CFR) Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards*, or Title 45 U.S. CFR Part 75.501 because it expended (or did not expend) more than \$750,000 in federal awards during the year.
- The health care entity has classified net assets as unrestricted, temporarily restricted, or permanently restricted based on its assessment of the donor's intention, as specified in original donor correspondence, when available. When not available, the entity used other corroborating evidential matter, including minutes of the board, accounting records, and financial statements. To the extent that it was unable to review original donor correspondence to determine the amount of the original gift and donor additions, its determination of such amount was based on its best estimate considering the relevant facts and circumstances. Amounts classified as temporarily restricted are subject to donor-imposed purpose or time restrictions that precluded the health care entity from

expending such amounts or recognizing such amounts as unrestricted as of the balance sheet date. Amounts classified as permanently restricted are subject to donor-imposed or statutory restrictions that require these amounts to be held in perpetuity. In addition, the health care entity has classified appreciation and income related to such donations in accordance with relevant donor or statutory restrictions. Losses on investments of a donor-restricted endowment fund have been classified in accordance with FASB ASC 958-205-45. Reclassifications between net asset classes are proper.

- The health care entity has properly classified a portion of its donor-restricted endowment funds of perpetual duration as permanently restricted net assets based on explicit donor stipulations or the entity's interpretation of relevant law in the absence of explicit donor stipulations. Unless otherwise stated in the gift agreement, the entity has classified the portion of its donor-restricted endowment funds that is not classified as permanently restricted net assets as temporarily restricted net assets until appropriated for expenditure.
- There have been no changes in the health care entity's interpretation of relevant law that underlies the health care entity's net asset classification of donor-restricted endowment funds. The health care entity's policy for the appropriation of endowment assets for expenditure is consistent with that interpretation.

Independent Auditor's Reports

2.97 The independent auditor's considerations related to reporting on an investor-owned health care entity would be similar to those for other investor-owned business entities. The form of the report would differ based on whether the audit is conducted under the standards of the PCAOB or under the standards of the AICPA.

2.98 The auditor's standard report described in paragraphs .22–.41 of AU-C section 700 uses the terminology results of operations to describe an entity's net income and other changes in net worth for a certain period. As described in chapter 3, "Unique Financial Statement Considerations for Not-for-Profit Business-Oriented Health Care Entities," the performance indicator of a not-for-profit business-oriented health care entity reports results of operations and represents an earnings measure for the entity. The opinion paragraph of the auditor's report for a NFP health care entity includes both results of operations and changes in net assets. This differs from the opinion of other types of NFP entities that do not report a performance indicator, where the opinion paragraph only refers to changes in net assets. Exhibit 2-1 provides an illustrative independent auditor's report under AICPA standards for a NFP business-oriented health care entity.

2.99 Auditors of governmental health care entities do not express an opinion on results of operations. Chapter 15, *State and Local Government Health Care Entities*, of this guide, discusses considerations and includes illustrative independent auditor's reports for governmental entities.

Exhibit 2-1

**Auditor's Report on Consolidated Comparative Financial Statements
Prepared in Accordance With
Accounting Principles Generally Accepted in the United States of
America—Not-for-Profit
Business-Oriented Health Care Entity
Independent Auditor's Report**

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of XYZ Health Care Entity, which comprise the consolidated statements of financial position as of June 30, 20X1 and 20X0, and the related consolidated statements of operations, changes in net assets, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated 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 consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion.⁶ An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

⁶ In circumstances when the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, the auditor should omit the phrase that the auditor's consideration of internal control is not for the purpose of expressing an opinion on the effectiveness of internal control, and accordingly, no such opinion is expressed.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of XYZ Health Care Entity as of June 30, 20X1 and 20X0, and the results of its operations, changes in net assets and cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Auditor's city and state]

[Date of the auditor's report]

Single Audit Act and Related Audit Considerations

2.100 An independent auditor may be engaged to perform a single audit (an audit of the financial statements and a compliance audit) for a health care entity that expends federal awards. This type of engagement is subject to the requirements of the Single Audit Act Amendments of 1996 and Title 2 U.S. CFR Part 200. Federal awards may take the form of grants, contracts, loans, loan guarantees, property, cooperative agreements, interest subsidies, and insurance or direct appropriations. Medicare payments to a nonfederal entity for providing patient care services to Medicare-eligible individuals are not considered expended federal awards under the Uniform Guidance. Medicaid payments to a subrecipient for providing patient care services to Medicaid-eligible individuals are not considered expended federal awards under the Uniform Guidance, unless a state requires the funds to be treated as expended federal awards.

2.101 The Uniform Guidance prescribes policies, procedures, and requirements to implement the Single Audit Act Amendments of 1996 and requires nonfederal entities that expend federal awards of \$750,000 or more in a fiscal year to have an audit performed in accordance with the Uniform Guidance. (Under the Uniform Guidance, a *nonfederal entity* is defined as a state, local government, Indian tribe, institution of higher education, or nonprofit organization that carries out a federal award as a recipient or subrecipient.)

2.102 Institutions covered by the Uniform Guidance include NFP hospitals, public hospitals, institutions of higher education and their affiliated hospitals, voluntary health and welfare entities, and other community-based entities. However, codification of the Uniform Guidance by the Department of Health and Human Services (HHS) also includes audit requirements for commercial entities, including for-profit hospitals that receive federal awards under HHS programs. Generally, the entity has two options regarding audits: a financial-related audit of a particular award, in accordance with *Government Auditing Standards*,⁷ or an audit that meets the requirements of the Uniform Guidance.

⁷ *Government Auditing Standards* (2011 revision), issued by the U.S. Government Accountability Office (GAO) in December 2011, contains requirements and guidance dealing with ethics, independence, auditors' professional judgment and competence, quality control, performance of the audit, and reporting. It is available on the GAO website, www.gao.gov. A practice aid, 2011 *Yellow Book Independence—Non-Audit Services Documentation Practice Aid*, is available to assist an auditor in

(continued)

2.103 The Uniform Guidance is applicable to federal awards obtained on or after December 26, 2014, with the exception of federal research and development awards under grants and contracts administered by hospitals, which are subject to the requirements provided in appendix IX, "Principles for Determining Costs Applicable to Research and Development Under Grants and Contracts With Hospitals," of 45 CFR 75.⁸

2.104 AU-C section 935, *Compliance Audits* (AICPA, *Professional Standards*), is applicable when an auditor is engaged, or required by law or regulation, to perform a compliance audit in accordance with all of the following:

- GAAS
- *Government Auditing Standards*
- A government audit requirement that requires an auditor to express an opinion on compliance

An audit in accordance with the Uniform Guidance is required to be performed in accordance with both GAAS and *Government Auditing Standards*. According to paragraph .12 of AU-C section 935, when performing a compliance audit, the auditor, using professional judgment, should adapt and apply the AU-C sections to the objectives of a compliance audit, except for the AU-C sections listed in paragraph .A41 of AU-C section 935. Furthermore, paragraph .14 of AU-C section 935 states a compliance audit is based on the premise that management is responsible for identifying the entity's government programs and understanding and complying with the compliance requirements. The auditor should determine which of those government programs and compliance requirements to test (that is, the applicable compliance requirements) in accordance with the governmental audit requirement.

2.105 When an independent auditor is engaged to perform an audit in accordance with the Uniform Guidance, both the financial statement audit and the compliance audit are performed in accordance with *Government Auditing Standards* issued by the U.S. Government Accountability Office. *Government Auditing Standards* incorporates by reference the AICPA standards and contains certain standards and requirements that are supplementary to those in GAAS, as well as guidance on how to apply those standards and requirements.

2.106 The Audit Guide *Government Auditing Standards and Single Audits* provides guidance on the auditor's responsibilities when conducting an audit of financial statements in accordance with generally accepted government auditing standards (GA-GAS) and a single audit or program-specific audit in

(footnote continued)

evaluating nonaudit services and the effect of performing such services on auditor independence. More information about the practice aid and how to obtain it can be found on the Resources page of the AICPA Governmental Audit Quality Center website at www.aicpa.org/interestareas/governmentalauditquality/resources/auditpracticetoolsands/pages/yellowbookaudittoolsandaids.aspx.

⁸ Cost principles applicable to hospitals are not superseded with the issuance of Title 2 U.S. Code of Federal Regulations (CFR) Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). As noted in appendix IX to Part 200, "Hospital Cost Principles," the OMB will instead establish a review process to consider existing hospital cost determination and how best to update and align the cost principles with the guidance in the rule. Until revised guidance is proposed and implemented for hospitals, the existing principles can be found in appendix IX, "Principles for Determining Cost Applicable to Research and Development Under Grants and Contracts with Hospitals," to Title 45 U.S. CFR Part 75. Note that upon agency implementation of the Uniform Guidance, the cost principles were moved to a new location in the CFR.

accordance with the Single Audit Act Amendments of 1996 and the Uniform Guidance. It discusses the auditor's responsibility for considering internal control and performing tests of compliance with federal statutes, regulations, and the terms and conditions of the federal awards. Further, it provides reporting guidance, including examples of the reports required by *Government Auditing Standards* and the Uniform Guidance.

Statutory Reporting Considerations for Health Plans

2.107 Most health plans that provide insurance coverage and bear financial risk are regulated by the state insurance commissioner or similar agency. Generally speaking, regulated insurers are required by their state of domicile to annually submit a set of audited financial statements that are prepared using that state's prescribed or permitted statutory accounting practices (statutory financial statements).

2.108 The National Association of Insurance Commissioners (NAIC) codified the statutory accounting practices for certain insurance entities, including regulated health plans. Annually, the NAIC issues a revised *Accounting Practices and Procedures Manual* (the NAIC Manual) reflecting revisions or additions to Statements of Statutory Accounting Principles (SSAPs) and interpretations of SSAPs. States generally require health plans to comply with the provisions of the NAIC Manual, unless the provisions are preempted by state statutes or regulations, or both. If the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the NAIC Manual, such state laws, regulations, and administrative rules take precedence. Preparers and auditors of statutory financial statements might find it useful to monitor the status of the NAIC Manual, as well as all the prescribed and permitted practices of an insurer's domiciliary state. Any permitted practices granted by the domiciliary state to the health plan must be reconfirmed annually.

2.109 Statutory financial statements prepared in accordance with the NAIC Manual, as well as other prescribed and permitted statutory accounting practices, are considered to be prepared in accordance with a special purpose framework as defined in AU-C section 800. Paragraph .A34 of AU-C section 800 sets forth guidance in evaluating the adequacy and appropriateness of informative disclosures in financial statements prepared in accordance with a special purpose framework. Although nonauthoritative, the AICPA Practice Aids *Applying Special Purpose Frameworks in State and Local Governmental Financial Statements* and *Accounting and Financial Reporting Guidelines For Cash- and Tax-Basis Financial Statements* are additional resources when financial statements are prepared using an alternative accounting and financial reporting framework.

2.110 Various SSAPs included in the NAIC Manual specifically address issues related to health plans. These include SSAP No. 25, *Affiliates and Other Related Parties*; No. 35R, *Guaranty Fund and Other Assessments*; No. 47, *Uninsured Plans*; No. 50, *Classifications of Insurance or Managed Care Contracts*; No. 54, *Individual and Group Accident and Health Contracts*; No. 55, *Unpaid Claims, Losses and Loss Adjustment Expenses*; No. 61R, *Life, Deposit-Type and Accident and Health Reinsurance*; No. 66, *Retrospectively Rated Contracts*; No. 73, *Health Care Delivery Assets and Leasehold Improvements in Health Care Facilities*; No. 84, *Health Care and Government Insured Plan Receivables*.

In addition to those noted previously, numerous other SSAPs apply to health plans. Preparers and auditors should consider the applicability of all the SSAPs and apply the SSAPs to each health plan, as appropriate.

Risk-Based Capital Requirements

2.111 The risk-based capital (RBC) formula is one of the tools used by regulators to evaluate the financial health of regulated entities. The RBC formula generally consists of the following principal risk elements: (a) affiliated investment risk, (b) asset risk, (c) underwriting risk, (d) credit risk, and (e) general business risk. Based on the outcome of the RBC formula, an insurer may be classified into one of four regulatory action levels. In order of increasingly stringent level of regulatory response, the action levels are company action level, regulatory action level, authorized control level, and mandatory control level. At a minimum, the company action level classification requires the filing of an RBC plan with the respective state insurance commissioner that details conditions leading to the classification event and the insurer's proposals of corrective action. State laws vary regarding compliance with the RBC formula and required actions to be taken by the health plan. Additional information can be found on the NAIC website at www.naic.org.

2.112 When assessing the risks of material misstatement, an auditor might consider the RBC formula and the impact that the RBC formula might have on the health plan's accounting and reporting.

Deficiencies in Internal Control

2.113 AU-C section 265, *Communicating Internal Control Related Matters in an Audit* (AICPA, *Professional Standards*), and PCAOB AS 2201 define the following terms: deficiency in internal control, material weakness, and significant deficiencies. The definitions in AU-C section 265, as detailed subsequently, are substantially consistent with PCAOB AS 2201.

- *Deficiency in internal control.* A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A deficiency in *design* exists when (a) a control necessary to meeting the control objective is missing, or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in *operation* exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.
- *Material weakness.* A deficiency or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.
- *Significant deficiency.* A deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

Communicating Internal Control Matters in an Audit

2.114 Audits performed pursuant to AU-C section 265 require the auditor to communicate in writing to those charged with governance on a timely basis, significant deficiencies and material weaknesses identified during the audit, including those that were remediated during the audit. AU-C section 265 also requires communication to management at an appropriate level of responsibility, on a timely basis:

- In writing, significant deficiencies and material weaknesses that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances.
- In writing or orally, other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention. If other deficiencies in internal control are communicated orally, the auditor should document the communication.

In accordance with paragraph .14 of AU-C section 265, the auditor's written communication of significant deficiencies and material weaknesses should include a description of the significant deficiencies and material weaknesses and an explanation of their potential effects.

Considerations for Audits Performed in Accordance With PCAOB Standards

Audits performed pursuant to PCAOB AS 2201 require the auditor to communicate in writing to management and the audit committee all material weaknesses identified during the audit. The written communication should be made prior to the issuance of the auditor's report on internal control over financial reporting. If the auditor concludes that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that conclusion in writing to the board of directors. PCAOB AS 2201 also requires the following:

- The auditor also should consider whether there are any deficiencies, or combinations of deficiencies, that have been identified during the audit that are significant deficiencies and must communicate such deficiencies, in writing, to the audit committee. This communication should be made in a timely manner and prior to the issuance of the auditor's report on internal control over financial reporting.
- The auditor also should communicate to management, in writing, all deficiencies in internal control over financial reporting (that is, those deficiencies in internal control over financial reporting that are of a lesser magnitude than material weaknesses) identified during the audit and inform the audit committee when such a communication has been made. When making this communication, it is not necessary for the auditor to repeat information about such deficiencies that has been included

in previously issued written communications, whether those communications were made by the auditor, internal audit function, or others within the organization.

Communications With Regulators

2.115 The NAIC Annual Financial Reporting Model Regulation, commonly referred to as the Model Audit Rule (MAR), incorporated the provisions of the extant standard, PCAOB AS 1305, *Communications About Control Deficiencies in an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*). MAR establishes requirements related to management reporting on the effectiveness of internal controls over statutory financial reporting, audit committees, auditor independence, and other statutory filing matters. Health plans with greater than \$500 million in direct written and assumed premiums are required to file a written communication to its domiciliary state on the effectiveness of its internal control, similar to the requirements under Section 404 of the Sarbanes-Oxley Act of 2002. The NAIC developed a companion publication, *Implementation Guide for the Annual Financial Reporting Model Regulation*. The MAR implementation guide is intended to supplement MAR, not create additional requirements, by providing interpretative guidance and clarifying the meaning of terms used in MAR. The MAR implementation guide will be updated in the future, as necessary, and is included in the NAIC Manual.

2.116 If a regulator, or a duly appointed representative, requests access to engagement documentation, refer to Interpretation No. 3 "Providing Access to or Copies of Engagement Documentation to a Regulator" (AICPA, *Professional Standards*, AT-C sec. 9105 paragraphs .15–.30), of AT-C section 105, *Concepts Common to All Attestation Engagements*.

Chapter 3

Unique Financial Statement Considerations for Not-for-Profit Business-Oriented Health Care Entities

Ⓢ Update 3-1 *Accounting and Reporting: Presentation of Financial Statements for Not-for-Profit Entities*

FASB Accounting Standards Update (ASU) No. 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*, issued in August 2016, is effective for annual financial statements issued for fiscal years beginning after December 15, 2017, and for interim periods within fiscal years beginning after December 15, 2018. Early application of the amendment is permitted.

FASB ASU No. 2016-14 makes significant changes to the reporting model for not-for-profit (NFP) health care entities. This edition of the guide has not been updated to reflect changes as a result of this ASU, however, the sections that follow will be updated in a future edition.

Refer to appendix H, "The New Not-for-Profit Financial Reporting Model Standards: FASB ASU No. 2016-14," of this guide for more information on this ASU. Readers are also encouraged to consult the full text of the ASU on FASB's website at www.fasb.org.

3.01 NFP business-oriented health care entities must apply the NFP financial reporting model described in FASB ASC 958, subject to, and in accordance with, additional financial reporting guidance provided in FASB ASC 954, *Health Care Entities*. The incremental financial reporting guidance in FASB ASC 954 tailors the NFP financial reporting model to better serve the needs of users of financial statements of NFP business-oriented health care entities.¹

Complete Set of Financial Statements

3.02 In accordance with FASB ASC 958-205-45-5, a set of financial statements of an NFP business-oriented health care entity should include (either in the body of the statements or accompanying notes) information required by generally accepted accounting principles (GAAP) that does not specifically exempt NFPs and information required by applicable, specialized accounting and reporting principles and practices.

3.03 The financial reporting for NFP business-oriented health care entities and investor-owned health care entities generally is consistent, except for transactions that clearly are not applicable. For example, NFP business-oriented health care entities would have nothing to report for shareholders' equity. On the other hand, investor-owned health care entities typically would not have anything to report for contributions.

¹ See paragraph 1.07 of this guide for a discussion of the financial reporting objectives of not-for-profit entities (NFPs) that are essentially self-sustaining from fees they charge for goods and services.

3.04 According to FASB ASC 954-205-45-1, the basic financial statements of health care entities consist of a balance sheet, a statement of operations, a statement of changes in net assets (or equity), a statement of cash flows, and notes to the financial statements.²

3.05 Some NFP business-oriented health care entities may use fund accounting for purposes of internal recordkeeping and managerial control. As noted in FASB ASC 958-205-45-3, reporting by fund groups is not a necessary part of external financial reporting; however, FASB ASC 958-205 does not preclude NFP's from providing disaggregated information by fund groups. In accordance with FASB ASC 958-210-45-2, because receivables and payables between fund groups are not entity assets or liabilities, a statement of financial position should clearly label and arrange those interfund items to eliminate their amounts when displaying total assets or liabilities.

Balance Sheet

3.06 NFP business-oriented health care entities are subject to the unique balance sheet reporting requirements for NFPs set forth in FASB ASC 958-210 and the more specific reporting requirements for health care entities contained in FASB ASC 954-210. In addition, NFP business-oriented health care entities also should apply the requirements of FASB ASC 210, *Balance Sheet*, that are not in conflict with the more specific industry requirements.

3.07 FASB ASC 958-210-45-1 requires that a statement of financial position focus on the NFP as a whole and report all of the following amounts: total assets; total liabilities; total net assets; and the amount of each of the three classes of net assets (permanently restricted, temporarily restricted, and unrestricted). FASB ASC 958-810-45-1 describes how to report non-controlling interests in the equity (net assets) of consolidated subsidiaries within the appropriate class(es) of net assets.

3.08 FASB ASC 954-210-45-1 requires health care entities, including NFP business-oriented health care entities, to classify assets and liabilities as current and noncurrent, as discussed in FASB ASC 210-10-45. However, rather than presenting a classified balance sheet, a continuing care retirement community may instead 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.

Statement of Operations

3.09 FASB ASC 958-225 describes the unique standards relating to the income statement (statement of activities) of an NFP. FASB ASC 954-225 modifies the requirements of FASB ASC 958-225 as they pertain to NFP business-oriented health care entities.

3.10 Health care entities present the information included within the statement of activities in two separate statements: a statement of operations,

² As noted in FASB *Accounting Standards Codification* 954-205-45-2, 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."

which reports all changes in unrestricted net assets for the period, and a statement of changes in net assets. Alternatively, in accordance with FASB ASC 954-225-45-1, these may be combined into a single statement of operations and changes in net assets.

3.11 Revenues, expenses, gains, and losses increase or decrease net assets and are classified in accordance with paragraphs 4–8 of FASB ASC 958-225-45, as briefly discussed subsequently. Reclassifications, equity transfers, and equity transactions should be reported as separate items. A *reclassification* is the simultaneous increase of one class of net assets and decrease of another, usually as a result of the release or lapsing of donor restrictions. Paragraphs 12.75–.78 of this guide describe equity transfers, and paragraphs 12.79–.82 of this guide describe equity transactions.

Performance Indicator

© **Update 3-2 Accounting and Reporting: Recognition and Measurement of Financial Assets and Financial Liabilities**

FASB ASU No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, was issued in January 2016. The amendments are effective for public business entities for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is not permitted by public business entities; however, this FASB ASU provides for early application of certain specified amendments as of the beginning of the fiscal year of adoption.

For all other entities including not-for-profit health care entities, the amendments in this update are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted by entities other than public business entities as of the fiscal years beginning after December 15, 2017, and interim periods within those fiscal years.

The amendments in this ASU address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, the sections that follow will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU No. 2016-01, see appendix D, "Accounting for Financial Instruments," of this guide.

3.12 FASB ASC 954-225-45-4 requires that the statement of operations for an NFP business-oriented health care entity include a performance indicator. The FASB ASC glossary states that a performance indicator reports results of operations. A performance indicator and the income from continuing operations reported by for-profit health care entities generally are consistent, except for transactions that clearly are not applicable to one kind of entity (for example, for-profit health care entities typically would not receive contributions, and NFP business-oriented health care entities would not award stock compensation). In other words, the performance indicator is analogous to income from continuing operations of a for-profit entity.

3.13 FASB ASC 954-225-45-4 also states that 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. NFP business-oriented health care entities should report the performance indicator in a statement that also presents the total changes in unrestricted net assets.

3.14 The performance indicator reports results of operations and represents an earnings measure for the entity.³ The section of the statement of operations below the performance indicator (referred to as "Other Changes in Unrestricted Net Assets") generally is regarded as the functional equivalent of other comprehensive income of an investor-owned entity.

3.15 FASB ASC 954-225-50-1 requires that the notes to the financial statements include a description of the nature and composition of the performance indicator.

Ⓢ Update 3-3 Accounting and Reporting: Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost

FASB ASU No. 2017-07, *Compensation—Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*, issued in March 2017, is effective for public business entities for annual periods beginning after December 15, 2017, including interim periods within those annual periods. For other entities, FASB ASU No. 2017-07 is effective for annual periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. Early adoption is permitted as of the beginning of an annual period for which financial statements have not been issued or made available for issuance.

FASB ASU No. 2017-07 requires that an employer separate pension and postretirement costs in service and other cost components. The service cost portion would be presented in the same financial statement line item as the related compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit cost are required to be presented separately, outside of an intermediate measure of operations, if one is presented, or the performance indicator.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, the paragraph that follows will be updated in a future edition.

Readers are encouraged to consult the full text of the ASU on FASB's website at www.fasb.org.

3.16 In accordance with FASB ASC 954-225-45-7, the following items are excluded from the performance indicator:

"Pending Content" in FASB ASC 954-225-45-7 states that the following items are excluded from the performance indicator:

³ Investor-owned entities are required by generally accepted accounting principles to include discontinued operations within their net income measure. NFPs are required to report discontinued operations just before the change in net assets, preceded by a subtotal. See paragraph 3.21. Accordingly, the performance indicator is considered to be analogous to income from continuing operations, rather than net income, of an investor-owned health care entity. Further, the term *net income* is not an appropriate caption for describing the earnings measure of an NFP.

- 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 in accordance with FASB ASC 220-10-45-10A, which includes, but is not limited to gains or losses, prior service costs or credits, and transition assets or obligations recognized in accordance with FASB ASC 715, *Compensation—Retirement Benefits*; 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 NFP standards. These include the effect of discontinued operations. See paragraph 3.21.
- g. Unrealized gains and losses on investments other than trading securities, in accordance with FASB ASC 954-320-45-1(b).
- h. Investment returns restricted by donors or law. See also FASB ASC 954-320-45-2.
- i. Investment losses that decrease unrestricted net assets if those losses reduce the assets of a donor-restricted endowment fund below the required level, as described in FASB ASC 958-205-45-22.
- j. Investment gains that increase unrestricted net assets if those gains restore the fair value of the assets of a donor-restricted endowment fund to the required level, as described in FASB ASC 958-205-45-22.
- k. An inherent contribution (see FASB ASC 958-805-25-31) received in an NFP acquisition transaction that increases temporarily-restricted or permanently-restricted net assets, as described in FASB ASC 954-805-45-2.

3.17 The preceding items that reflect increases or decreases in unrestricted net assets are reported below the performance indicator in the statement of operations. Items that reflect increases or decreases in temporarily-restricted or permanently-restricted net assets are reported in the statement of changes in net assets.

Other Intermediate Subtotals

3.18 As noted in paragraphs 5–6 of FASB ASC 954-225-45, 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, an NFP business-oriented health care entity may classify items as operating and nonoperating, expendable and nonexpendable, earned and unearned, recurring and nonrecurring, or in other ways. The guidance neither requires nor precludes reporting such intermediate measures or subtotals. As discussed in paragraphs 9–12 of

FASB ASC 958-225-45, NFPs have the flexibility to choose whether to report an operating measure.

3.19 FASB ASC 958-225-45-11 states that if an intermediate measure of operations is reported, other subtopics within FASB ASC impose limitations on an entity's use of that measure. If a subtotal is presented, such as income from operations, it should include the amounts of the following items:

- a. An impairment loss recognized for a long-lived asset (asset group) that is to be held and used, pursuant to FASB ASC 360-10-45-4
- b. Costs associated with an exit or a disposal activity that does not involve a discontinued operation, pursuant to FASB ASC 420-10-45-3
- c. A gain or loss recognized on the sale of a long-lived asset (disposal group) that is not a component of an entity, pursuant to FASB ASC 360-10-45-5

3.20 As required by FASB ASC 958-225-50-1, if an NFP business-oriented health care entity's use of the term *operations* 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.

Discontinued Operations and Accounting Changes

3.21 As illustrated in "Pending Content" in FASB ASC 958-225-55-6, GAAP requires an NFP to appropriately report labeled subtotals for changes in classes of net assets before the effects of discontinued operating segments, if any.

3.22 Normally, a FASB ASU will provide specific transition requirements. If a newly issued standard requires that the effect of an accounting change be reported as a cumulative-effect adjustment to the change in net assets of the period of the change, rather than by retrospective application, that amount would also be displayed with discontinued operations, unless the transition requirements provided otherwise.

Revenues

© Update 3-4 *Accounting and Reporting: Revenue from Contracts With Customers*

FASB ASU No. 2014-09, *Revenue from Contracts with Customers*, as amended, provides a framework for revenue recognition and supersedes or amends several of the revenue recognition requirements in FASB ASC 605, *Revenue Recognition*, as well as guidance within the industry-specific topics, including FASB ASC 954, *Health Care Entities*, and FASB ASC 958, *Not-for-Profit Entities*. The standards apply to any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance or lease contracts).

The effective date of the new revenue standards for health care entities is dependent on the type of reporting entity, as follows:

- Health care entities that are either public business entities or NFPs that have issued, or are conduit bond obligors for, securities that are

traded, listed, or quoted on an exchange or an over-the-counter market are required to apply the standards for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Earlier application by those entities is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

- All other health care entities are required to apply the guidance in FASB ASU No. 2014-09 to annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. Earlier application by those health care entities is permitted only as of an annual reporting period beginning after December 15, 2016, including interim reporting periods within that reporting period, or an annual reporting period beginning after December 15, 2016, and interim reporting periods within annual reporting periods beginning one year after the annual reporting period in which an entity first applies the guidance in FASB ASU No. 2014-09.

Readers are encouraged to consult the full text of FASB ASU No. 2014-09 on FASB's website at www.fasb.org.

The AICPA has formed 16 industry task forces to assist in developing a new accounting guide on revenue recognition that will provide helpful hints and illustrative examples for how to apply the new standard. Revenue recognition implementation issues identified by the Health Care Entities Revenue Recognition Task Force will be available for informal comment, after review by the AICPA Financial Reporting Executive Committee, at www.aicpa.org/interestareas/frc/accountingfinancialreporting/revenuerecognition/pages/rtrf-healthcare.aspx. Readers are encouraged to submit comments to revrecomments@aicpa.org.

For more information, see appendix C, "The New Revenue Recognition Standard: FASB ASC 606," of this guide.

This edition of the guide has not been updated to reflect changes as a result of FASB ASC 606, however, the section that follows will be updated in a future edition.

3.23 FASB ASC 958-225-45-5 requires that revenues be reported as increases in unrestricted net assets, unless the use of the received assets is limited by donor-imposed restrictions.

3.24 The financial statement display requirements for patient service revenue and capitation revenue are discussed in chapter 10, "Health Care Service Revenue and Related Receivables," of this guide, and display of managed care revenue is discussed in chapter 13, "Financial Accounting and Reporting for Managed Care Services," of this guide.

3.25 As discussed in FASB ASC 954-605-05-4, other revenue, gains, or losses are derived from services other than providing health care services to patients, residents, or enrollees. These typically include the following:

- Interest and dividends from all funds held by a trustee, malpractice funds, or other miscellaneous investment activities
- Certain realized changes in fair values of marketable securities

- 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 the sale of cafeteria meals and guest trays to employees, medical staff, and visitors
- Proceeds from the sale of scrap, used X-ray film and so forth
- Proceeds from sales at gift shops, snack bars, newsstands, parking lots, vending machines, or other service facilities operated by the health care entity

Expenses

3.26 FASB ASC 958-225-45-7 requires an NFP to report all expenses as decreases in unrestricted net assets. FASB ASC 958-720-45 provides standards for the presentation of expenses in the financial statements of an NFP.

3.27 Expenses may be reported on the face of the statement of operations using either a natural classification (for example, salaries and wages, supplies, and so on) or functional presentation (a method of grouping expenses according to the purpose for which costs are incurred). Pursuant to FASB ASC 958-205-55-11, NFPs that report using a natural classification of expenses on the face of the statement of operations are required to disclose expenses by functional classification in the notes to the financial statements.

3.28 According to FASB ASC 954-225-45-3, the primary functional classifications are program services and supporting activities. The extent of classification and subclassification of expenses depends on many factors, such as the nature and complexity of the health care entity. For example, in complying with the functional reporting requirements of FASB ASC 958-205-45-6, 958-720-05-4, and 958-720-45-2, some NFP business-oriented health care entities may present only two categories: health services (including inpatient services, outpatient procedures, home health services, and so forth) and general and administrative. Others may present additional distinctions, such as physician services, research, and teaching. Functional allocations should be based on full cost allocations.

Statement of Changes in Net Assets (or Equity)

3.29 The statement of changes in net assets (or equity) reports all changes that have occurred during the reporting period in each classification of net assets (unrestricted, temporarily restricted, and permanently restricted). As discussed in paragraph 3.10, this statement may be combined with the statement of operations or presented separately.

3.30 The statement of changes in net assets displays the four measures required by FASB ASC 958-225-45-1: the change in permanently-restricted net assets, the change in temporarily-restricted net assets, the change in unrestricted net assets, and the change in net assets for the entity as a whole. As illustrated in FASB ASC 958-205-55-16, generally, the information presented for the unrestricted net asset category in the statement of changes in net assets is highly aggregated.

3.31 Restricted contributions and restricted investment returns, which are excluded from the performance indicator, are reported as increases or decreases in temporarily-restricted or permanently-restricted net assets in the statement of changes in net assets. Restricted contributions are discussed in chapter 11, "Contributions Received and Made," of this guide, and restricted investment returns are discussed in paragraphs 4.32–.34 of this guide.

3.32 Because all expenses must be reported as decreases in unrestricted net assets, as discussed in paragraph 3.26, no expenses should be reported in the temporarily-restricted or permanently-restricted net asset categories. However, certain losses may be reported within those categories, as discussed in FASB ASC 958-225-45-8.

Statement of Cash Flows

🕒 Update 3-5 Accounting and Reporting: Statement of Cash Flows

FASB ASU No. 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (a consensus of the Emerging Issues Task Force)*, was issued in August 2016 to increase the consistency of reporting the following cash flows: debt prepayment or debt extinguishment costs, settlement of debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing (such as zero-coupon bonds), cash payments made to settle a contingent consideration liability arising from an acquisition, proceeds from the settlement of insurance claims, proceeds from the settlement of corporate-owned life insurance policies, distributions received from equity method investees, and beneficial interests in securitization transactions. In addition, the ASU includes guidance for classification of cash receipts and payments that have aspects of more than one class of cash flows.

FASB ASU No. 2016-15 is effective for fiscal years, including interim periods within those fiscal years, of a public business entity beginning after December 15, 2017. For all other entities, FASB ASU No. 2016-15 is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity that elects adoption must adopt all of the amendments in the same period.

This edition of the guide has not been updated to reflect changes as a result of this FASB ASU; however, the section that follows will be updated in a future edition. Readers are encouraged to consult the full text of the FASB ASU on FASB's website at www.fasb.org.

Ⓢ Update 3-6 Accounting and Reporting: Restricted Cash

FASB ASU No. 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash*, issued in November 2016, is effective for fiscal years, including interim periods within those fiscal years, of a public business entity beginning after December 15, 2017.

For all other entities, FASB ASU No. 2016-18 is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years beginning after December 15, 2019. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period.

FASB ASU No. 2016-18 requires that a statement of cash flows explain the change during the period in total of cash, cash equivalents, and amount generally described as restricted cash or restricted cash equivalents. Therefore, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The ASU does not define restricted cash.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this section will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org

3.33 The general standards for reporting cash flows are provided in FASB ASC 230, *Statement of Cash Flows*. FASB ASC 958-230 provides incremental guidance related to reporting NFP-specific transactions within this statement. According to FASB ASC 230-10-45, the statement of cash flows may be prepared using the direct or indirect method of reporting cash flows.

3.34 FASB ASC 230-10-45-28 requires an NFP to reconcile the change in net assets to net cash flows from operating activities. FASB ASC 958-205-55-20 provides an example of this reconciliation.

3.35 The reconciliation should accommodate certain items that are not included in the statement of cash flows prepared for investor-owned health care entities, such as equity transfers, contributions of long-lived assets, other contributions restricted for long-term purposes, unrealized gains and losses on certain investments, investment returns restricted for long-term purposes by donor or law, and the effective portion of fair value changes of cash flow hedging derivatives.

3.36 FASB ASC 958-230 expands the description of financing activities in FASB ASC 230 to encompass receipts of resources that are donor-restricted for long-term purposes. As discussed in FASB ASC 958-210-45-6, cash or other assets received with a donor-imposed restriction that limits their use to long term should not be classified on a statement of financial position with cash or other assets that are unrestricted and available for current use. Therefore, as discussed in FASB ASC 958-230-55-3, when an NFP reports cash received with a donor-imposed restriction that limits its use to long-term purposes, in conformity with FASB ASC 958-210-45-6, an adjustment is necessary for the statement of cash flows to reconcile beginning and ending cash and cash equivalents. To report in conformity with FASB ASC 230, the receipt of a cash

contribution that is restricted for the purchase of equipment should be reported as a cash flow from financing activities (using a caption such as "Contributions Restricted for Purchasing Equipment"), and it should be simultaneously reported as a cash outflow from investing activities (using a caption such as "Purchase of Assets Restricted to Investment in Property and Equipment" or, if the equipment was purchased in the same period, "Purchase of Equipment"). An adjustment to reconcile the change in net assets to net cash used or provided by operating activities would also be needed if the contributed asset is not classified as cash or cash equivalents on the statement of financial position. When the equipment is purchased in a subsequent period, both the proceeds from the sale of assets restricted to investment in the equipment and the purchase of the equipment should be reported as cash flows from investing activities.

3.37 In accordance with FASB ASC 230-10-45-21A, cash receipts from the sale of donated financial assets (for example, debt or equity instruments) by NFP business-oriented health care entities that upon receipt were directed without imposed limitations for sale and were converted nearly immediately into cash should be classified as operating cash flows. If, however, the donor restricted the use of the contributed resource to a long-term purpose of the nature of those described in paragraph FASB ASC 230-10-45-14(c), then those cash receipts meeting all the conditions in this paragraph should be classified as a financing activity.

Notes to the Financial Statements

3.38 The individual chapters of this guide discuss the notes to the financial statements that are unique to, or prevalent for, health care entities.

Subsequent Events

3.39 FASB ASC 855, *Subsequent Events*, establishes standards for accounting for, and disclosure of, events that occur after the balance sheet date but before financial statements are issued or available to be issued. In accordance with FASB ASC 855-10-25, an entity should recognize in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. An entity should not recognize subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after the balance sheet date but before financial statements are issued or available to be issued. Instead, nonrecognized subsequent events are disclosed if they are of such a nature that they must be disclosed to keep the financial statements from being misleading.

3.40 As discussed in paragraphs 7.06–.08 of this guide, because of their use of conduit debt that trades in public markets, many NFP business-oriented health care entities fall into the class of entities that are required to evaluate subsequent events through the issuance date of their financial statements. However, if an NFP business-oriented health care entity issued tax-exempt debt in a private placement, and the debt has not subsequently begun trading in a public market, the entity is not a conduit bond obligor for the purpose of FASB ASC 855 because its debt does not trade in a public market.

3.41 If an NFP business-oriented health care entity does not have conduit debt that trades in a public market, it is required to evaluate subsequent events up through the date that the financial statements are available to be issued. The FASB ASC glossary definition of *financial statements are available to be issued* states that "[f]inancial statements are considered available to be issued when they are complete in a form and format that complies with GAAP and all approvals necessary for issuance have been obtained, for example, from management, the board of directors, and/or significant shareholders."

Example Financial Statements

3.42 Some health care entities choose to present very detailed financial statements; others present highly condensed statements, providing only summary totals of major classifications of revenue and expense. Each entity should use the presentation that it considers to be most informative given its own facts and circumstances, provided that the statements comply with the reporting parameters of GAAP.

3.43 Examples of financial statements of health care entities are not included in this guide. Examples may be found in the following places:

- The website for Electronic Municipal Market Access (EMMA), (<http://emma.msrb.org>) for financial statements of NFP business-oriented health care entities. EMMA is the official source for municipal disclosures and market data maintained by the Municipal Securities Rulemaking Board. EMMA contains official statements and continuing disclosures for NFPs with tax-exempt bonds.
 - The website for the Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system (www.sec.gov/edgar/aboutedgar.htm) for financial statements of investor-owned health care entities that are required to file forms with the SEC. EDGAR is the system for the automated collection, validation, indexing, acceptance, and forwarding of submissions by companies and others that are required by law to file forms with the SEC.
 - The websites of health care entities that are considered peers of the reporting entity.
 - The websites of regulatory agencies, such as the secretary of state or departments of health or insurance.
 - The AICPA publications *Not-for-Profit Entities—Best Practices in Presentation and Disclosure* and *U.S. GAAP Financial Statements—Best Practices in Presentation and Disclosure* (www.aicpastore.com), provide useful disclosure examples, even though they do not contain example financial statements of health care entities.
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Chapter 4

Cash, Cash Equivalents, and Investments

Cash and Cash Equivalents

4.01 Health care entities, both investor-owned and not for profit (NFP), hold cash balances to meet payments arising in the ordinary course of operations and unanticipated contingencies. These balances may be held as cash or cash equivalents. This chapter discusses the following industry-pervasive matters about accounting for cash and cash equivalents:

- Centralized cash management arrangements (see paragraphs 4.03–.06)
- Cash from restricted donations (see paragraph 4.07)
- Other restricted or designated cash amounts (see paragraphs 4.08–.11)

4.02 The FASB *Accounting Standards Codification* (ASC) glossary defines a *cash equivalent* as

short-term, highly liquid investments that have both of the following characteristics:

- a. Readily convertible to known amounts of cash
- b. So near their maturity that they present insignificant risk of changes in value because of changes in interest rates.

Generally, only investments with original maturities of three months or less qualify under that definition. Original maturity means original maturity to the entity holding the investment. For example, both a three-month U.S. Treasury bill and a three-year U.S. Treasury note purchased three months from maturity qualify as cash equivalents. However, a Treasury note purchased three years ago does not become a cash equivalent when its remaining maturity is three months. Examples of items commonly considered to be cash equivalents are Treasury bills, commercial paper, money market funds, and federal funds sold (for an entity with banking operations).

Centralized Cash Management Arrangements

4.03 Many health care entities have centralized cash management arrangements whereby excess cash is swept into a cash pool. Subsidiary cash requirements are met through withdrawals or borrowings from the cash pool. The cash pool is invested in assets, such as deposits at banks, that are in the parent company's name. Under this type of arrangement, the parent company and its subsidiaries have sweep arrangements with their respective banks whereby cash is transferred daily between the bank accounts of the entities (the parent and its subsidiaries). These arrangements serve to reduce lending costs and provide a higher rate of return on invested cash. Careful review of centralized cash management arrangements is necessary to determine the appropriate accounting and reporting of a subsidiary's deposit in the cash pool.

4.04 The FASB ASC glossary states that *cash* "includes not only currency on hand but demand deposits with banks or other financial institutions. Cash

also includes other kinds of accounts that have the general characteristics of demand deposits in that the customer may deposit additional funds at any time and also effectively may withdraw funds at any time without prior notice or penalty."

4.05 Funds deposited by a subsidiary in a parent company's cash account under a centralized cash management arrangement generally would not be classified as cash and cash equivalents in the subsidiary's financial statements if the subsidiary does not have legal title to the cash on deposit. Generally, legal title in a cash account is evidenced by the cash or cash equivalent being deposited in a demand deposit account at a bank or other financial institution in the subsidiary's name. A subsidiary's deposit in a cash pool generally is not a short-term highly-liquid investment, as contemplated in the definition of a *cash equivalent* in paragraph 4.02; rather, the deposit is considered a loan, and the subsidiary would classify the deposit in the cash pool as a receivable from an affiliated entity.

4.06 If the indirect method is used to prepare the statement of cash flows, changes in the subsidiary's receivable relating to a centralized cash management program are presented as investing activities—as such, balances are generally considered loans. Payments to, and receipts from, the cash pool would be presented on a gross or net basis, in accordance with the guidance in paragraphs 7–9 of FASB ASC 230-10-45.

Cash From Restricted Donations

4.07 FASB ASC 954-305-45-3 states that for fiduciary purposes, NFP business-oriented health care entities may maintain separate checking or savings accounts for restricted donations. However, unless required by FASB ASC 954-305-45-1, as discussed in paragraph 4.08, such accounts 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 the use of specific assets.¹

Other Restricted or Designated Cash Amounts

4.08 FASB ASC 954-305-45-1 states that cash and claims to cash that meet any of the following conditions should be reported separately and excluded from current assets:

- a. They are restricted regarding withdrawal or use for other-than-current operations.
- b. They are designated for expenditure in the acquisition or construction of noncurrent assets.
- c. They are required to be segregated for the liquidation of long-term debt.
- d. They are limited to use for long-term purposes by a donor-imposed restriction (see paragraph 11.25 of this guide).

Further, according to FASB ASC 954-210-45-4, 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 Per FASB *Accounting Standards Codification* (ASC) 954-305-45-3, a columnar presentation that highlights the three classes of net assets (permanently restricted, temporarily restricted, and unrestricted) is not precluded if the totals for the reporting entity as a whole are displayed.

4.09 For example, such amounts could be reported on a separate line and described as assets whose use has been limited or whose use is restricted, such as designated for construction, limited by donor-imposed restrictions, held by the trustee for liquidation of long-term debt, and so on.

4.10 FASB ASC 958-210-45-6 states that the asset whose use is limited should be described in the notes to the financial statements if its nature is not clear from the description on the face of the balance sheet.

4.11 Restricted cash is similar to investments in that the holder's ability to withdraw restricted cash amounts is contractually limited. As a result, deposits and withdrawals of principal balances in restricted cash accounts would be reported as investing activities in the statement of cash flows.

Investments

🕒 **Update 4-1 Accounting and Reporting: Recognition and Measurement of Financial Assets and Financial Liabilities**

FASB Accounting Standards Update (ASU) No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, was issued January 2016. The amendments are effective for public business entities for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. For all other entities including not-for-profit entities and employee benefit plans within the scope of FASB ASC 960, *Plan Accounting—Defined Benefit Pension Plans*, and FASB ASC 965, *Plan Accounting—Health and Welfare Benefit Plans*, on plan accounting, the amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. All entities that are not public business entities may adopt the amendments in this ASU earlier as of the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.

Early application by public business entities to financial statements of fiscal years or interim periods that have not yet been issued or, by all other entities, that have not yet been made available for issuance of the following amendments in this ASU are permitted as of the beginning of the fiscal year of adoption.

Except for the early application guidance previously discussed, early adoption of the amendments is not permitted.

The amendments in this ASU address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, the sections that follow will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU No. 2016-01, see appendix D, "Accounting for Financial Instruments," of this guide.

4.12 Health care entities can maintain and manage significant investment portfolios. The nature of such investments held by health care entities is

dependent upon various factors, such as an entity's investment policies and strategies, donor and other external restrictions, and regulations. The legal structure, term, and features specific to an instrument, such as restrictions on disposing of the investment or other internal and external restrictions, can affect both the accounting and reporting of an investment and the valuation of the investment.

4.13 This chapter discusses the following industry-pervasive matters about accounting for investments:

- The fair value option to measure financial assets (see paragraphs 4.17–.22)
- Investments in equity securities that have readily determinable fair values and all investments in debt securities for which an entity has not elected to apply the fair value option (see paragraphs 4.23–.35)
- Investments for which a readily determinable fair value does not exist and for which an entity has not elected to apply the fair value option, including alternative investments, such as collective trusts, funds of funds, or hedge funds (see paragraphs 4.36–.38)
- Investment pools (see paragraphs 4.39–.47)
- Fair value measurement (see paragraph 4.48)
- Impairment of investments (see paragraphs 4.49–.59)
- Securities lending arrangements (see paragraph 4.60)
- Transfers of assets to an NFP or charitable trust for investment (see paragraphs 4.61–.63)
- Regulation (see paragraph 4.64)
- Other financial statement presentation matters (see paragraphs 4.65–.73)

4.14 The following investments are discussed elsewhere in this guide:

- Chapter 5, "Derivatives," discusses investments in derivative instruments that are accounted for in accordance with FASB ASC 815, *Derivatives and Hedging*.
- Chapter 12, "The Reporting Entity and Related Entities," discusses investments accounted for under the equity method if the investees are an integral part of the entity's operations, such as a physician hospital organization or joint venture.²
- Chapter 12 also discusses investments in consolidated or combined entities.

4.15 According to FASB ASC 954-325-35-1, 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 subject to impairment considerations consistent with the "Impairment or Disposal of Long-lived Assets" sections of FASB ASC 360-10.

² This chapter discusses the accounting and reporting for equity investments accounted for under the equity method if such investment's purpose is investment income or return, such as collective trusts, funds of funds, hedge funds, or other alternative investments, versus an equity investment that represents an integral part of the reporting entity's operations, such as a physician hospital organization or joint venture.

4.16 Health care entities can use this chapter, NFP business-oriented health care entities can use exhibit 12-1, and investor-owned health care entities can use paragraph 12.59 to assist with the determination of which investments are required to be consolidated and which are accounted for using the equity method if the entity has not elected to apply the fair value option, as discussed in paragraph 4.17.

Fair Value Option

4.17 Most investments owned by health care entities are *financial assets*, as defined in FASB ASC 825-10-20. The "Fair Value Option" sections of FASB ASC 825-10 permit all entities to choose to measure eligible items at fair value (the fair value option) at specified election dates. Paragraphs 4–5 of FASB ASC 825-10-15 describe which financial assets are eligible items.

4.18 The decision about whether to elect the fair value option should be (a) applied instrument by instrument, except as discussed in FASB ASC 825-10-25-7; (b) irrevocable, unless a new election date occurs, as discussed in FASB ASC 825-10-25-4; and (c) applied only to an entire instrument, and not to only specified risks, specific cash flows, or portions of that instrument.

4.19 Health care entities should follow the guidance in FASB ASC 820, *Fair Value Measurement*, to determine and report an investment's fair value. FASB ASC 825-10-25-3 requires that upfront costs and fees related to items for which the fair value option is elected be recognized in earnings as incurred and not deferred. Health care entities that elect to apply the fair value option to an instrument should refer to the guidance in FASB ASC 825-10-50 and 820-10-50 for the required financial statement disclosures. FASB ASC 825-10-45-3 requires that entities classify cash receipts and payments related to items measured at fair value according to their nature and purpose, as required by FASB ASC 230, *Statement of Cash Flows*.

4.20 In accordance with FASB ASC 825-10-35-4, investor-owned health care entities should report unrealized gains and losses on items for which the fair value option has been elected in earnings.

4.21 In accordance with FASB ASC 825-10-15-7, NFP health care entities should report unrealized gains and losses on items for which the fair value option has been elected within the performance indicator or as part of discontinued operations, as appropriate. Consistent with the provisions of FASB ASC 958-10 and 954-225-45-5, an NFP health care entity may present such gains and losses either within or outside an intermediate measure of operations, unless such gains or losses are part of discontinued operations; however, that intermediate measure must be within the performance indicator. For NFPs, the disclosure requirements of FASB ASC 825-10-50-30 apply not only with respect to the effect on performance indicators or other intermediate measures of operations, if presented, but also on the change in each of the net asset classes (unrestricted, temporarily restricted, and permanently restricted), if applicable.

4.22 Per FASB ASC 825-10-50-28(f), for investments that would have been accounted for under the equity method if the health care entity had not chosen to apply the fair value option, the health care entity should disclose the information required by FASB ASC 323-10-50-3, excluding the disclosures in FASB ASC 323-10-50-3(a)(3), (b), and (d).

Investments in Debt Securities and Certain Equity Securities With a Readily Determinable Fair Value That Are Not Recorded Under the Fair Value Option

4.23 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 investor-owned and NFPs for which the health care entity has not elected to apply the fair value option to the instrument, as discussed in paragraph 4.17.

Investor-Owned Entities

Ⓢ **Update 4-2 Accounting and Reporting: Premium Amortization on Purchased Callable Debt Securities**

FASB ASU No. 2017-08, *Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities*, issued in March 2017, is effective for fiscal years, and interim periods within those fiscal years, of a public business entity beginning after December 15, 2018.

For all other entities, FASB ASU No. 2017-08 is effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years beginning after December 15, 2020. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period.

FASB ASU No. 2017-08 shortens the amortization period of premiums on certain purchased callable debt securities to the earliest call date. The amendments affect all entities that hold investments in call-able debt securities that have an amortized cost basis in excess of the amount that is repayable by the issuer at the earliest call date (that is, at a premium).

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this section will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

4.24 Investor-owned health care entities are subject to the accounting and reporting requirements of FASB ASC 320, *Investments—Debt and Equity Securities*. FASB ASC 320 does not apply to (a) instruments for which the health care entity elected to apply the fair value option, as discussed in paragraphs 4.17–.22; (b) equity securities that, absent the election of the fair value option under FASB ASC 825-10-25-1, would be required to be accounted for under the equity method; (c) investments in consolidated entities; (d) derivative instruments that are accounted for in accordance with FASB ASC 815, including those that have been separated from a host contract as required by FASB ASC 815-15-25 (an investment that would otherwise be within the scope of FASB ASC 320 and it has within it an embedded derivative that is required by FASB ASC 815-15-25 to be separated, the host instrument remains within the scope of FASB ASC 320), and (e) equity securities accounted for under the cost method in accordance with FASB ASC 325-20, except with respect to impairment guidance in FASB ASC 320-10-35. FASB ASC 320-10-15 provides a more complete description of the scope of FASB ASC 320.

4.25 FASB ASC 320-10-25-1 states that at acquisition, an entity shall classify its debt and equity securities into one of three categories:

- a. *Trading securities.* If a security is acquired with the intent of selling it within hours or days, the security should be classified as trading. However, at acquisition, an entity is not precluded from classifying as trading a security it plans to hold for a longer period. Classification of a security as trading should not be precluded simply because the entity does not intend to sell it in the near term.
- b. *Available-for-sale securities.* Investments in debt securities and equity securities that have readily determinable fair values and are not classified as trading securities or held-to-maturity securities should be classified as available-for-sale securities.
- c. *Held-to-maturity securities.* Investments in debt securities should be classified as held to maturity only if the reporting entity has the positive intent and ability to hold those securities to maturity.

4.26 Per FASB ASC 320-10-35-1, investments in debt securities that are classified as held to maturity should be measured subsequently at amortized cost in the balance sheet. Investments that are classified as trading should be measured subsequently at fair value in the balance sheet, and unrealized holding gains and losses for trading securities should be included in earnings. Investments that are classified as available for sale should be measured subsequently at fair value in the balance sheet, and unrealized holding gains and losses for available-for-sale securities, including those classified as current assets, should be excluded from earnings and reported in other comprehensive income until realized, except as indicated in the following sentence. 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 should be recognized in earnings during the period of the hedge, pursuant to paragraphs 1–4 of FASB ASC 815-25-35.

4.27 For investments within the scope of FASB ASC 320, investor-owned health care entities should follow the disclosure requirements of FASB ASC 320-10-50.

Not-for-Profit Entities

4.28 NFP business-oriented health care entities are subject to the accounting and reporting requirements of FASB ASC 958-320 and 954-320. FASB ASC 958-320 does not apply to (a) instruments for which the health care entity elected to apply the fair value option, as discussed in paragraphs 4.17–.22; (b) equity investments accounted for under the equity method; (c) investments in consolidated subsidiaries; (d) investments in derivative instruments that are accounted for in accordance with FASB ASC 815; (e) investments held by a financially interrelated entity, as discussed in paragraph 12.76 of this guide; and (f) short sales of securities. FASB ASC 958-320-15 provides a more complete description of the scope of FASB ASC 958-320.

4.29 NFP health care entities can designate investment portfolios or portions of investment portfolios as trading. Investment returns from investments, inclusive of those securities designated as trading, accounted for under FASB ASC 958-320 should be included as changes in net assets, consistent with paragraphs 4.30–.34.

4.30 FASB ASC 958-320-35 requires investments in equity securities with readily determinable fair values and all debt securities to be measured at fair value in the balance sheet. According to FASB ASC 954-320-45-1, investment returns, including realized and unrealized gains and losses, not restricted by donors or law should be classified as changes in unrestricted net assets as follows:

- a. The following are included in the performance indicator (see paragraphs 3.12–.17 of this guide):
 - i. Dividend, interest, and other similar investment income
 - ii. Realized gains and losses
 - iii. Unrealized gains and losses on trading securities
 - iv. Other-than-temporary impairment losses
- b. The following is excluded from the performance indicator:
 - i. Unrealized gains and losses on other-than-trading securities

4.31 Because the performance indicator is analogous to income from continuing operations of an investor-owned health care entity, as discussed in paragraph 3.12 of this guide, the performance indicator would also include unrealized gains and losses on investments recorded under the fair value option and equity earnings from investments in entities, such as investment companies and other alternative investments, accounted for under the equity method. The performance indicator would exclude the portion of other-than-temporary impairment losses on debt securities that is related to factors other than credit losses, as discussed in paragraph 4.55.

4.32 Pursuant to paragraphs 1–2 of FASB ASC 958-320-45, except as described in paragraphs 4.33–.34, dividend, interest, and other investment income and gains and losses should be reported as increases or decreases in unrestricted net assets, unless their use is temporarily or permanently restricted by explicit donor stipulations or law. Donor-restricted investment income should be reported as an increase in temporarily or permanently restricted net assets, depending on the type of restriction.

4.33 FASB ASC 958-320-45-3 states that 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 NFP has a similar policy for reporting received contributions, as discussed in paragraphs 3–5 of FASB ASC 958-605-45; reports consistently from period to period; and discloses its accounting policy. The classification of these gains and investment income within unrestricted net assets should be consistent with paragraph 4.30.

4.34 Paragraphs 16–35 of FASB ASC 958-205-45 describe the accounting for gains and losses on investments of donor-restricted endowment funds. FASB ASC 958-205-45-22 states that in the absence of donor stipulations or law to the contrary, losses on the investments of a donor-restricted endowment fund should 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 should reduce unrestricted net assets. FASB ASC 954-225-45-7 requires that the portion of the loss that reduces the assets of a donor-restricted endowment fund below the required

level³ be excluded from the determination of the performance indicator. FASB ASC 958-205-45-24 states that 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 should be classified as increases in unrestricted net assets. FASB ASC 954-225-45-7 requires that those gains be excluded from the determination of the performance indicator.

4.35 NFP health care entities should follow the disclosure requirements included in FASB ASC 954-320 and 958-320-50.

Investments in Certain Other Financial Instruments Without a Readily Determinable Fair Value That Are Not Recorded Under the Fair Value Option

4.36 In an effort to improve investment returns, health care entities may invest in investment companies structured as limited liability companies, limited partnerships, institutional trusts, common and collective trusts, or financial instruments that do not have a readily determinable fair value. These types of investments are commonly referred to as alternative investments. Assuming that the health care entity has not elected to apply the fair value option to account for these investments, the accounting for these types of investments can vary depending upon the legal structure of the investment, as well as the investment's terms and features. An alternative investment may have a formal notification period that requires the investor to provide the investee 60, 90, or 360 day's notification prior to redeeming the investment for cash. Additionally, the legal structure of certain alternative investments provides the investor ownership rights and responsibilities similar to a limited partnership whereas others do not provide such ownership rights to the investor. The terms and features of each alternative investment must be carefully considered before concluding on the appropriate method of accounting. Exhibit 12-1 of this guide provides helpful guidance for determining the appropriate method of accounting for NFP health care entities and investor-owned health care entities, respectively. Paragraphs 4.39–.47 provide additional discussion for investment pools.

4.37 Determining the fair value of alternative investments may be necessary for recognition or disclosure purposes. Many of these investees provide their investors with a net asset value (NAV) per share or its equivalent that has been calculated in a manner consistent with FASB ASC 946, *Financial Services—Investment Companies*. If those investments do not have readily determinable fair values, FASB ASC 820-10-35-59 permits a reporting entity, as a practical expedient, to estimate the fair value of an investment within the scope of paragraphs 4–5 of FASB ASC 820-10-15 using the NAV per share of the investment or its equivalent, such as member units or an ownership interest in partners' capital to which a proportionate share of net assets is attributed, if the NAV per share of the investment or its equivalent is calculated in a manner

³ 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. Not-for-profit (NFP) health care entities in states that have adopted the Uniform Prudent Management of Institutional Funds Act should refer to paragraphs 28–32 of FASB ASC 958-205-45 for additional information about the classification of net assets of donor-restricted endowment funds. NFP health care entities in other states should refer to paragraphs 33–35 of FASB ASC 958-205-45.

consistent with the measurement principles of FASB ASC 946 as of the reporting entity's measurement date. "Pending content" in FASB ASC 820-10-50-6A requires certain disclosures for alternative investments measured at fair value, which are measured using NAV as a practical expedient for fair value. These investments should not be classified in the fair value hierarchy.

4.38 Technical Questions and Answers (Q&A) sections 2220.18–26 (AICPA, *Technical Questions and Answers*) are intended to assist reporting entities in applying the provisions of FASB ASC 820, which are discussed in the preceding paragraph. Q&A section 2220.27, "Determining Fair Value of Investments When the Practical Expedient Is Not Used or Is Not Available" (AICPA, *Technical Questions and Answers*), assists reporting entities in determining the fair value of investments in circumstances in which the practical expedient NAV is not used or available.

Investment Pools

4.39 In order to effectively manage investments and improve total investment returns, many NFP health care entities pool part or all of their investments with other NFP health care entities. The NFPs may or may not be financially-interrelated entities, as discussed in FASB ASC 958-20-15-2 and paragraph 12.80 of this guide. The pooled investments are generally managed by a sponsoring entity's treasury department (for example, a parent treasury division) in a manner similar to a mutual fund arrangement. When a pool is established, ownership interests are initially assigned (typically through unitization) to the various pool investors (sometimes referred to as participants) based on the fair value of the cash and securities placed in the pool by each investor (participant). Current fair value is generally used to determine the number of units allocated to additional assets placed in the pool and to value withdrawals from the pool (for example, the sponsor calculates a NAV per unit, and the investor's [participant's] purchases and sales are based on the NAV unit value). Investment income, realized gains and losses, and any recognized unrealized gains and losses are allocated equitably based on the number of units assigned to each investor (participant). Generally the investor's (participant's) ownership interest in the pool is due on demand; however, in certain arrangements, investors (participants) may be required to provide notification to the pool sponsor prior to divesting, or further limitations on withdrawal may be imposed on the investors (participants). The investors (participants) generally do not have rights or interests in specific assets or investments held in the pool but, instead, own a beneficial-type interest in the pool. These pools typically do not have a formal legal structure, and no security, as defined by either FASB ASC 825, *Financial Instruments*, or FASB ASC 958-320, is created. Paragraphs 4.40–.47 provide the Financial Reporting Executive Committee's (FinREC's) recommendation on how to implement the standards in FASB ASC 958-20 and the "Transfers of Assets to a Not-for-Profit Entity or Charitable Trust that Raises or Holds Contributions for Others" sections of FASB ASC 958-605 when they are applied to investment pools.

4.40 The underlying investments are owned by the sponsor and included in the sponsor's assets. The investor's (participant's) recognition of its beneficial-type interest in the pool depends upon the relationship of the sponsor and investor (participant), as follows:

- If the investor (participant) and sponsor are neither affiliates nor financially interrelated entities (see paragraph 12.76 of this

guide), the investor (participant) should recognize its beneficial-type interest as described in paragraphs 4.41–42.

- If the investor (participant) and sponsor are affiliates or otherwise financially interrelated entities, the investor (participant) should recognize its beneficial-type interest as described in paragraphs 4.43–45.

4.41 If the investor (participant) (beneficiary) and sponsor (recipient entity) are neither affiliates nor financially interrelated entities, the investor (participant) would recognize its rights to the assets held by the sponsor as a beneficial interest in an identifiable pool of assets, as described in FASB ASC 958-605-25-33(d). FASB ASC 958-605-30-14 and 958-605-35-3 state that if a 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 should measure and subsequently remeasure that beneficial interest at fair value.

4.42 Changes in fair value of the beneficial interest in the investment pool are reported above (included in) the performance indicator in the statement of operations if the investment return was unrestricted. In the investor's (participant's) balance sheet, the interest in the pool might be reported using a caption such as "Beneficial Interest in Investment Pool" or "Interest in Investment Pool." If the investor's (participant's) balances are due on demand, the change in value of the beneficial interest that related to purchases and sales of pool units would be reported net in the "Investing" section of the cash flow statement. However, if the balances are not due on demand, the purchases and sales of pool units would be recorded gross in the investor's (participant's) "Investing" section of the cash flow statement, unless the cash flows qualified for net reporting, as discussed in paragraphs 7–9 of FASB ASC 230-10-45. The change in value of the beneficial interest related to unrealized gains and losses would be reported in the cash flow statement in the same manner as unrealized gains and losses on investments are reported.

4.43 If the investor (participant) and sponsor are financially-interrelated entities, as discussed in FASB ASC 958-20-15-2 and paragraph 12.76 of this guide, the investor (participant) (beneficiary) would account for its investment in the pool as part of its interest in the sponsor (recipient entity). FASB ASC 958-20-25-2 requires that if a beneficiary and recipient entity are financially-interrelated entities, the beneficiary should recognize its interest in the net assets of the recipient entity. Recognizing an interest in the net assets of the recipient entity and adjusting that interest for a share of the change in net assets of the recipient entity is similar to the equity method, which is described in FASB ASC 323-10. Alternatively, the investor (participant) may elect the fair value option described in the "Fair Value Option" sections of FASB ASC 825-10.

4.44 Q&A sections 6400.36–43 (AICPA, *Technical Questions and Answers*), which are reproduced in the appendix, "Q&A Section 6400, *Health Care Entities*," of chapter 11, "Contributions Received and Made," of this guide, discuss how a beneficiary should report and classify its interest in the net assets of a recipient entity and changes in that interest. In the investor's (participant's) balance sheet, the interest in the pool might be reported using a caption such as "Beneficial Interest in Investment Pool" or "Interest in Investment Pool." If the investor's (participant's) balances are due on demand, the change in value of the beneficial interest that related to purchases and sales of pool units would be reported net in the "Investing" section of the cash flow statement. However,

if the balances are not due on demand, the purchases and sales of pool units would be recorded gross in the investor's (participant's) "Investing" section of the cash flow statement, unless the cash flows qualified for net reporting, as discussed in paragraphs 7–9 of FASB ASC 230-10-45. The change in value of the beneficial interest related to unrealized gains and losses would be reported in the cash flow statement in the same manner as all unrealized gains and losses on investments are reported.

4.45 Q&A section 6400.42, "Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (Recipient Entity)—Accounting for Unrealized Gains and Losses on Investments Held by the Foundation" (AICPA, *Technical Questions and Answers*), discusses how a beneficiary should display unrealized gains and losses related to investments held for its benefit by a financially interrelated entity. It states that in circumstances in which the beneficiary (investor or participant) can influence the financial decisions of the recipient entity (pool sponsor) to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient entity to the beneficiary, changes in a beneficiary's interest in the net assets of the recipient entity should be included in, or excluded from, the beneficiary's performance indicator in the same manner that they would have been had the beneficiary held the investments directly. Thus, the beneficiary should include in the performance indicator the portion of the change attributable to unrealized gains and losses on trading securities that are not restricted by donors or law and should exclude from the performance indicator the portion of the change attributable to all other unrealized gains and losses. This manner of reporting is similar to the reporting by an investor that combines its proportionate share of an investee's other comprehensive income amounts with its own other comprehensive income items, as described in FASB ASC 323-10-45-3. Q&A section 6400.42 also discusses how to report unrealized gains and losses in circumstances in which the beneficiary cannot influence the financial decisions of the recipient organization to such an extent that it can determine the timing and amount of distributions that it receives from the recipient entity.

4.46 As noted in FASB ASC 958-20-45-3, if the beneficiary and recipient entity are included in consolidated financial statements, the beneficiary's interest in the net assets of the recipient entity should be eliminated, in accordance with FASB ASC 810-10-45-1. Therefore, if the investor (participant) and sponsor were both included in consolidated financial statements, the interest in the investment pool and changes in that interest would be eliminated.

4.47 To determine the sponsor's accounting, the pooling arrangement would be carefully reviewed to determine if the sponsor has legal ownership and rights to the underlying investments (for example, would the pool sponsor's creditors have claim against the investments in the pool in bankruptcy) or if the sponsor is merely acting as an agent for the investors (participants). If the investments in the pool are legally owned by the sponsor, then the sponsor would report the pool of investments and related activities in its financial statements on a gross basis. At each reporting period, the sponsor would record 100 percent of the pooled investments in its balance sheet, along with a corresponding liability to the respective pool investor (participant). The sponsor would report the pool's investment returns gross in its statement of operations. If the sponsor is an NFP that is acting as an agent, FASB ASC 958-320 and 958-325 require investments held as agent and investment return to be reported as

assets and liabilities, rather than changes in net assets. However, if the sponsor is an investor-owned entity merely acting as an agent, it may be appropriate for the sponsor to record the investments and related liability to the investors (participants) on a net basis in the sponsor's financial statements.

Fair Value Measurements

4.48 FASB ASC 820 defines *fair value*, establishes a framework for measuring fair value, and requires extensive disclosures about fair value measurements. Health care entities that are required to apply fair value measures and that provide fair value disclosures are advised to read FASB ASC 820 in its entirety.

Impairment of Investments

4.49 The following guidance should be considered when determining and evaluating whether an investment's impairment is other than temporary:

- Paragraphs 17–35 of FASB ASC 320-10-35
- Paragraphs 1A–2 of FASB ASC 325-20-35
- Paragraphs 8–13 of FASB ASC 958-325-35

Paragraphs 4.50–.58 summarize some of the more significant matters included in those paragraphs. The list is not meant to be all-inclusive. Health care entities should refer to the aforementioned guidance for comprehensive guidance of matters to consider.

4.50 According to FASB ASC 320-10-35-20, impairment is assessed at the individual security level (referred to as an investment). *Individual security level* means the level and method of aggregation used by the reporting entity to measure realized and unrealized gains and losses on its debt and equity securities. FASB ASC 320-10-35-21 states that an investment is impaired if the fair value of the investment is less than its cost.

4.51 Per FASB ASC 320-10-35-25, because the fair value of cost-method investments is not readily determinable, the evaluation of whether an investment is impaired should be determined as follows:

- a. If an entity has estimated the fair value of a cost-method investment (for example, for disclosure under FASB ASC 825-10-50), that estimate should be used to determine if the investment is impaired for the reporting periods in which the entity estimates fair value.
- b. For reporting periods in which an entity has not estimated the fair value of a cost-method investment, the entity should evaluate whether an event or a change in circumstances has occurred in that period that may have a significant adverse effect on the fair value of the investment (an impairment indicator, examples of which are provided in paragraphs 27–28 of FASB ASC 320-10-35).

4.52 Per FASB ASC 320-10-35-30, if the fair value of an investment is less than its amortized cost basis at the balance sheet date of the reporting period for which impairment is assessed, the impairment is either temporary or other than temporary. Other than temporary does not mean permanent. The standards for measuring other-than-temporary impairment are dependent upon the type of investment: equity securities or debt securities. Per FASB ASC 320-10-35-17, entities should not look through the form of their investment to the nature of the securities held by an investee. For example, an investment in shares

of a mutual fund that invests primarily in debt securities would be assessed for impairment as an equity security under FASB ASC 320-10-35.

4.53 For equity securities, FASB ASC 320-10-35-32A states that an entity should apply guidance that is pertinent to the determination of whether an impairment is other than temporary, such as FASB ASC 325-40-35. Additionally, FASB ASC 320-10-35-33 states that when an entity has decided to sell an impaired available-for-sale security, and the entity does not expect the fair value of the security to fully recover before the expected time of sale, the security should be deemed other-than-temporarily impaired in the period in which the decision to sell is made, not the period in which the sale occurs. However, an entity should recognize an impairment loss when the impairment is deemed other than temporary, even if a decision to sell has not been made. Further, FASB ASC 325-20-35-2 states that a series of operating losses of an investee or other factors may indicate that a decrease in value of the investment has occurred that is other than temporary and that should be recognized. FASB ASC 320-10-S99-1 provides guidance in the form of Topic No. 5(M), "Other Than Temporary Impairment of Certain Investments in Equity Securities," of the Securities and Exchange Commission's *Codification of Staff Accounting Bulletins*.

4.54 For a debt security, an other-than-temporary impairment should be considered to have occurred if an entity (a) has decided to sell the debt security, as discussed in FASB ASC 320-10-35-33A, or (b) has not decided to sell the debt security, but the entity more likely than not will be required to sell the security before recovery of its amortized cost basis, as discussed in FASB ASC 320-10-35-33B. Paragraphs 33C–33I of FASB ASC 320-10-35 provide additional guidance for making an assessment of whether an impairment of a debt security is other than temporary, including guidance for determining whether the entire amortized cost basis of the debt security will be recovered.

4.55 In accordance with FASB ASC 320-10-35-34C, if the health care entity does not intend to sell the debt security, and it is not more likely than not that the health care entity will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment should be separated into both of the following:

- a. Amounts representing the credit loss
- b. Amounts related to all other factors

4.56 In accordance with FASB ASC 320-10-45-8A, in periods in which an investor-owned health care entity determines that a security's decline in fair value below its amortized cost basis is other than temporary, the entity should present the total other-than-temporary impairment in the statement of earnings, with an offset for the amount of the total other-than-temporary impairment, if any, that is recognized in other comprehensive income, in accordance with FASB ASC 320-10-35-34D (for example, the portion of the loss on a debt security that is due to factors other than the credit loss). The amount of the total other-than-temporary impairment on a debt security that is related to the other factors should be recognized in other comprehensive income net of applicable taxes. An NFP health care entity would report the total other-than-temporary impairment within the performance indicator, with an offset for the portion of the loss on a debt security that is due to factors other than the credit loss, in accordance with FASB ASC 320-10-35-34D, as modified by FASB ASC 320-10-35-17. The amount of the total other-than-temporary impairment on a

debt security that is related to the other factors should be recognized outside of the performance indicator.

4.57 FASB ASC 320-10-35-34 states that the measurement of the impairment of an equity security should not include partial recoveries subsequent to the balance sheet date. The fair value of the investment would then become the new amortized cost basis of the investment and should not be adjusted for subsequent recoveries in fair value.

4.58 FASB ASC 320-10-35-34E states that for debt securities, the previous amortized cost basis less the other-than-temporary impairment recognized in earnings becomes the new amortized cost basis of the debt security. That new amortized cost basis should not be adjusted for subsequent recoveries in fair value. However, the amortized cost basis should be adjusted for accretion and amortization, as prescribed in FASB ASC 320-10-35-35.

4.59 FinREC believes that if a health care entity engages an external investment manager and grants the manager broad discretion to purchase and sell investments to achieve a stated portfolio objective, the health care entity may not be able to assert that it has both the intent and ability to hold equity investments that have unrealized losses until those unrealized losses can be recovered. Further, if a debt security was sold shortly after year-end, the health care entity may not be able to assert that there was not the intent to sell the debt security at the balance sheet date. If the health care entity cannot make the necessary assertions, then the entity should recognize an other-than-temporary impairment loss. If a health care entity develops procedures to determine whether the manager has made a decision at the balance sheet date to sell any debt securities, it will be able to document when the decision was made, by whom, the factors that drove the decision to sell, and when the health care entity became aware of those factors.

Securities Lending Activities

4.60 A health care entity that has a significant investment portfolio may enter into securities lending arrangements. These arrangements allow the health care entity to increase the overall yield from the investment activity. Depending on the terms of the security lending agreements, collateral received may be required to be shown separately on the transferor's balance sheet, with a corresponding liability to show the obligation to return the collateral. Each agreement should be carefully reviewed, and the guidance in FASB ASC 860-30 should be considered to determine the appropriate accounting and reporting.

Transfers of Assets to an NFP or Charitable Trust for Investment

4.61 Sometimes, a health care entity transfers assets, including investments, to an NFP or charitable trust (the recipient entity) that accepts those assets and agrees to use them on behalf of the health care entity or transfer them or their investment return, or both, back to the health care entity or its affiliate. Examples of this type of reciprocal transfer include (a) a health care entity that transfers assets to a community foundation to establish an endowment for the benefit of the health care entity or its affiliate and (b) a health care entity that transfers assets to a foundation that it creates to hold those assets.

4.62 FASB ASC 958-605-25-33 states that a transfer of assets to a recipient entity is not a contribution if the resource provider (the health care entity) specifies itself or its affiliate as the beneficiary of the transfer. Paragraphs

4–7 of FASB ASC 958-20-25 describe the following two types of reciprocal transfers:

- An *equity transaction*, which is a transfer of assets to a recipient entity that meets all of the following conditions: (a) the resource provider (health care entity) specifies itself or its affiliate as the beneficiary; (b) the resource provider (health care entity) and the recipient entity are financially interrelated entities; and (c) neither the resource provider (health care entity) nor its affiliate expects payment of the transferred assets, although payment of investment return on the transferred assets may be expected. Paragraph 12.76 of this guide discusses financially interrelated entities.
- The resource provider (health care entity) specifies itself or its affiliate as the beneficiary, and the transfer is not an equity transaction (one or both of criteria (b) and (c) in the previous bullet are not met).

4.63 According to FASB ASC 958-605-25-33, if the transfer in which the resource provider specifies itself or its affiliate as the beneficiary is not an equity transaction, the resource provider (health care entity) should report an asset, and the recipient entity should report a liability. Accounting for equity transactions is discussed in paragraphs 12.79–.82 of this guide. If the resource provider (the health care entity) transfers assets to a recipient entity and specifies itself or its affiliate as the beneficiary, it should disclose the following information for each period for which a statement of financial position is presented, in accordance with FASB ASC 958-605-50-6:

- The identity of the recipient entity to which the transfer was made.
- Whether variance power was granted to the recipient entity and, if so, a description of the terms of the variance power. Because of their reciprocal nature, such transfers are presumed not to be contributions received or made, even if the health care entity granted variance power at the time of transfer.
- The terms under which amounts will be distributed to the health care entity 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 entity or as another asset (for example, as a beneficial interest in assets held by others or a refundable advance).

Regulation

4.64 Because health plans have a public responsibility to be able to meet their obligations to policy holders, state statutes and regulations prescribe standards and limitations on investment activities. Regulatory requirements and restrictions vary by state. Most states require health plans to invest a certain percentage of policy reserves in specified classes of investments. Once the state regulatory agency's minimum standards are met, the health plan may invest in other types of investments. However, many states specify a maximum percentage of assets that may be invested in particular classes of investments. State

regulations may also prescribe methods for reporting investments, set requirements regarding matters such as the location and safeguarding of assets, and set limitations on investing in derivatives. For example, a regulatory authority may require some investments to be deposited with the state insurance department as a condition of writing business in that state. Insurance statutes and regulations vary by state, but the regulations of the state of domicile have precedence; however, compliance provisions in states in which the plan does business also must be followed. An understanding of the statutory requirements to be followed by a health plan concerning investments is advisable, so that their impact on investment strategy, as well as accounting and reporting, are appropriately considered.

Other Financial Statement Presentation Matters

Classification

4.65 Securities should be reported as either current or noncurrent, as appropriate, under the provisions of FASB ASC 210-10-45. According to the FASB ASC glossary, the term *current assets* is used to designate cash and other assets or resources commonly identified as those that are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business. According to FASB ASC 210-10-45-1, current assets include marketable securities representing the investment of cash available for current operations, including investments in debt and equity securities classified as trading securities under FASB ASC 320-10. FASB ASC 210-10-45-3 indicates that a one-year time period should be used as a basis for the segregation of current assets in cases when several operating cycles occur within a year. FASB ASC 210-10-45-4 states that the concept of the nature of current assets contemplates the exclusion from that classification cash and claims to cash that are restricted regarding withdrawal or use for other-than-current operations, designated for expenditure in the acquisition or construction of noncurrent assets, or segregated for the liquidation of long-term debts. Even though not actually set aside in special accounts, funds that are clearly to be used in the near future for the liquidation of long-term debts, payments to sinking funds, or similar purposes should also, under this concept, be excluded from current assets. However, if such funds are considered to offset maturing debt that has been set up properly as a current liability, they may be included within the current asset classification. FASB ASC 958-205-55-7 explains that when a statement of financial position that sequences assets and liabilities based on their relative liquidity is presented, cash and cash equivalents of permanent endowment funds held temporarily until suitable long-term investment opportunities are identified are included in the long-term investments classification.

4.66 According to FASB ASC 230-10-45-19, cash receipts and payments resulting from purchases, sales, and maturities of trading securities, as discussed in FASB ASC 320, should be classified as investing or operating cash flows based on the nature and purpose for which the securities were acquired. According to FASB ASC 230-10-45-11, cash flows from purchases, sales, and maturities of available-for-sale securities should be classified as cash flows from investing activities and reported gross in the statement of cash flows. FASB ASC 320-10-45-13 states that if entities report certain investments in debt securities as cash equivalents, in accordance with the provisions of FASB ASC

230, the notes to the financial statements should reconcile the reporting classifications used in the statement of financial position.

4.67 Paragraphs 4.28–.34 discuss the classification of investment income, realized and unrealized gains and losses on investments, and equity earnings from investments in investment companies accounted for under the equity method by an NFP health care entity.

Disclosure

4.68 All health care entities with investments that meet the definition of *financial instruments* set forth in the FASB ASC glossary are subject to the disclosure requirements of FASB ASC 825-10-50.⁴ Investor-owned health care entities with investments in equity and debt securities should refer to the disclosure requirements of FASB ASC 320-10-50 and 323-10-50. NFP health care entities should refer to the disclosure requirements of FASB ASC 958-320-50 and 958-325-50.

4.69 If the health care entity has concentrations of credit risk related to financial instruments, the disclosure requirements of paragraphs 20–22 of FASB ASC 825-10-50 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 limits and investments in obligations that are not insured or guaranteed by the government.

4.70 Health care entities that are accounting for investments under the equity method, including alternative investments held for investment-return purposes, should consider the disclosure requirements of FASB ASC 323-10-50.

4.71 FASB ASC 860-30-50⁵ requires entities that enter into securities lending transactions or repurchase agreements to disclose their policies for requiring collateral or other security. FASB ASC 860-30-50 also requires the disclosure of (a) the fair value of collateral at the reporting date and (b) the portion of the collateral that has been sold or repledged if an entity accepts collateral that is permitted by contract or custom to be sold or repledged. Health care entities that are public entities should also consider the disclosure requirements of FASB ASC 860-10-50.

4.72 Health care entities should consider the fair value disclosure requirements in FASB ASC 820-10-50.

4.73 NFP health care entities that have investments held in donor-restricted endowment funds should consider the disclosure requirements of FASB ASC 958-205-50.

⁴ Disclosures about the fair value of financial instruments prescribed in FASB ASC 825-10-50 are optional for an entity that meets the criteria in FASB ASC 825-10-50-3.

⁵ Health care entities that factor receivables should consider whether in a repurchase financing arrangement, the repurchase agreement should be accounted for separately from the initial transfer of the financial asset, as described in FASB ASC 860-20. This would result in the initial transferor accounting for the initial transfer as a sale of a financial asset (if all derecognition criteria are met) and the initial transferee accounting for the initial transfer symmetrically as a purchase, with both parties accounting for the repurchase agreement component of the transaction as a secured borrowing. This may require the disclosures for factoring of receivables described in the "Pending Content" in paragraphs 4A–4D of FASB ASC 860-20-50.

Auditing

4.74 Auditing objectives and procedures for investments of health care entities generally are similar to those of other entities. AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items* (AICPA, *Professional Standards*), 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 AU-C section 501 applies to debt and equity securities. AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (AICPA, *Professional Standards*), addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates and related disclosures in an audit of financial statements. AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*), addresses auditing investments accounted for using the equity method of accounting. The AICPA Audit Guide *Special Considerations in Auditing Financial Instruments* also provides guidance on audit evidence that may be relevant to the fair value of derivative instruments and investments in securities.

Considerations for Audits Performed in Accordance With PCAOB Standards⁶

Paragraph .11 of PCAOB AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *PCAOB Standards and Related Rules*), states that when performing an integrated audit of financial statements and internal control over financial reporting, paragraph .39 of PCAOB AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*), states that "[t]he auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of material misstatement to each relevant assertion." Therefore, in an integrated audit of financial statements and internal control over financial reporting, if relevant assertions exist that are related to the company's investments in derivatives and securities, the auditor's understanding of controls should include controls over derivatives and securities transactions from their initiation to their inclusion in the financial statements and should encompass controls placed in operation by the entity and service organizations whose services are part of the entity's information system.

PCAOB Staff Audit Practice Alert No. 2, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.02), provides guidance on auditors' responsibilities for auditing fair value measurements of financial instruments and when using the work of specialists under the existing standards

⁶ The auditing content in this guide focuses primarily on generally accepted auditing standards issued by the Auditing Standards Board and is applicable to audits of nonissuers. These standards are codified in AICPA *Professional Standards* and referenced by "AU-C" section numbers within the codification.

of the PCAOB. PCAOB Staff Audit Practice Alerts are neither rules of the PCAOB nor have they been approved by the PCAOB.

4.75 In addition, the independent auditor may need to consider the examples of specific audit objectives, specific control objectives, and substantive audit procedures that are presented in exhibit 4-1.

Exhibit 4-1

The following table illustrates the use of assertions in developing audit objectives and designing substantive tests. The examples are not intended to be all-inclusive nor is it expected that all the procedures are necessarily applied in an audit. Irrespective of the assessed risks of material misstatement, paragraph .18 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), states the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. The use of assertions in assessing risks and designing appropriate audit procedures to obtain audit evidence is described in paragraphs .26–.32 of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*). Various audit procedures and the purposes for which they may be performed are described in paragraphs .A10–.A26 of AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*).

Audit Considerations

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i> ⁷	<i>Substantive Audit Procedures</i> ⁸
Account Balances			
Existence, completeness, rights and obligations, and valuation and allocation	Marketable securities are fairly stated and 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 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 AU-C section 620, <i>Using the Work of an Auditor's Specialist</i> (AICPA, <i>Professional Standards</i>); AU-C section 402, <i>Audit Considerations Relating to an Entity Using a Service Organizations</i> (AICPA, <i>Professional Standards</i>); or PCAOB AS 2601, <i>Consideration of an Entity's Use of a Service Organization</i> (AICPA, <i>PCAOB Standards and Related Rules</i>). ¹
Valuation and allocation, 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 values of endowments are at required levels through confirmation. Review treatment of gains and losses on endowment funds to ensure that they are properly classified.

⁷ The auditor should consider a combination of preventive and detective controls responsive to the control objectives.

⁸ The auditor should determine the nature, timing, and extent of substantive procedures to perform, considering, for example, the results of tests of controls and risk areas.

Audit Considerations—continued

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
<i>Transactions</i>			
Accuracy and completeness	Investment income and gains or losses, or both, are recorded in accordance with donor restrictions.	Review investment transactions to ensure that they are recorded in compliance with donor restrictions.	Test the recording of selected transactions to ensure that amounts are properly classified in accordance with donor restrictions.
<i>Presentation and Disclosure</i>			
Classification and understandability	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.	Test the classification of investments as trading, available for sale, or held to maturity to determine whether gains and losses are properly classified within or outside the performance indicator (for NFP health care entities) or within the income statement or statement of other comprehensive income (for investor-owned health care entities).
<p>¹ Paragraphs .06 and .A11–.A19 of AU-C section 501, <i>Audit Evidence—Specific Considerations for Selected Items</i> (AICPA, <i>Professional Standards</i>), establish requirements and provide guidance to auditors on audit evidence that may be used to support assertions about the fair value of securities. The AICPA Audit Guide <i>Special Considerations in Auditing Financial Instruments</i> also provides guidance on that topic and should be considered in the context of specific accounting requirements. AU-C section 540, <i>Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures</i> (AICPA, <i>Professional Standards</i>), provides guidance on auditing fair value measurements and disclosures contained in financial statements. AU-C section 540 does not address specific types of assets, liabilities, components of equity, transactions, or industry-specific practices.</p>			

Chapter 5

Derivatives

Gray shaded text in this chapter reflects guidance issued but not yet effective as of the date of this guide, September 1, 2017, but becoming effective on or prior to June 30, 2018, exclusive of any option to early adopt ahead of the mandatory effective date. Unless otherwise indicated, all unshaded text reflects guidance that was already effective as of the date of this guide.

Introduction

5.01 Health care entities use a wide range of derivative products,¹ with the objective of more effectively managing their financial risks related to debt, investments, and other assets and liabilities and transactions. FASB *Accounting Standards Codification (ASC) 815-10-15-83* describes a *derivative instrument* as

a financial instrument or other contract with all of the following characteristics:

- a. Underlying, notional amount, payment provision. The contract has both of the following terms, which determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required:
 1. One or more underlyings
 2. One or more notional amounts or payment provisions or both.
- b. Initial net investment. The contract requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- c. Net settlement. The contract can be settled net by any of the following means:
 1. Its terms implicitly or explicitly require or permit net settlement.
 2. It can readily be settled net by a means outside the contract.
 3. It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

5.02 FASB ASC 815-10-15-88 states that an *underlying* is a variable that, along with either a notional amount or payment provision, determines the settlement of a derivative instrument. FASB ASC 815-10-15-88 provides examples

¹ Chapter 18, "Derivative Instruments: Futures, Forwards, Options, Swaps, and Other Derivative Instruments," of the AICPA Audit and Accounting Guide *Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies, and Mortgage Companies* provides useful background information on various types of derivative instruments and hedging activities and the risks associated with various forms of contracts and transactions.

of underlyings, which include a security price or security price index, a commodity price or commodity price index, and an interest rate or interest rate index. As explained in FASB ASC 815-10-15-92, a notional amount is a number of currency units, shares, bushels, pounds, or other units specified in the contract. FASB ASC 815-10-15-93 states that a payment provision specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner. Paragraphs 83–139 of FASB ASC 815-10-15 provide a more complete definition of a *derivative instrument*.

5.03 One of the most common uses of derivatives by health care entities is in conjunction with borrowings. The objective is that the combined cash flows of the derivative and the debt will effectively create long-term fixed-rate or variable-rate debt at an aggregate cost lower than traditional fixed- or variable-rate debt. Common examples include the following:

- An interest rate swap that is intended to effectively convert variable-rate debt to fixed-rate debt.
- An interest rate swap that is intended to effectively convert fixed-rate debt to variable-rate debt.
- A basis swap in which counterparties exchange payments based on the changes of two variable rates.
- An option on an interest rate swap—a swaption—that gives the purchaser the right but not the obligation to enter into an interest rate swap. The purchaser pays a premium to the issuer or writer.
- An interest rate cap specifically purchased to give the purchaser protection against rates rising above a given level.

5.04 Derivative instruments also might be used to

- lock in the interest rate for an anticipated future borrowing. At times, a health care entity may need to borrow money in the near term and wish to fix the interest rate on the borrowing at the current rate, even though the money will not be needed until sometime in the future. Derivative instruments, such as interest-rate options or forward contracts, can accomplish this objective.
- lock in the current price of a commodity, such as electricity, for anticipated purchases. This hedging strategy often involves the use of forward contracts or option combinations that can be settled net. A derivative instrument that is used to fix the price of anticipated future purchases could be a cash flow hedge if the derivative instrument does not meet the conditions for the normal purchase exception.

5.05 FASB ASC 815-10-55-2 contains a diagram that depicts the process for determining whether a freestanding contract is within the scope of FASB ASC 815, *Derivatives and Hedging*. The diagram is a visual supplement to the written standards. It should not be interpreted to alter any requirements of FASB ASC 815 nor should it be considered a substitute for the requirements. In addition, FASB ASC 815-15 excludes certain contracts from being accounted for using the guidance in FASB ASC 815, even though, technically, the contract may meet the definition of a *derivative instrument*.

General Guidance

5.06 FASB ASC 815 establishes accounting and reporting standards for derivative instruments and hedging activities. FASB ASC 815-10-05-4 explains that FASB ASC 815 requires that an entity recognize derivative instruments, including certain derivative instruments embedded in other contracts, as either assets or liabilities in the statement of financial position and measure them at fair value. If certain conditions are met, an entity may elect to designate a derivative instrument in any one of the following ways: (a) a hedge of the exposure to changes in the fair value of a recognized asset or liability or of an unrecognized firm commitment that is attributable to a particular risk (referred to as a fair value hedge), (b) a hedge of the exposure to variability in the cash flows of a recognized asset or liability or of a forecasted transaction that is attributable to a particular risk (referred to as a *cash flow hedge*), or (c) a hedge of foreign currency exposure.²

5.07 FASB ASC 954-815-25-2 states that except as provided in FASB ASC 954-815-50-1 and as discussed in paragraph 5.44, not-for-profit (NFP) business-oriented health care entities should apply the provisions of FASB ASC 815, including the provisions pertaining to cash flow hedge accounting, in the same manner as for-profit entities. The gain or loss items that affect a for-profit entity's income from continuing operations similarly should affect the NFP health care entity's performance indicator, and the gain or loss items that are excluded from a for-profit entity's income from continuing operations, such as items reported in other comprehensive income, similarly should be excluded from the performance indicator by the NFP health care entity. As explained in FASB ASC 954-815-45-1, the absence of a requirement to report a separate component of equity in the balance sheet of an NFP business-oriented health care entity should not preclude those entities 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 an NFP health care entity's net assets, no compelling need exists for it to be reported separately in the balance sheet.

Accounting for Changes in Fair Value of Derivative Instruments

5.08 FASB ASC 815-10-35-2 states that the accounting for changes in the fair value (that is, gains and losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and, if so, the reason for holding it.

Fair Value Hedges

5.09 FASB ASC 815-20-35-1(b) states that the gain or loss on a derivative instrument designated and qualifying as a fair value hedging instrument, as well as the offsetting loss or gain on the hedged item attributable to the hedged risk, should be recognized currently in earnings in the same reporting period, as provided in paragraphs 1–6 of FASB ASC 815-25-35. Thus, investor-owned health care entities recognize the gain or loss on the derivative in earnings in

² Health care entities do not frequently enter into foreign currency hedges; therefore, this chapter focuses on matters pertaining to fair value and cash flow hedges.

the period of change, together with the offsetting loss or gain on the hedged item attributable to the risk being hedged. Similarly, NFP health care entities report the derivative gains and losses, together with the offsetting loss or gain on the hedged item, in the performance indicator in the period of change.

Cash Flow Hedges

5.10 FASB ASC 815-20-35-1(c) states that the effective portion of the gain or loss on a derivative instrument designated and qualifying as a cash flow hedging instrument should be reported as a component of other comprehensive income (outside earnings) and reclassified into earnings in the same period(s) during which the hedged forecasted transaction affects earnings (such as in the periods that depreciation expense, interest expense, or cost of sales is recognized), as provided in FASB ASC 815-30-35-3 and paragraphs 38–41 of FASB ASC 815-30-35. The remaining gain or loss on the derivative instrument, if any, should be recognized currently in earnings, as provided in FASB ASC 815-30-35-3.³

5.11 Thus, for an investor-owned health care entity, 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. For an NFP health care entity, the effective portion of the derivative's gain or loss is initially excluded from the performance indicator and subsequently reclassified into the performance indicator when the forecasted transaction affects earnings. For example, the accumulated gain or loss of a derivative instrument that hedges the variability of the cash flows of long-term debt is amortized into earnings or the performance indicator over the remaining term of the debt instrument (that is, as long as the debt remains outstanding), even if the cash flow hedge itself is terminated. Any ineffective portion of the gain or loss is immediately reported in earnings or the performance indicator.

Derivatives Not Designated as a Hedging Instrument

5.12 Some derivatives may represent hedges for risk management purposes (entered into to hedge a specific exposure) that do not receive special hedge accounting either because the hedge relationship does not qualify for hedge accounting under the criteria in FASB ASC 815 or because an entity does not elect hedge accounting. Alternatively, nonhedging derivatives may be entered into for speculative purposes. The gain or loss on a derivative instrument not designated as a hedging instrument should be recognized in current earnings or, in the case of an NFP health care entity, the performance indicator.

Hedge Accounting Requirements⁴

5.13 A primary purpose of hedge accounting is to link items or transactions whose changes in fair values or cash flows are expected to offset each

³ If an entity's defined risk management strategy for a particular hedging relationship excludes a specific component of the gain or loss (or related cash flows) on the hedging derivative from the assessment of hedge effectiveness, as explained in paragraphs 81–83 of FASB *Accounting Standards Codification* (ASC) 815-20-25, that excluded component of the gain or loss should be recognized currently in earnings.

⁴ FASB has a project that would make targeted improvements to hedge accounting. If ultimately adopted, it would significantly modify certain aspects of the existing hedge accounting model discussed in this section. An exposure draft is scheduled to be completed in late 2016.

other. FASB ASC 815-20-25 sets forth criteria that must be met for designated hedging instruments and hedged items or transactions to qualify for hedge accounting. These are (a) formal designation and documentation at hedge inception, (b) eligibility of hedged items and transactions, (c) eligibility of hedging instruments, and (d) hedge effectiveness.

5.14 To qualify for hedge accounting, at inception of the hedge, there must be formal documentation of all the information identified in FASB ASC 815-20-25-3. Specific documentation requirements include identifying the hedging relationship, the hedging instrument, the hedged item or transaction, the nature of the risk being hedged, the method that will be used to retrospectively and prospectively assess hedge effectiveness, and the method that will be used to measure hedge ineffectiveness, among others.

5.15 To qualify for hedge accounting, the hedging relationship, both at inception of the hedge and on an ongoing basis, should be expected to be highly effective. An entity should consider hedge effectiveness in two different ways: in prospective considerations and retrospective evaluations. Paragraphs 74–119 of FASB ASC 815-20-25 provide the criteria for assessing hedge effectiveness that are applicable to fair value hedges and cash flow hedges.

5.16 FASB ASC 815-20-35-2 states that at least quarterly, the hedging entity should determine whether the hedging relationship has been highly effective in having achieved offsetting changes in fair value or cash flows through the date of the periodic assessment. (An exception to assessing how effective the hedging relationship has been is provided for hedges of interest rate risk that qualify for use of the shortcut method described in paragraphs 5.20–.28.) If the hedge fails the effectiveness test at any time (that is, if the entity does not expect the hedge to be highly effective at achieving offsetting changes in fair values or cash flows), the hedge ceases to qualify for hedge accounting.⁵

5.17 FASB ASC 815-25-40-1 and 815-30-40-1 state that an entity must discontinue prospectively specialized hedge accounting for an existing hedge if any one of the following occurs: (a) any criteria in FASB ASC 815-20-25 is no longer met; (b) the derivative instrument expires or is sold, terminated, or exercised; or (c) the entity removes the designation of the hedge.

FASB ASC 815-25-40-1 and 815-30-40-1 state that an entity must discontinue prospectively specialized hedge accounting for an existing hedge if any one of the following occurs: (a) any criteria in FASB ASC 815-20-25 is no longer met; (b) the derivative instrument expires or is sold, terminated, or exercised; or (c) the entity removes the designation of the hedge. A change in the counterparty to a derivative instrument that has been designated as the hedging instrument does not, in and of itself, require termination of that hedging relationship provided that all other hedge accounting criteria (including those in paragraphs 1418 of FASB ASC 815-20-35) continue to be met.⁶

⁵ The requirement to assess hedge effectiveness at least every three months applies to health care entities that issue quarterly financial statements as well as entities that issue financial statements only on an annual basis.

⁶ FASB Accounting Standards Update (ASU) No. 2016-05, *Derivatives and Hedging (Topic 815): Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships (a consensus of the Emerging Issues Task Force)*, is effective for public business entities for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. For all other entities, the amendments in this ASU are effective for financial statements issued for fiscal

(continued)

5.18 Documentation that the criteria described in FASB ASC 815-20-25 are met for the entire period to which hedge accounting is being applied is critical. Derivative instruments are designated as hedges only if appropriate, contemporaneous documentation of both the election and periodic assessment of effectiveness has been executed in conformity with FASB ASC 815.

5.19 *Considerations for Private Companies That Elect to Use Standards Issued by FASB as a Consensus of the Private Company Council*

For health care entities that meet the definition of a *private company* as defined in the FASB ASC Master Glossary, FASB ASC 815-10-35-1A provides an option to elect a simplified hedge accounting approach to account for interest rate swaps that are entered into for the purpose of economically converting variable-rate interest payments to fixed-rate payments. Under the simplified hedge accounting approach, if specific criteria in FASB ASC 815-20-25-131D are satisfied, the entity can assume that there is no ineffectiveness in the cash flow hedging relationship and therefore, the swap qualifies for hedge accounting. If the simplified hedge accounting approach is elected, a private company has the option to measure the designated swap at its settlement value instead of fair value. The simplified hedge accounting approach can only be applied to existing swaps the first time the election is made. After the initial election is made to apply the simplified hedge accounting approach to existing swaps, no further retrospective applications to existing swaps (full or modified) are permitted.

Shortcut Method

5.20 As noted in paragraph 5.03, one of the most common uses of derivatives by health care entities is entering into interest rate swaps in connection with borrowings. If an entity enters into transactions to hedge interest rate risk related to a recognized liability, a shortcut method for determining effectiveness is available if certain conditions are met. If a hedging relationship qualifies for use of the shortcut method, the effectiveness of the hedge does not have to be proven in order to qualify for hedge accounting.

5.21 Paragraphs 102–117 of FASB ASC 815-20-25 describe a set of conditions that determine which hedging relationships qualify for a shortcut version of hedge accounting, which does not immediately recognize hedge ineffectiveness. If all of the applicable conditions in the list in FASB ASC 815-20-25-104 are met, an entity may assume no ineffectiveness in a relationship hedging interest rate risk that involves a recognized interest-bearing asset or liability and an interest rate swap. In addition, FASB ASC 815-20-25-105 provides incremental conditions that apply to fair value hedges only, and FASB ASC 815-20-25-106 provides incremental conditions that apply to cash flow hedges only. Special rules apply to a firm commitment arising on the trade (pricing) date to purchase or issue an interest-bearing asset or liability. The set of conditions and resulting assumption of ineffectiveness are known as the shortcut method. FASB ASC 815-20-25-103 notes that implicit in the conditions for the shortcut

(footnote continued)

years beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018. An entity has the option to apply the amendments in this update on either a prospective basis or a modified retrospective basis. Early adoption is permitted, including adoption in an interim period.

method is the requirement that a basis exist for concluding on an ongoing basis that the hedging relationship is expected to be highly effective in achieving offsetting changes in fair values or cash flows.

5.22 FASB ASC 815-20-25-102 states that given the potential for not recognizing hedge ineffectiveness in earnings under the shortcut method, its application should be limited to hedging relationships that meet each and every applicable condition. All the conditions applicable to fair value hedges must be met to apply the shortcut method to a fair value hedge, and all the conditions applicable to cash flow hedges must be met to apply the shortcut method to a cash flow hedge. A hedging relationship cannot qualify for application of the shortcut method based on an assumption of no ineffectiveness justified by applying other criteria.

5.23 If an interest rate swap does not qualify for use of the shortcut method, the entity must prove (initially and on an ongoing basis, as discussed in FASB ASC 815-20-25) that the hedging relationship between the hedging instrument and hedged item (the liability being hedged) is highly effective in achieving the offset of changes in those fair values or cash flows that are attributable to the hedged risk.

5.24 As a condition for using the shortcut method, FASB ASC 815-20-25-104(f) requires that the index on which the variable leg of the interest rate swap is based match the benchmark interest rate designated as the interest rate risk being hedged for that hedging relationship. FASB ASC 815-20-25-6A states that, currently, only the interest rates on direct Treasury obligations of the U.S. government and, for practical reasons, the London Interbank Offered Rate (LIBOR) swap rate and the Fed Funds Effective Swap Rate (also referred to as the Overnight Index Swap rate) are considered to be benchmark interest rates in the United States. In each financial market, only the one or two most widely used and quoted rates that meet these criteria may be considered benchmark interest rates. The prime rate, the Federal National Mortgage Association (Fannie Mae) par mortgage rate, and the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index (formerly called the Bond Market Association/PSA Municipal Swap Index) should not be used as benchmark interest rates in the United States.

5.25 Many health care entities use swaps whose underlying is the SIFMA Municipal Swap Index as hedges of interest rate risk associated with variable-rate tax-exempt debt. Because the SIFMA Municipal Swap Index does not constitute a benchmark interest rate for purposes of applying the shortcut method, if the variable leg of a swap is indexed to the SIFMA Municipal Swap Index (or any rate other than Treasury obligations, LIBOR, or Fed Funds Effective Swap Rate), the hedging relationship does not qualify for the shortcut method.

5.26 Paragraphs 71–79 of FASB ASC 815-20-55, paragraphs 40–52 of FASB ASC 815-25-55, and paragraphs 24–33 of FASB 815-30-55 contain implementation guidance and examples for use of the shortcut method.

5.27 In cash flow hedges of variable-rate debt, interest rate risk cannot be hedged, unless the cash flows of the hedged transaction are explicitly based on the same benchmark interest rate. Many NFP health care entities have issued

a form of variable-rate debt referred to as auction-rate debt. The interest rate is reset through a Dutch auction process.⁷

5.28 FASB ASC 815-20-55-42 states that a variable-rate financial asset or liability that is reset through an auction process is not based on a benchmark interest rate. Although the interest rate may be described as a designated benchmark interest rate plus or minus an adjustment specified by the bidder, the clearing rate is effectively established by a bidding process that does not provide for transparent separation of interest rate risk and credit risk. Thus, the designated risk being hedged in an auction rate note cannot be interest rate risk. However, health care entities wishing to hedge auction rate debt may be able to do so as a cash flow hedge of a risk of overall changes in the hedged cash flows, as described in FASB ASC 815-20-55-43.

Hybrid Instruments, Host Contracts, and Embedded Derivatives

5.29 FASB ASC 815-15-05-1 explains that contracts that do not meet the definition of a *derivative instrument* in their entirety, such as bonds, insurance policies, and leases, may contain embedded derivatives. *Embedded derivatives*, as defined in the FASB ASC glossary, are "[i]mplicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by a contract in a manner similar to a derivative instrument." The effect of embedding a derivative instrument in another type of contract (the host contract) is that some or all of the cash flows or other exchanges that otherwise would be required by the host contract, whether unconditional or contingent on the occurrence of a specified event, will be modified based on one or more underlyings. FASB ASC 815-15 applies to embedded derivatives. A contract that embodies both an embedded derivative and a host contract is referred to as a hybrid instrument.

5.30 If an embedded derivative is within the scope of FASB ASC 815-15, as defined in FASB ASC 815-15-15, and all of the criteria in FASB ASC 815-15-25-1 are met, the embedded derivative instrument must be separated from the host contract and accounted for separately as a derivative instrument pursuant to FASB ASC 815-10. However, if a hybrid instrument is a financial instrument, paragraphs 4–6 of FASB ASC 815-15-25 allow an entity to irrevocably elect to initially and subsequently measure the hybrid financial instrument in its entirety at fair value, with changes in fair value recognized in earnings, instead of requiring bifurcation. Alternatively, the entity may elect to measure the hybrid financial instrument at fair value, as described in the "Fair Value Option" sections of FASB ASC 825-10.

5.31 Although the requirement to separate an embedded derivative from a host contract applies to both parties to a contract, application of the requirements of FASB ASC 815-15 may result in different conclusions regarding the need for bifurcation based on whether the reporting entity is the holder or issuer of the hybrid instrument.

5.32 The most common host for an embedded derivative is a debt instrument that pays a fixed-rate, floating-rate, or zero-coupon rate of interest. When

⁷ In a Dutch auction, investors bid for the bonds, which are sold at the lowest yield necessary to sell the entire issue.

applying the clearly- and closely-related criteria in FASB ASC 815-15-25-1 to debt hosts, the focus is on determining whether the economic characteristics and risks of the embedded derivative have features unrelated to interest rates, such as equity-like or commodity-like features, or, if the characteristics of the derivative are related to interest rates, whether the features involve leverage or do not change in the same direction as interest rates (an inverse floater). Host contracts with debt characteristics are discussed in paragraphs 23–51 of FASB ASC 815-15-25.

Calls and Puts in Debt

5.33 Bonds and other forms of long-term debt often are structured with call and put options. An entity applies paragraphs 26–27 and 40–43 of FASB ASC 815-15-25 to determine whether embedded calls and puts are derivatives that must be accounted for separately from the debt host contract. Additional guidance is provided by the table in FASB ASC 815-15-55-13.

5.34 Issuance of convertible debt securities when the conversion feature is a written call option may involve a host of potential embedded derivatives. In such case, the need for bifurcation of embedded derivatives may differ for the holder of the debt instrument than for the issuer, particularly if the conversion is contingent on the occurrence of a specified event.

Derivatives Embedded in Split-Interest Agreements

5.35 The FASB ASC glossary defines a *split-interest agreement* as "[a]n agreement in which a donor enters into a trust or other arrangement under which a not-for-profit entity ... receives benefits that are shared with other beneficiaries."⁸ The amount of benefit to each beneficiary often is a function of the fair value of the donated assets over the term of the agreement. NFPs that are trustees or fiscal agents for a split-interest agreement report a liability for the obligation to make future payments to the other beneficiaries of the agreement. Although that liability is initially measured at its fair value, it will not reflect fair value in future periods because the discount rate used in remeasuring the liability each period is not revised to reflect current interest rates, unless a fair value election is made. Because the liability is not measured at fair value, the potential for an embedded derivative exists.

5.36 Paragraphs 7–14 of FASB ASC 958-30-25 and FASB ASC 958-30-55 provide guidance for determining whether a split-interest agreement includes an embedded derivative and, if so, whether the embedded derivative must be separated from its debt host contract and accounted for separately. As explained in FASB ASC 958-30-25-8, if the obligation is solely life contingent (that is, contingent upon the survival of an identified individual, in which case the payments are made only if the individual is alive when the payments are due), that obligation would qualify for the exception from bifurcation in paragraphs 52–57 of FASB ASC 815-10-15. If the payments are variable, and the agreement is period certain rather than life contingent, FASB ASC 958-30-25-12 states that, generally, the liability representing an obligation under a split-interest agreement contains an embedded derivative. The embedded derivative should be bifurcated and accounted for as a derivative instrument pursuant to the

⁸ See FASB ASC 958-30 and chapter 6, "Split-Interest Agreements and Beneficial Interests in Trusts," of the AICPA Audit and Accounting Guide *Not-for-Profit Entities* for a detailed discussion of split-interest agreements.

requirements of FASB ASC 815-15-25-1, unless a fair value election is made pursuant to FASB ASC 815-15-25 or the "Fair Value Option" sections of FASB ASC 825-10.

5.37 Irrevocable split-interest agreements held by an independent third-party trustee generally do not give rise to embedded derivatives. Neither do (a) revocable split-interest agreements or (b) situations in which an NFP holds a split-interest agreement in the capacity of an independent trustee without having any beneficial interest in the arrangements (that is, acting similar to a financial institution or fiscal agent).

Other Matters

Changes in Fair Value of Hedged Item

5.38 Paragraphs 8–9 of FASB ASC 815-25-35 provide standards for accounting for the changes in fair value of the hedged item in a fair value hedge. The adjustment of the carrying amount of a hedged asset or liability required by FASB ASC 815-25-35-1(b) should be accounted for in the same manner as other components of the carrying amount of that asset or liability. An adjustment of the carrying amount of a hedged interest-bearing financial instrument should be amortized to earnings. Amortization should begin no later than when the hedged item ceases to be adjusted for changes in its fair value that are attributable to the risk being hedged.

Termination of Cash Flow Hedge by Debt Extinguishment

5.39 FASB ASC 815-30-35-44 states that if a reclassification to earnings of the amount in accumulated comprehensive income resulting from a cash flow hedge of debt is required when debt is extinguished, the amount reclassified from accumulated comprehensive income to earnings should be excluded from extinguishment gain or loss.

Additional Presentation and Disclosure Requirements for NFP Business-Oriented Health Care Entities

5.40 According to FASB ASC 954-815-50-2, FASB ASC 815 discusses how certain financial statement presentation and disclosure requirements related to derivative instruments and hedging activities should be applied by NFP business-oriented health care entities. Certain aspects of presentation and disclosure relative to classification of derivative gains and losses are highlighted subsequently.

5.41 Paragraphs 5.10–.12 describe how to report the gains and losses on cash flow hedges and fair value hedges. FASB ASC 815-10-50-4G states that for purposes of the disclosure requirements beginning in FASB ASC 815-10-50-4A, NFP business-oriented health care entities should present a similarly formatted table. They should refer to amounts within their performance indicator, instead of in income, and amounts outside their performance indicator, instead of in other comprehensive income. All NFPs also would indicate which class or classes of net assets (unrestricted, temporarily restricted, or permanently restricted) are affected.

5.42 FASB ASC 954-815-50-1 requires NFP business-oriented health care entities to separately disclose the beginning and ending accumulated

derivative gain or loss that has been excluded from the performance indicator, as discussed in paragraph 5.07; 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 FASB ASC 815-30-50-2. Similarly, FASB ASC 954-815 requires NFP business-oriented health care entities to provide disclosures that are analogous to those required by paragraphs 1–3 of FASB ASC 815-30-50 and FASB ASC 815-35-50-2 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.

5.43 In accordance with FASB ASC 958-225-45-8, the changes in fair value of derivative instruments or hedged items are classified as increases or decreases in unrestricted net assets, unless their use is temporarily or permanently restricted by explicit donor stipulations or law.

Auditing

5.44 AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items* (AICPA, *Professional Standards*), provides guidance on auditing procedures for assertions that are made in an entity's financial statements about derivative instruments and hedging activities. The AICPA Audit Guide *Special Considerations in Auditing Financial Instruments* also provides guidance on audit evidence that may be relevant to the fair value of derivative instruments and investments in securities.

Chapter 6

Property and Equipment and Other Assets

Overview

6.01 Health care entities use various kinds of property and equipment. Those assets are generally significant to the financial position of institutional health care entities, such as hospitals, continuing care retirement communities, and nursing homes. Typical accounts used to record property and equipment transactions are land, land improvements, buildings and improvements, leasehold improvements, fixed and movable equipment, leased property and equipment, accumulated depreciation and amortization, and construction in progress.

6.02 Health care entities also have intangible assets, which may be acquired in connection with business combinations or purchases or developed from other resources of the entity. Intangibles with finite lives are amortized according to their useful life. Examples of intangibles associated with health care entities include the following:

- Health plans
 - Customer relationships, such as employer groups or members
 - Provider networks
 - Trademarks
 - Trade names
 - Software
 - Licenses
 - Favorable leases
 - Noncompete agreements
 - Goodwill
- Hospitals and other health care facilities
 - Licenses
 - Favorable leases
 - Certificates of need
 - Managed care contracts
 - Goodwill
- Physician practices
 - Favorable leases
 - Medical charts
 - Noncompete agreements
 - Managed care contracts
 - Goodwill

6.03 Supplies inventories are generally not very significant to the financial position of health care entities. However, because of the volume and cost of supplies used, they may be much more significant to operating expenses and the statement of operations. Supplies typically include medical and surgical supplies; pharmaceuticals; linens, uniforms, and garments; food and other commodities; and housekeeping, maintenance, and office supplies. In addition, entity management must safeguard items such as certain pharmaceuticals, which may be very expensive per unit, be subject to significant regulatory oversight, and have a high risk of drug diversion. Attention should be given to ensuring inventory that is consigned and not owned is properly accounted for in the inventory records. In addition, particular attention should be given to expired supplies and pharmaceuticals to ensure they are removed from the inventory for both financial reporting and patient safety purposes.

6.04 Health care entities, whether investor-owned or not-for-profit, may receive donations in the form of property, equipment, or supplies. Donations of property, equipment, and supplies are measured at fair value at the date of donation, which then becomes the cost basis for the assets, and are recorded as an increase to fixed assets or supplies inventory as appropriate. Entities should ensure they properly account for assets acquired through government or private grants with reversionary interest of proceeds (that is, if an entity disposes of such an asset and it receives cash or trade-in value).

6.05 Accounting policies and disclosure requirements for property and equipment, supplies, and certain other assets of health care entities are similar to those used by other business entities. Health care entities should apply the guidance in FASB *Accounting Standards Codification (ASC) 360, Property, Plant, and Equipment*, and FASB ASC 340, *Other Assets and Deferred Costs*, except when the guidance conflicts with the specialized guidance in FASB ASC 954, *Health Care Entities*.

Capitalized Interest

6.06 Many not-for-profit (NFP) health care entities finance acquisitions, additions, and renovations of facilities by issuing tax-exempt debt, as discussed in chapter 7, "Municipal Bond Financing," of this guide. If the proceeds of tax-exempt borrowings are externally restricted to finance the acquisition of specified qualifying assets or to service the related debt, the amount of interest cost to be capitalized is determined in accordance with paragraphs 8–12 of FASB ASC 835-20-30. If the health care entity uses taxable debt or otherwise does not qualify for interest capitalization under those paragraphs, then the amount of interest cost to be capitalized is determined pursuant to paragraphs 2–7 of FASB ASC 835-20-30. Frequently, NFP health care entities are required to capitalize interest under paragraphs 2–7 of FASB ASC 835-20-30 for some projects and paragraphs 8–12 of FASB ASC 835-20-30 for others.

6.07 Among the differences between the two sets of guidance are the interest cost to be capitalized and the capitalization period. For interest costs on qualifying assets acquired with proceeds of tax-exempt borrowings that are externally restricted, FASB ASC 835-20-30-11 requires that the amount of capitalized interest be all interest cost of the borrowing less any interest earned on related interest-bearing investments acquired with proceeds of the related tax-exempt borrowings from the date of the borrowing until the assets are ready

for their intended use. For other borrowings, paragraphs 2–7 of FASB ASC 835-20-25 use a weighted average construction expenditures concept that is applied during the period for which the three criteria in FASB ASC 835-20-25-3 are present. Those criteria are (a) expenditures for the asset have been made, (b) activities that are necessary to get the asset ready for its intended use are in progress, and (c) interest cost is being incurred.

6.08 In accordance with FASB ASC 835-20-30-12, the interest cost of a tax-exempt borrowing should be eligible for capitalization on other qualifying assets of the entity when the specified qualifying assets are no longer eligible for interest capitalization. The entire interest cost on that portion of the proceeds that is available for other uses, such as refunding an existing debt issue other than a construction loan related to those assets, also is eligible for capitalization on other qualifying assets. Example 1 in FASB ASC 835-20-55-4 illustrates this guidance.

6.09 In certain circumstances in which an entity has an investment (equity, loans, and advances) accounted for by the equity method, and the investee has not begun its planned principal operations, FASB ASC 835-20-35-2 requires capitalization of interest cost. As explained in FASB ASC 835-20-15-5(c), the investor's investment in the investee, not the individual assets or projects of the investee, is the qualifying asset for purposes of interest capitalization. Interest is capitalized while the investee has activities in progress necessary to commence its planned principal operations, provided that the investee's activities include the use of funds to acquire qualifying assets for operations.

6.10 FASB ASC 835-20-15 specifies the types of assets for which interest is not capitalized. Among the listed items are assets acquired with gifts and grants that are restricted by the donor or grantor to acquisition of those assets, to the extent that funds are available from such gifts and grants; interest earned from the temporary investment of those funds that is similarly restricted should be considered an addition to the gift or grant for this purpose. Other items include assets not included in the consolidated balance sheet of the parent company and consolidated subsidiaries and assets that are not being used in the earning activities of the entity and not undergoing the activities necessary to get them ready for use.

6.11 Some health care entities finance construction projects with municipal securities that have both taxable and tax-exempt components. The aggregate proceeds are to finance a specific construction project and are restricted by a common indenture or trust agreement to use only for construction of the project, repayment of the debt, or both. In such situations, the interest to be capitalized on the taxable portion of the issue is accounted for separate from the interest on the tax-exempt portion, based on paragraphs 2–7 of FASB ASC 835-20-30.

Supplies, Rebates, and Discounts

6.12 Many health care entities receive rebates and discounts from purchase agreements or other arrangements with vendors. Time may pass between the purchase of supplies and receipt of the rebate. Rebates and discounts are credited to the related expense or asset account. Paragraphs 10–12 of FASB

ASC 605-50-25¹ and paragraphs 12–15 of FASB ASC 605-50-45² provide guidance when a health care entity is given cash considerations, rebates, refunds, or other up-front considerations by vendors.

6.13 Supply purchase contracts or other arrangements that include the use of vendor equipment may be considered to include a lease, as discussed in FASB ASC 440-10-25.

Lessee Involvement in Fixed Asset Construction

Ⓢ Update 6-1 *Accounting and Reporting: Leases*

FASB Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842): Amendments to the FASB Accounting Standards Codification*, was issued in February 2016. The amendments in this ASU are effective for public business entities, not-for-profit entities that have issued, or are a conduit bond obligor for securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and employee benefit plans that file financial statements with the SEC for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early application of the amendments is permitted for all entities.

The amendments in this ASU increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, the section that follows will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on ASU No. 2016-02, see appendix G, "The New Leases Standard: FASB ASU No. 2016-02," of this guide.

6.14 Frequently, health care entities, such as hospitals and the hospitals' employed physicians, enter into agreements with real estate developers for the construction of satellite buildings (for example, ambulatory surgery centers and medical office buildings). If the health care entity agrees to lease space in the building, the transaction is referred to as a build-to-suit transaction.

6.15 In these situations, FASB ASC 840-40-15-5 states that the health care entity (lessee) should be considered the owner of an asset during the construction period and, thus, be subject to FASB ASC 840-40 if it bears substantially all of the construction period risks; effectively, a sale and leaseback of the asset occurs when construction of the asset is complete, and the lease term begins. Paragraphs 2–16 of FASB ASC 840-40-55 provide specific criteria to apply in order to determine whether the health care entity (lessee) should be

¹ These paragraphs will be superseded by FASB Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. See appendix C, "The New Revenue Recognition Standard: FASB ASC 606," of this guide for more information.

² See footnote 1.

considered the owner of the asset during the construction period. If deemed to be the owner, the health care entity (lessee) should account for the arrangement as a sale-leaseback, in accordance with FASB ASC 840-40.

6.16 Thus, if the health care entity (lessee) bears substantially all of the construction-period risks, it should recognize construction in progress and a related financing obligation during the construction period. When the construction of the asset is complete, the health care entity (lessee) determines if it has met the requirements of sale-leaseback accounting, and if so, the deemed sale is recognized.

6.17 Additional guidance for build-to-suit transactions is found in the following standards:

- Paragraphs 42–47 of FASB ASC 840-40-55 provide guidance for costs incurred by a lessee before entering into a lease agreement with the developer-lessor.
- Paragraphs 7–16 of FASB ASC 958-810-55 provide guidance if an NFP health care entity is engaged in leasing transactions with a special-purpose-entity lessor.

Asset Retirement and Environmental Remediation Obligations

6.18 Many health care entities operate facilities that were originally constructed prior to the existence of modern building codes. FASB ASC 410, *Asset Retirement and Environmental Obligations*, provides guidance for a facility that, upon disposal or abandonment, by current regulations is required to remove, treat, or dispose of items such as asbestos; hazardous chemicals; test equipment; and building improvements, such as lead shielding or underground storage tanks, and to remediate environmental liabilities.

6.19 FASB ASC 410-20 addresses financial accounting and reporting for obligations associated with the retirement, sale, abandonment, recycling, disposal, or other-than-temporary idling of tangible long-lived assets and the associated asset retirement costs. It applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development, or normal operation of a long-lived asset, except for certain obligations. Paragraphs 8.62–.64 of this guide provide additional information about asset retirement obligations.

6.20 FASB ASC 410-30 requires that an entity recognize a liability for obligations associated with environmental remediation that relate to pollution arising from some past act, generally as a result of the provisions of Superfund, the corrective-action provisions of the Resource Conservation and Recovery Act, or analogous state and non-U.S. laws and regulations. Generally, an environmental remediation liability results from the improper operation of a long-lived asset; an environmental remediation liability that results from the normal operation of a long-lived asset and is associated with the retirement of that asset is an asset retirement liability, as discussed in paragraph 6.19. FASB ASC 410-30 provides a brief overview of environmental laws and regulations, which may be helpful in understanding potential remediation liabilities.

Impairment or Disposal

6.21 The "Impairment or Disposal of Long-Lived Assets" sections of FASB ASC 360-10 provide guidance whenever events or changes in circumstances indicate that the carrying amount of a long-lived asset (asset group)³ may not be recoverable. FASB ASC 360-10-35-17 states that an impairment loss should be recognized only if the carrying amount of the long-lived asset or asset group is not recoverable and exceeds its fair value.

6.22 Some of the following changes in circumstances of health care providers may indicate that the carrying amount of a long-lived asset group is not recoverable:

- There has been an adverse change in the use of the assets, such as the loss of certain core services to a specialty hospital or other competing facility.
- Patient volumes or revenues have significantly declined.
- Market conditions, such as the payment rates being received, increased competition, declining market demographics, or other conditions, have changed in such a manner that operating cash flow losses have been incurred or are projected to occur.
- The provider has lost its eligibility to be paid for services by a major payor, such as Medicare, or has lost a significant contract with a nongovernmental third-party payor.
- The provider has lost its federal or state tax exemption.

6.23 FASB ASC 360-10-35-23 requires that for purposes of recognition and measurement of an impairment loss, a long-lived asset or assets be grouped with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities. Further, because FASB ASC 205-20 requires discontinued operations to be reported separately from continuing operations at the level of a component of an entity, a health care entity needs to determine whether a disposal group is a component of an entity. The FASB ASC glossary states that a *component of an entity* "comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity."

6.24 It may be difficult for health care systems to apply those guidelines due to arrangements that affect numerous entities under common control, such as multi-entity managed care contracts, centralized billing offices, and shared purchasing operations and arrangements with physicians involved in providing services at multiple locations. Additionally, it is not uncommon for health care entities that operate multiple entities to support a service or facility that generates ongoing negative cash flows because the related services may be either (a) central to the furtherance of the overall entity's mission or (b) offered in order to reach a market segment that management believes will ultimately utilize other services within the entity to generate positive cash flows.

³ The FASB *Accounting Standards Codification* glossary defines an *asset group* as "the unit of accounting for a long-lived asset or assets to be held and used, which represents the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities." The FASB ASC glossary states that "[a] *disposal group* for a long-lived asset or assets to be disposed of by sale or otherwise represents assets to be disposed of together as a group in a single transaction and liabilities directly associated with those assets that will be transferred in the transaction."

6.25 If a health care entity commits to a plan to abandon a long-lived asset before the end of its previously estimated useful life, FASB ASC 360-10-35-47 requires depreciation estimates to be revised, in accordance with paragraphs 17–20 of FASB ASC 250-10-45 and FASB ASC 250-10-50-4, to reflect the use of the asset over the shortened useful life.

6.26 Paragraphs 9–11 of FASB ASC 360-10-45 provide the criteria for classifying a long-lived asset group as held for sale. Consideration of those criteria by NFP health care entities may be complicated by multiple levels of corporate governance and the interests of other authorities, such as the state attorney general, in the use of the assets. Large health care systems may be organized in such a way that the sale of certain assets must be approved by the governing board of the entity that owns the assets; any parent corporations; and, potentially, appointed representatives of groups that sponsor the system, such as religious congregations. Additionally, many transactions require approval by the state attorney general. These factors will affect the assessment of whether management has the authority to approve a sale and may also affect the timing of the completion of the transaction and, thus, the probability that the sale will be completed within one year.

6.27 In accordance with FASB ASC 360-10-35-44, if the health care entity decides not to sell a long-lived asset (disposal group) previously classified as held for sale, the asset (disposal group) should be reclassified as held and used. A long-lived asset that is reclassified should be measured individually at the lower of (a) its carrying amount before the asset (disposal group) was classified as held for sale, adjusted for any depreciation (amortization) expense that would have been recognized had the asset (disposal group) been continuously classified as held and used, or (b) its fair value at the date of the subsequent decision not to sell.

Discontinued Operations

6.28 Per "Pending Content" in FASB ASC 205-20-45-1A, a discontinued operation may include a component of an entity or a group of components of an entity, or a business or nonprofit activity.

6.29 Per "Pending Content" in FASB ASC 205-20-45-1B, a disposal of a component of an entity or a group of components of an entity should be reported in discontinued operations if the disposal represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results when any of the following occurs:

- a. The component of an entity or group of components of an entity meets the criteria in FASB ASC 205-20-45-1E to be classified as held for sale.
- b. The component of an entity or group of components of an entity is disposed of by sale.
- c. The component of an entity or group of components of an entity is disposed of other than by sale in accordance with FASB ASC 360-10-45-15 (for example, by abandonment or in a distribution to owners in a spinoff).

6.30 Per "Pending Content" in FASB ASC 205-20-45-1C, examples of a strategic shift that has (or will have) a major effect on an entity's operations and financial results could include a disposal of a major geographical area, a major line of business, a major equity method investment, or other major

parts of an entity. Paragraphs 83–101 of FASB ASC 205-20-55 provide examples of disposals that represent strategic shifts that have a major effect on an entity's operations and financial results and are reported in discontinued operations.

6.31 Per FASB ASC 205-20-45-3, the results of discontinued operations less applicable income taxes (benefit) should be reported as a separate component of income. For NFP health care entities, FASB ASC 954-225-45-7 requires that discontinued operations be reported separately from the performance indicator.

Nonreciprocal Transfers

6.32 A health care entity may transfer ownership of its long-lived assets, either individual pieces of equipment or an entire facility, to another health care entity in a nonreciprocal transaction.

6.33 FASB ASC 720-25 applies if such transactions are *contributions*, as defined in the FASB ASC glossary. Accounting for contributions made is discussed in paragraph 11.47 of this guide.

6.34 Similar to the recording of an impairment of long-lived assets, a gain or loss recognized to adjust to fair value would be included in income from continuing operations before income taxes in the income statement of an investor-owned health care entity or in the performance indicator in the statement of operations of an NFP entity. If a subtotal, such as "Income From Operations," is presented, it would include the amounts of those gains or losses.

Other Long-Lived Assets

© Update 6-2 *Accounting and Reporting: Internal-Use Software*

FASB ASU No. 2016-19, *Technical Corrections and Improvements*, was issued in December 2016. The amendments for internal-use software in this ASU are effective for public business entities for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018. Early application of the amendments is permitted for all entities.

This ASU clarifies that an entity should apply the existing recognition and measurement requirements in generally accepted accounting principles (GAAP) for acquired intangible assets to a hosting arrangement that includes a license to software (as described in paragraphs 14C of FASB ASC 350-40-15).

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, the section that follows will be updated in a future edition.

Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

6.35 Health care entities that incur costs for upgrading or improving computer systems (for example, ICD-10 upgrades) should follow the guidance in FASB ASC 350-40 for costs of computer software developed or obtained for

internal use and fees paid in a cloud computing arrangement, and FASB ASC 720-45 for business and technology reengineering. Business and technology reengineering may include software development, software acquisition, software implementation, training, and ongoing support. FASB ASC 720-45-55-1 illustrates the typical cost components of a business process reengineering or IT transformation project and whether they should be expensed or capitalized.

6.36 Many health care entities have other long-lived or intangible assets, such as goodwill, trademarks, prepaid benefits, patents, and costs associated with certificates of need. These assets may be acquired by purchase, through internal development, or through research and development efforts, among other activities.

6.37 The cost of an intangible asset acquired other than in an acquisition by an NFP entity or business combination is capitalized in accordance with FASB ASC 350, *Intangibles—Goodwill and Other*. Costs of start-up activities, including organization costs, should be expensed as incurred, as discussed in FASB ASC 720-15.

© Update 6-3 Accounting and Reporting: Goodwill Impairment

FASB ASU No. 2017-04, *Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*, issued in January 2017, is effective for a public business entity that is a SEC filer for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. A public business entity that is not an SEC filer should adopt the amendments in this ASU for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2020.

For all other entities, including not-for-profit entities, FASB ASU No. 2017-04 is effective for their annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2021.

Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017.

FASB ASU No. 2017-04 removes the second step of the two-step goodwill impairment test. An entity will apply a one-step quantitative test and record the amount of goodwill impairment as the excess of a reporting unit's carrying amount over its fair value, not to exceed the total amount of goodwill allocated to the reporting unit. The new guidance does not amend the optional qualitative assessment of goodwill impairment.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, this paragraph will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

6.38 In accordance with FASB ASC 350-20, goodwill that is not written off on the acquisition date, as discussed in paragraph 12.107 of this guide, should not be amortized, except when the alternative for private companies is elected. Instead, it should be tested for impairment at a level of reporting referred to as a reporting unit. Paragraphs 33–46 of FASB ASC 350-20-35 provide guidance on determining reporting units. *Impairment* is the condition that exists when the carrying amount of goodwill exceeds its implied fair value. The fair value of goodwill can be measured only as a residual and cannot be measured

directly. FASB ASC 350-20-35 includes a methodology to determine an amount that achieves a reasonable estimate of the value of goodwill for the purpose of measuring an impairment loss. That estimate is referred to as the *implied fair value of goodwill*. Paragraphs 3A–3G of FASB ASC 350-20-35 allow an entity to first assess qualitative factors to determine if it is more likely than not that the fair value of the reporting unit is less than the carrying amount before performing the two-step quantitative assessment of the goodwill impairment test, which is discussed in paragraphs 4–19 of FASB ASC 350-20-35. If determined to be necessary, the two-step impairment test should be used to identify potential goodwill impairment and measure the amount of goodwill impairment loss to be recognized, if any.

6.39 *Considerations for Private Companies that Elect to use Standards Issued by FASB as a Consensus of the Private Company Council*

Per FASB ASC 350-20-35, entities within the scope of FASB ASC 350-20-15-4 may elect to amortize goodwill on a straight-line basis over a period of 10 years (or less). This does not preclude the entity from assessing the goodwill for impairment. A policy should be adopted to test goodwill for impairment at either the entity level or reporting unit level.

6.40 Under the requirements of FASB ASC 350-30, accounting for a recognized intangible asset is based on its useful life to the reporting entity. An intangible asset with a finite useful life should be amortized; an intangible asset with an indefinite useful life should not be amortized. If an intangible asset has a finite useful life, but the precise length of that life is not known, that intangible asset should be amortized over the best estimate of its useful life. The method of amortization should reflect the pattern in which the economic benefits of the intangible asset are consumed or otherwise used up. If that pattern cannot be reliably determined, a straight-line amortization method should be used. An intangible asset that is subject to amortization should be reviewed for impairment in accordance with the "Impairment or Disposal of Long-Lived Assets" sections of FASB ASC 360-10 by applying the recognition and measurement provisions in paragraphs 17–35 of FASB ASC 360-10-35.

6.41 If an intangible asset is determined to have an indefinite useful life, it should not be amortized until its useful life is determined to be no longer indefinite. An entity should evaluate the remaining useful life of an intangible asset that is not being amortized each reporting period to determine whether events and circumstances continue to support an indefinite useful life. If an intangible asset that is not being amortized is subsequently determined to have a finite useful life, the asset should be tested for impairment in accordance with paragraphs 18–19 of FASB ASC 350-30-35. That intangible asset should then be amortized prospectively over its estimated remaining useful life and accounted for in the same manner as other intangible assets that are subject to amortization.

6.42 An intangible asset that is not subject to amortization should be tested for impairment annually and more frequently if events or changes in circumstances indicate that it is more likely than not that the asset is impaired. An entity may first perform a qualitative assessment, as described in paragraphs 18B–18F of FASB ASC 350-30-35, to determine whether it is necessary to perform the quantitative impairment test as described in FASB ASC 350-30-35-19. An entity has an unconditional option to bypass the qualitative assessment for any indefinite-lived intangible asset in any period and proceed directly

to performing the quantitative impairment test as described in FASB ASC 350-30-35-19. An entity may resume performing the qualitative assessment in any subsequent period. If an entity elects to perform a qualitative assessment, it first should assess qualitative factors to determine whether it is more likely than not (that is, a likelihood of more than 50 percent) that an indefinite-lived intangible asset is impaired. In assessing whether it is more likely than not that an indefinite-lived intangible asset is impaired, an entity should assess all relevant events and circumstances that could affect the significant inputs used to determine the fair value of the indefinite-lived intangible asset.

6.43 FASB ASC 350-30-35-18B includes examples of events and circumstances that may affect the assessment of whether it is more likely than not that an indefinite-lived intangible asset is impaired. An entity should assess all relevant events and circumstances that could affect the significant inputs used to determine the fair value of the indefinite-lived intangible asset. FASB ASC 350-30-35-18C provides considerations that the entity should consider when determining whether it is more likely than not that the indefinite-lived intangible asset is impaired.

Financial Statement Presentation

6.44 Financial statement presentation of property and equipment, supplies, and other assets of health care entities is similar to that of other business entities.

6.45 FASB ASC 954-205-45-9 states 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 ASC 958-205-45-12. Thus, if contributions of long-lived assets with explicit donor restrictions are reported as temporarily-restricted support, a health care entity reports expirations of those donor restrictions when the stipulation is fulfilled, and the assets are placed in service. Similarly, 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, and expirations of those donor restrictions are reported when the acquired long-lived assets are placed in service, and donor-imposed restrictions are satisfied.

6.46 According to FASB ASC 954-360-45-1, property held for investment purposes is presented as part of investments.

6.47 FASB ASC 958-360-50-4 requires that donor or legal restrictions on the use of, or proceeds from, the disposition of donated property and equipment or property and equipment purchased with cash restricted for the acquisition of long-lived assets be disclosed.

Auditing

6.48 Auditing objectives for property and equipment, supplies, and other assets of health care entities are similar to those in audits of other business entities. The auditor may be able to assess the risks of material misstatement for property and equipment and supplies 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. As discussed in paragraph .02 of AU-C section 315, *Understanding the Entity and Its Environment and*

Assessing the Risks of Material Misstatement (AICPA, *Professional Standards*), the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

6.49 A health care entity 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 entity; (c) use property and equipment provided by a related entity, such as a religious order, or an unrelated entity under an affiliation program; or (d) use property and equipment provided by a government agency or unit or government-related hospital district. The independent auditor should consider the nature of any relationship between the health care entity and lessors, bailors, or other owners of property and review the financial statements for appropriate related disclosures.

6.50 In evaluating the entity's capitalization policies, the independent auditor should consider whether interest has been capitalized in accordance with the provisions of FASB ASC 835-20.

6.51 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 (most recently in 2013) and sets forth plant asset classifications and the estimated useful lives of depreciable assets. Additionally, social, economic, and scientific advances in the health care industry make obsolescence an important factor to be considered when evaluating depreciation policies and methods.

6.52 In considering a health care entity's application of the "Impairment or Disposal of Long-Lived Assets" sections of FASB ASC 360-10, 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 entity 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.

6.53 In obtaining sufficient appropriate audit evidence with respect to property and equipment, supplies, and other assets, the auditor may consider the examples of specific audit objectives, specific control objectives, and substantive audit procedures that are presented in exhibit 6-1.

Exhibit 6-1

The following table illustrates the use of assertions in developing audit objectives and designing substantive tests. The examples are not intended to be all-inclusive nor is it expected that all the procedures are necessarily applied in an audit. Irrespective of the assessed risks of material misstatement, paragraph .18 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), states the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. The use of assertions in assessing risks and designing appropriate audit procedures to obtain audit evidence is described in paragraphs .26–.32 of AU-C section 315. Various audit procedures and the purposes for which they may be performed are described in paragraphs .A10–.A26 of AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*).

Audit Considerations

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives⁴</i>	<i>Substantive Audit Procedures⁵</i>
Donated Property Equipment			
<i>Account Balances</i>			
Valuation and allocation	Donated property and equipment is reported at fair value at the date of donation. ¹	Procedures ensure that the donation of property and equipment is known and recorded and that documentation supports the determination of the fair value.	Review the documentation supporting the determination of the fair value. ²
<i>Presentation and Disclosure</i>			
Classification and understandability	The receipt of donated property and equipment is properly reported.		Review material donated property and equipment transactions to ensure the propriety of the reporting. Ensure any reversionary interest has been properly accounted for in any disposals of donated or grant acquired assets.

(continued)

⁴ The auditor should consider a combination of preventive and detective controls responsive to the control objectives.

⁵ The auditor should determine the nature, timing, and extent of substantive procedures to perform, considering, for example, the results of tests of controls and risk areas.

Audit Considerations—continued

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
Property and Equipment Not Held for Use in Operations			
Presentation and Disclosure			
Classification and understandability	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.
		Additions are authorized in the capital budget.	
Existence and valuation and allocation	Recorded property and equipment are owned by the entity and carried at the appropriate amounts.	Inventory of property and equipment is taken periodically. Detailed property records are periodically reconciled to the recorded amounts.	Review a summary of property and equipment (cost and accumulated depreciation), including additions, deletions, and transfers.
<p>¹ For additional discussion on fair value measurements, refer to chapter 4, "Cash, Cash Equivalents, and Investments," of this guide.</p> <p>² AU-C section 540, <i>Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures</i> (AICPA, <i>Professional Standards</i>), provides guidance on auditing fair value measurements and disclosures contained in financial statements. AU-C section 540 does not address specific types of assets, liabilities, components of equity, transactions, or industry-specific practices.</p> <p><i>Considerations for Audits Performed in Accordance With PCAOB Standards</i></p> <p>PCAOB Staff Audit Practice Alert No. 2, <i>Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists</i> (AICPA, <i>PCAOB Standards and Related Rules</i>, PCAOB Staff Guidance, sec. 400.02), provides guidance on auditors' responsibilities for auditing fair value measurements of financial instruments and when using the work of specialists under the existing standards of the PCAOB. This practice alert is focused on specific matters that are likely to increase audit risk related to the fair value of financial instruments in a rapidly changing economic environment. This practice alert also highlights certain requirements in the auditing standards related to fair value measurements and disclosures in the financial statements and certain aspects of GAAP that are particularly relevant to the current economic environment. PCAOB Staff Audit Practice Alerts are neither rules of the PCAOB nor have they been approved by the PCAOB.</p>			

Chapter 7

Municipal Bond Financing

Gray shaded text in this chapter reflects guidance issued but not yet effective as of the date of this guide, September 1, 2017, but becoming effective on or prior to June 30, 2018, exclusive of any option to early adopt ahead of the mandatory effective date. Unless otherwise indicated, all unshaded text reflects guidance that was already effective as of the date of this guide.

Introduction

7.01 Although health care entities utilize many forms of debt financing, this chapter focuses on municipal bonds issued on behalf of not-for-profit (NFP) health care entities. Because of its capital-intensive nature, health care is among the largest industry sectors that raise funds through the municipal securities market.

7.02 Typically, a qualified governmental agency, such as a health care financing authority (the issuer), issues the securities and then lends the proceeds to the health care entity (the obligor). In these conduit financings, although the securities bear the name of the issuing government, the issuer has no obligation for repayment of the debt; the bondholders' principal and interest will be paid solely from resources of the obligor.

7.03 Most municipal bonds issued on behalf of health care entities are revenue bonds. For revenue bond issues, the health care entity pledges a specific revenue stream, typically revenue derived from the project or enterprise being funded. There may also be a mortgage on the financed property and other restrictive covenants. To obtain project financing, a financing authority may require a health care entity to enter into a lease arrangement, a sublease arrangement, or both. It is also common practice for a health care system to create an obligated group of affiliated entities, the assets and revenues of which serve as collateral for the debt.

7.04 Municipal bonds are issued with either a variable or fixed interest rate. A fixed-rate bond bears interest at a specified, constant rate. Variable-rate (floating-rate) bonds bear interest at a rate that is reset from time to time. Some documents provide the ability to change the interest mode (for example, from auction rate¹ to variable rate). In addition, financing strategies have emerged that convert a variable-rate obligation into a fixed-rate obligation, or vice versa, using derivative instruments. For example, a common financing structure involves creating fixed-rate debt by initially issuing lower cost variable-rate debt coupled with a floating-to-fixed interest rate swap. Additional considerations related to interest rate swaps are discussed in chapter 5, "Derivatives," of this guide.

7.05 The type of project(s) that is funded with municipal bond proceeds affects the taxability of income received by the bond holders and, thus, whether

¹ In a Dutch auction, investors bid for the bonds, which are sold at the lowest yield necessary to sell the entire issue.

the bonds are characterized as tax exempt or taxable. Generally, tax-exempt bonds are issued to finance services or facilities that are for the public good. Interest paid to holders of tax-exempt bonds is often exempt from all federal income taxes and sometimes state or local taxes, as well. Taxable bonds may be issued for uses not qualifying for tax-exempt financing (for example, medical office buildings). Tax considerations are discussed in paragraphs 7.40–44.

Conduit Bonds That Trade in Public Markets

7.06 In certain topics and subtopics of the FASB *Accounting Standards Codification* (ASC), entities that have issued securities that trade in public markets are subject to different accounting, reporting, disclosure, effective date, or transition requirements.² Generally, the rationale behind these differential requirements is that the entity's financial statements are being utilized in public markets for making decisions about whether to buy, sell, or hold that entity's securities.

7.07 The FASB ASC glossary has multiple definitions for the term *public entity*.³ Generally, these are entities that have debt or equity securities that trade in public markets. When applying accounting standards that refer to public entities, careful attention should be paid to the requirements to determine which definition applies and whether the definition includes conduit bond obligors within its scope. If within its scope, it is also necessary to determine whether the obligor's securities trade in public markets (for example, over-the-counter markets). As discussed in paragraph 7.12, if conduit bonds have been issued on behalf of a health care entity in a competitive or negotiated offering, they are deemed to trade in public markets. Bonds issued in a private placement would not be deemed to trade in public markets for as long as the bonds are privately held.

7.08 The fact that an NFP health care entity with conduit bonds that trade in public markets is considered a public entity does not change that entity's status for purposes of applying accounting standards with requirements that are specific to NFPs or that explicitly exclude NFPs. If the scope of an accounting standard that contains expanded disclosure requirements or additional accounting requirements for public entities explicitly excludes NFPs, NFP health care entities would not apply that standard. Additionally, classification as a public entity under generally accepted accounting principles (GAAP) does not impose SEC or other regulatory filing requirements (such as Regulations S-X or S-K) on NFP health care conduit debt obligors. It also does not result in an NFP health care entity being required to comply with the portions of the Sarbanes-Oxley Act of 2002 that apply only to *issuers*, as defined by the Securities Exchange Act of 1934.

² FASB Accounting Standards Update (ASU) No. 2013-12, *Definition of a Public Business Entity—An Addition to the Master Glossary*, changed, on a prospective basis, the approach used to indicate the applicability of differential guidance within FASB *Accounting Standards Codification* (ASC). Thus, standards issued prior to FASB ASU No. 2013-12 make the distinction in a different manner than standards issued after FASB ASU No. 2013-12, as discussed further in paragraph 7.07.

³ For guidance that predates FASB ASU No. 2013-12, a bright-line public versus nonpublic distinction was made among all entities, with conduit bond obligors for municipal securities that trade in public markets (including not-for-profit obligors) typically classified as *public*.

Credit Enhancement⁴

7.09 Health care entities may utilize credit enhancements to make their bonds more attractive to investors or to allow them to access the market at more favorable rates. Credit enhancement involves the use of the credit standing of an entity, other than the issuer or obligor, to provide additional security in a bond or note financing. Credit enhancement typically refers to bond insurance, bank letters of credit, and similar facilities but also may refer more broadly to the use of any form of guaranty; secondary source of payment; or similar, additional credit-improving instruments.

7.10 When credit enhancement is provided through a bank letter of credit, the bonds bear the rating of the issuing bank that commits to pay the principal and interest on the securities in the event that the obligor is unable to do so. Letters of credit cover a specified time period. *Bond insurance* is an unconditional and irrevocable commitment from a municipal bond insurance company to make scheduled bond debt service payments in the event of nonpayment by the obligor. Bonds secured by a municipal bond insurance policy carry the rating of the municipal bond insurer. Once acquired, a bond insurance policy generally is in place for the life of the bonds. Government programs, such as the Federal Housing Administration Section 242 mortgage insurance program, enable some obligors to enhance their credit using the creditworthiness of the federal government.

7.11 Because credit-enhanced bonds are rated based on the credit standing of another entity, downgrades of the other entity's ratings can have implications for the obligor's own credit ratings, as well as potentially triggering defaults under debt agreements and derivative contracts. See related discussion in paragraph 7.83.

Issuance of Municipal Bonds

7.12 Municipal bonds are issued through negotiated sales, competitive bids, or private placements. In a negotiated sale, the issuer or obligor negotiates a price with one or more underwriters. In a competitive bid sale, the securities are sold to one or more underwriters who submitted the best acceptable bid(s). The underwriters then resell the securities to the general investing public. Municipal bonds issued in negotiated sales or competitive bids are deemed to be traded in public markets; thus, conduit borrowers under those arrangements are considered public entities for purposes of providing certain disclosures under accounting standards, as discussed in paragraph 7.06. In addition, when underwriters sell municipal securities to the general investing public, the SEC imposes certain requirements on the underwriters, who in turn require the obligors to file certain disclosure documents. An overview of SEC considerations related to municipal bonds is provided in the appendix, "Municipal Securities Regulation," of this chapter. In a private placement, the securities generally are sold directly to qualified investors (for example, an institutional investor), rather than through an offering to the general investing public. Municipal bonds issued in private placements are not deemed to trade in public markets because the investors typically are subject to restrictions on resale.

⁴ Paragraph 7.70 discusses the fair value of bonds with third-party credit enhancements, whether measured for purposes of disclosure or reporting under the "Fair Value Option" sections of FASB ASC 825-10.

7.13 A health care entity that is issuing municipal bonds through a financing authority prepares an official statement that offers the securities for sale and provides appropriate financial and other information about the offering, the health care entity, and any guarantors or credit-enhancement providers. Financial advisers; bond counsel; and, frequently, engineers, appraisers, and independent auditors assist the health care entity in preparing information for the official statement. Auditor involvement with municipal securities offerings are discussed beginning at paragraph 7.86. The following are important stages in a municipal securities offering (the time periods between these stages may vary):

- The preliminary official statement is issued to all prospective buyers of the securities.
- The financing authority, health care entity, and underwriters execute the bond purchase agreement.
- The official statement is issued at the time of sale (sometimes referred to as the effective date) and identifies the buyers and the actual debt service requirements of the securities.
- The closing date is the date that the transaction is finalized, and the proceeds are transferred from the buyers to the health care entity.

Extinguishment and Modification Transactions

7.14 NFP health care entities generally follow the same accounting and financial reporting standards for extinguishment and modification of debt as investor-owned entities. Those standards are found in FASB ASC 405-20 and 470-50.

7.15 FASB ASC 405-20-40 states that a liability is extinguished either when the debtor pays the creditor and is relieved of its obligation for the liability or when the debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor. FASB ASC 405-20-40-1(a)(4) states that paying the creditor includes reacquisition by the debtor of its outstanding debt securities, regardless of whether the securities are cancelled or held as Treasury bonds.

7.16 Thus, a debt obligation is derecognized if a health care entity reacquires its bonds through open market purchases, regardless of whether the reacquired securities are then held by the debtor as Treasury bonds or retired. Treasury bonds that are held should never be reported as an asset of the health care entity, even if the entity intends to remarket the bonds at a future date or hold and manage them as part of its investment portfolio.

7.17 Another way that a health care entity may extinguish its debt is by issuing new bonds whose proceeds are used to repay the previously-issued bonds (a refunding transaction). If the new bonds are held by the same creditor as the old bonds, the refunding may be a modification of debt terms, rather than an extinguishment, as discussed in paragraphs 6–12 of FASB ASC 470-50-40. See also paragraphs 7.27–.31. Three types of refunding transactions exist: current refunding, advance refunding, and crossover refunding. In a current refunding, the new debt proceeds may be used to repay the old bonds within 90 days of the first call date or maturity of the bonds to be refunded. In an advance refunding, the new debt proceeds are placed with an escrow agent and invested

until they are used to pay principal and interest of the old debt at a future time; outstanding securities are refinanced more than 90 days prior to their call or maturity date.⁵ In a crossover refunding, bonds referred to as crossover bonds are issued for the purpose of paying off an existing bond issue (referred to as the refunded bonds). The crossover bonds are initially collateralized by an escrow of investments purchased with the crossover bond proceeds, and the refunded bonds continue to be secured by their original collateral or revenue stream. On a specified date, the investments held in escrow are sold, and the refunded bonds are redeemed. Then, the crossover bonds become collateralized by the original collateral or payable from the original revenue stream. In refunding transactions, the entity must either call the bonds (if allowed) to redeem them early or irrevocably set aside the funds to pay them off in a defeasance. These situations are discussed subsequently.

Calls and Mode Conversions

7.18 Some bond contracts allow a health care entity to repay the bonds prior to their scheduled maturity date, which is referred to as a call option. Typically, new bonds are issued to pay off the outstanding bonds (a refunding).

7.19 Some bonds are structured as multimodal, which permits the health care entity to exercise an interest mode conversion. A multimodal feature provides the health care entity with a contractual right to change the interest feature of the bond from one form to another (for example, an auction-based interest rate to a fixed-rate or index-based variable interest rate). In most cases, a mode conversion involves a call (referred to as a mandatory tender) of the old bonds and marketing of new bonds to new investors, as well as existing bondholders. Thus, the mode conversion is similar to a traditional refunding, and the same accounting considerations apply to mode conversions as refunding.

Defeasance

7.20 If the health care entity would like to retire the debt early but does not have a call option, defeasance is a financing tool that allows it to obtain some or all of the benefits of repaying bondholders prior to actually retiring the debt. In a defeasance, the health care entity purchases government securities for deposit into an escrow account and irrevocably pledges the securities to the payment of the outstanding bonds. The securities and their related earnings are sufficient to pay the principal and interest on the bonds when they come due. In essence, the health care entity is substituting collateral on the debt. Often, some or all of the funds deposited into the escrow account arise from an advance refunding. Generally, the revenues originally pledged as security on the outstanding securities switch over to become security for payment of the refunding bonds (the new issue) on the date that the advance refunding bonds are issued.

7.21 Defeasances are categorized as legal or economic. The terms of some bond contracts allow for *legal defeasance*, which is the termination of the rights and interests of the bondholders and their lien on the pledged revenues or other security. When the conditions specified in the bond contract for legal defeasance are met, the health care entity's obligation for repayment of the bonds is satisfied in full, and the debt is extinguished.

⁵ Per the Tax Reform Act of 1986, new money bonds issued prior to January 1, 1986, can be advance refunded twice, but bonds issued on or after that date can only be advance refunded once.

7.22 In other situations, sometimes referred to as an in-substance or economic defeasance, establishing a defeasance escrow account makes the revenues pledged as collateral available for other purposes without actually effecting a legal defeasance. This might be used if, for example, the bond contract does not provide a procedure for termination of the bondholders' rights and interests other than through redemption of the bonds. In an economic defeasance, if for some reason the escrowed funds prove insufficient to make future payments on the old debt, the health care entity is still legally obligated to make payment on such debt from the pledged revenues.

7.23 FASB ASC 405-20-55 provides implementation guidance on the extinguishment of liabilities, including in-substance and legal defeasances.

7.24 When a defeasance occurs, the debtor has not paid the creditor. Therefore, liabilities are considered extinguished for accounting purposes only if the debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor. In a legal defeasance, generally, the creditor legally releases the debtor from being the primary obligor under the liability; however, the question of whether the debtor has in fact been legally released is a matter of law, not an accounting determination. A legal opinion may be required. An in-substance defeasance transaction normally does not meet the derecognition criteria for either the liability or escrowed assets, unless a legal release is obtained.

7.25 Paragraphs 4–6 of FASB ASC 860-10-40 provide standards for determining whether financial assets should be derecognized.

7.26 Derecognition of the assets in the defeasance trust may need to be separately evaluated, even if the defeased debt has met the criteria for derecognition. Because the obligor must surrender control over the assets transferred to the trust, and the transferred assets must be legally isolated from the obligor (for example, presumptively put beyond the reach of the obligor and its creditors, even in bankruptcy or other receivership), if the obligor has any type of continuing involvement with the transferred assets (for example, if the obligor has the ability to direct the investment of trust assets or is entitled to residual assets upon termination of the trust), a separate legal isolation opinion may be required in order to conclude that the conditions for derecognition have been met.

Modifications

7.27 When one debt instrument is replaced with another, such as occurs in refundings or interest mode conversions, and the new debt instrument is held by the same creditor(s) as the old, questions may arise about whether the transaction is considered a debt modification or debt extinguishment.

7.28 Paragraphs 6–12 of FASB ASC 470-50-40 provide guidance for determining whether a replacement of one debt instrument with another is a modification of the original debt terms or the extinguishment of one obligation and issuance of another. FASB ASC 470-50-40-6 states that an exchange of debt instruments with substantially different terms is a *debt extinguishment* and should be accounted for in accordance with FASB ASC 405-20-40-1 by derecognizing the liability. FASB ASC 470-50-40-10 states that from the debtor's perspective, an exchange of debt instruments between a debtor and creditor in a nontroubled debt situation is deemed to have been accomplished with debt instruments that are substantially different if the present value of the cash

flows under the terms of the new debt instrument is at least 10 percent different from the present value of the remaining cash flows under the terms of the original instrument. However, if the debt modification is considered a troubled debt restructuring, the guidance in FASB ASC 470-60 would apply.

7.29 When evaluating whether a modification or an exchange has occurred with a public debt issuance, the debt instrument is the individual security held by an investor, and the creditor is the security holder. Thus, the unit of account is not for the bond issue in total but on a bondholder-by-bondholder basis. As a practical matter, if the bonds are widely held, it may be reasonable to conclude that the issuance of new bonds to pay off old bonds is not a refinancing of debt with the same creditors; thus, it is an extinguishment, rather than a modification. If the bonds are not widely held, and the transaction is in essence a refinancing of debt with the same creditor(s), it is necessary to determine whether the difference between the present value of the remaining cash flows associated with the original obligation and the present value of the cash flows associated with the new obligation is less than 10 percent. If the difference is less than 10 percent, the transaction is a modification.

7.30 For a conduit bond offering involving a governmental financing agency, a health care entity should determine whether the financing agency is acting as a principal or an agent of the obligor in order to determine whether the transaction is an extinguishment or a modification.

7.31 Paragraphs 19–20 of FASB ASC 470-50-40 and paragraphs 4–7 of FASB ASC 470-50-55 provide guidance and indicators to consider in making such a determination.

Gain or Loss on Debt Extinguishment

7.32 FASB ASC 470-50 addresses how a gain or loss on a debt extinguishment should be measured. It applies to all extinguishments of debt, regardless of whether the extinguishment is early, except debt that is extinguished through a troubled debt restructuring or convertible debt. Per FASB ASC 470-50-40-2, the difference between the reacquisition price and net carrying amount of the extinguished debt should be recognized currently in income of the period of extinguishment as losses or gains and identified as a separate item. Gains and losses should not be amortized to future periods. See paragraph 7.65 for additional discussion.

7.33 The *reacquisition price* of debt is the amount paid on extinguishment, including a call premium and miscellaneous costs of reacquisition. If extinguishment is achieved by a direct exchange of new securities, the reacquisition price is the fair value of the new securities. The net carrying amount of the extinguished debt is the amount due at maturity, adjusted for unamortized premium, discount, and cost of issuance.

Debt Issuance Costs Incurred in Connection With an Exchange or Modification of Debt Instruments

7.34 Paragraphs 17–18 of FASB ASC 470-50-40 provide guidance for reporting costs incurred by the debtor in connection with an exchange or a modification of debt instruments. The accounting treatment depends on whether the fees are paid to the creditor or other third parties. The following paragraph summarizes that guidance but is not a substitute for reading the referenced paragraphs.

7.35 If the exchange or modification is to be accounted for in the same manner as a debt extinguishment, and the new debt instrument is initially recorded at fair value, then (a) the fees between the debtor and creditor are included in determining the debt extinguishment gain or loss to be recognized, and (b) the third-party costs are amortized over the term of the new debt instrument using the interest method in a manner similar to debt issue costs. If the exchange or modification is not accounted for in the same manner as a debt extinguishment, then (a) the fees between the debtor and creditor, along with any existing unamortized premium or discount, are amortized as an adjustment of interest expense over the remaining term of the replacement or modified debt instrument using the interest method, and (b) the third-party costs are expensed as incurred.

7.36 As discussed in FASB ASC 470-50-40, in the event of a mode conversion, modification, or extinguishment of debt, there may be effects on the related prepaid bond issuance costs or deferred issuance costs, such as writing off all or a portion of these costs or revised amortization periods.

Puts or Tender Options

7.37 Some bond contracts allow the bonds to be repaid prior to their stated maturity at the option of the bondholder. The bondholder's right to request earlier payment is referred to as a tender option (or sometimes a put option). Some health care entities utilize bank agreements, such as letters of credit or standby bond purchase agreements (a liquidity facility), to provide liquidity for the put or tender feature. If a bondholder exercises its put option, the health care entity generally will seek to sell the put bonds to another investor through its remarketing agent. If another investor is found who accepts the same terms as the original bondholder, the transaction occurs between the bondholders and does not affect the accounting by the health care entity. The proceeds of the resale are used to pay the original bondholder. If another investor cannot be found (for example, a failed remarketing), the health care entity is required to pay the bondholder. If the health care entity has a liquidity facility, then the liquidity provider generally advances the funds needed to pay the bondholder. At that point, ownership of the bonds transfers to the liquidity provider, and they become bank bonds. The interest rate payable on bank bonds converts to the rate stipulated in the liquidity facility agreement. Efforts continue to remarket the bank bonds for the period of time stipulated in the liquidity facility agreement. If another bondholder is found within that period, the proceeds generally are used to pay off the liquidity facility; the interest rate returns to the terms in the original bond agreement; and the bonds revert to their normal status, with the one exception discussed in paragraph 7.15.

7.38 If another buyer cannot be found after a certain period, the liquidity facility generally ceases to be interest only and converts to a term loan. The health care entity repays the debt over a relatively short period of time, rather than over the original stated maturity of the bonds. In effect, the bank (the liquidity facility) exchanges the term loan for the bond, and the bond is derecognized because its terms are substantially different from those of the term loan.

7.39 In some cases, health care entities may forego using an external liquidity facility. If a failed remarketing occurs, the health care entity pays the holder of the put bonds using its own cash and liquid investments (self-liquidity). In these situations, the bonds are considered extinguished when the

failed remarketing occurs, regardless of whether the put bonds are retained by the health care entity as Treasury bonds or retired.

IRS Considerations

7.40 As discussed in paragraph 7.05, interest paid to holders of tax-exempt bonds is often exempt from all federal income taxes and sometimes state or local taxes, as well. In order to maintain the bonds' tax-exempt status, health care entities must comply with all applicable federal tax laws and Treasury regulations, including, but not limited to, the use of bond-financed property and arbitrage requirements. The IRS encourages IRC Section 501(c)(3) organizations to implement procedures that will enable them to adequately safeguard against postissuance violations that could result in the loss of the tax-exempt status of the bonds. IRS Publication 4078, *Tax-Exempt Private Activity Bonds* (available for download at <https://www.irs.gov/pub/irs-pdf/p4078.pdf>) is a helpful source of information regarding the requirements. Requirements related to arbitrage and the qualified use of proceeds are briefly summarized subsequently.

7.41 Tax-exempt bonds bear interest at lower rates than taxable bonds due to the inherent federal tax subsidy. Safeguards exist, so that entities do not attempt to inappropriately benefit from this subsidy by issuing tax-exempt bonds and then investing the proceeds to earn *arbitrage*, which is the difference between the interest earned on the invested funds and the interest rate that the health care entity must pay to the bondholders. Specific IRS requirements control arbitrage and dictate which bond issues are subject to rebate (for example, remitting excess earnings to the federal government) and when the yield on investments must be restricted. Certain exceptions apply to these provisions based on the nature and timing of the expenditures paid by the bond proceeds.

7.42 FASB ASC 954-470-25-2 states that IRS regulations concerning tax-exempt debt prohibit the yield realized from the investment of the proceeds of tax-exempt debt from exceeding the interest rate to be paid on such debt. Whenever a health care entity invests tax-exempt bond proceeds, and the ultimate yield is higher than the interest rate on the bonds, the entity 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 retroactively disqualify the issue. The earnings in excess of interest expense represent a liability that must be paid to the Department of the 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.

7.43 The type of project(s) that is funded by a bond affects the taxability of income received by the bondholders. Conduit bonds issued for projects that only benefit private parties (private activity bonds) normally are taxable. Conduit bonds issued to finance facilities owned and utilized by IRC Section 501(c)(3) nonprofit organizations are exempt from federal income tax if they are qualified 501(c)(3) bonds. To qualify for tax exemption, at least 95 percent of the net bond proceeds must be used for exempt activities. Thus, no more than 5 percent of the net proceeds may be used in any private business use or by the NFP in an unrelated trade or business activity. Bond issuance costs are considered part of the 5 percent private use and reduce the available net proceeds for other types of private use. IRC Section 501(c)(3) borrowers must ensure that the IRS

rules on private use are met both at the time that the bonds are issued and throughout the life of the bonds.

7.44 Treasury regulations provide for certain remedial actions to cure uses of proceeds that would otherwise cause the qualified 501(c)(3) bonds to lose their exempt status. Those remedial actions can include redemption or defeasance of bonds, alternative qualified use of disposition proceeds, or alternative use of the bond-financed facilities. Entities may also be eligible to enter into a closing agreement under IRS Notice 2008-31, *Voluntary Closing Agreement Program For Tax-Exempt Bonds and Tax Credit Bonds*, which is available at <https://www.irs.gov/pub/irs-drop/n-08-31.pdf>.

Financial Statement Presentation and Disclosure

Balance Sheet

© Update 7-1 *Accounting and Reporting: Leases*

FASB Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842): Amendments to the FASB Accounting Standards Codification*, was issued in February 2016. The amendments in this ASU are effective for public business entities, not-for-profit entities that have issued, or are a conduit bond obligor for securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and employee benefit plans that file financial statements with the SEC for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early application of the amendments is permitted for all entities.

The amendments in this ASU increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, the section that follows will be updated in a future edition.

Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU No. 2016-02, see appendix G, "The New Leases Standard: FASB ASU No. 2016-02," of this guide.

7.45 According to FASB ASC 954-470-25-1, when a financing authority issues tax-exempt bonds or similar debt instruments and uses the proceeds for the benefit of a health care entity, the obligation should be reported as a liability in the entity's balance sheet if the health care entity is responsible for repayment. In some cases, this obligation may take the form of a liability arising from a capital lease. The "Pending Content" in FASB ASC 835-30-45 requires that debt issuance costs related to a recognized debt liability be presented in the statement of financial position as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts, and that the amortization of debt issuance costs be reported as interest expense. If a health care entity 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 entity should not reflect the liability on its balance sheet. In such circumstances, proceeds from the bond issue shall be reported as contributions from the sponsoring entity.

7.46 Although bonds typically have a stated maturity of many years, careful consideration should be given to classification of the liability as current or noncurrent based on the features of the debt. Debt that appears to be long term based on its legal maturity might not be considered long term for financial reporting purposes because of subjective acceleration clauses or due-on-demand (put) provisions. Careful consideration of the bond agreements and related documents (for example, bond indenture, loan and trust agreement, liquidity facility, and so on) may be required in order to make a determination of whether debt is properly classified.

7.47 The principal guidance for evaluating the appropriate balance sheet classification of debt obligations is found in FASB ASC 210-10-45, 470-10-45, and 470-10-55.

Classification of Debt With Due-on-Demand or Put Provisions

7.48 FASB ASC 470-10-45-10 states that the current liability classification should include obligations that, by their terms, are due on demand or will be due on demand within one year (or operating cycle, if longer) from the balance sheet date, even though liquidation may not be expected within that period.

7.49 For example, some variable-rate bonds have a demand feature (a put or tender option) whereby the bondholder may require the health care entity or its remarketing agent to repurchase the bonds, often on short notice. Demand obligations normally are classified as current liabilities, despite the fact that the bond's stated maturities cover many years. However, such obligations often are supported by a liquidity facility; such as a standby bond purchase agreement or letter of credit from a financial institution, that provides the health care entity with the ability to refinance, on a long-term basis, any obligation that may arise if tendered bonds cannot immediately be remarketed to another investor, as discussed in paragraph 7.37.

7.50 FASB ASC 470-10-55-8 states that debt agreements that allow a debt holder to redeem (or put) a debt instrument on demand (or within one year) should be classified as short-term liabilities despite the existence of a best-efforts remarketing agreement. Unless the issuer (health care entity) of the redeemable debt instrument has the ability and intent to refinance the debt on a long-term basis, as provided for in FASB ASC 470-10-45-14, the debt should be classified as a current liability.

7.51 FASB ASC 470-10-45-14 requires that the intent to refinance the short-term obligation on a long-term basis be supported by an ability to consummate the refinancing that is demonstrated in either of the following ways: (a) postbalance sheet date issuance of a long-term obligation or equity securities or (b) a financing agreement. If a financing agreement is used to justify noncurrent classification of the bonds, FASB ASC 470-10-45-14(b) requires that before the balance sheet is issued or available to be issued, the entity must have entered into a financing agreement that clearly permits the entity to refinance the short-term obligation on a long-term basis on terms that are readily determinable, and all three conditions in FASB ASC 470-10-45-14(b) must be met.

7.52 In summary, those three conditions are as follows:

- a. The agreement does not expire within one year from the date of the entity's balance sheet, and during that period, the agreement is not cancelable by the lender, except for violation of a provision with which compliance is objectively determinable or measurable. Further, any obligations incurred under the agreement are not callable during that period.
- b. No violation of any provision in the financing agreement exists at the balance sheet date, and no available information indicates that a violation has occurred thereafter, or if a violation has occurred thereafter, a waiver has been obtained.
- c. The lender is expected to be financially capable of honoring the agreement.

However, the conditions are very complex, and the preceding summary is not intended as a substitute for reading paragraphs 14–20 of FASB ASC 470-10-45.

7.53 If the liquidity facility, which is the financing agreement, contains a subjective acceleration clause, the liquidity facility does not meet the first condition in the previous paragraph because compliance with that clause is not objectively determinable or measurable. The health care entity is not deemed to have the ability and intent to finance on a long-term basis and, thus, cannot classify the debt as noncurrent, even if the repayment terms of the liquidity facility would otherwise support such classification. See paragraph 7.55 for the definition of a *subjective acceleration clause*. The probability of the subjective acceleration clause being exercised is irrelevant when attempting to demonstrate the ability to refinance a short-term obligation on a long-term basis. See related discussion in paragraph 7.56.

7.54 Rather than utilizing a liquidity facility issued by an external third party, some health care entities choose to utilize their own funds for satisfying puts or tenders. Health care entities that do so have no basis for excluding those put and tender obligations from current liabilities because no third party provides liquidity that would effectively allow the entity to refinance the debt on a long-term basis.

Classification of Debt With a Subjective Acceleration Clause

7.55 The FASB ASC glossary defines a *subjective acceleration clause* as "a provision in a debt agreement that states that the creditor may accelerate the scheduled maturities of the obligation under conditions that are not objectively determinable (for example, if the debtor fails to maintain satisfactory operations or if a material adverse change occurs)." For long-term obligations, the effect of a subjective acceleration clause on balance sheet classification is determined by FASB ASC 470-10-45-2. That paragraph states that in some situations, the circumstances (for example, recurring losses or liquidity problems) would indicate that long-term debt subject to a subjective acceleration clause should be classified as a current liability. Other situations would indicate only disclosure of the existence of such clauses. Neither reclassification nor disclosure would be required if the likelihood of the acceleration of the due date was remote, such as if the lender historically has not accelerated due dates of loans containing similar clauses and the financial condition of the borrower is strong and its prospects are bright.

7.56 In other words, a long-term obligation could continue to be classified as noncurrent, unless it was probable it would be called. For an obligation that by its terms is short term, FASB ASC 470-10-55-1 states that a higher standard is required for a financing agreement that permits an entity to refinance a short-term obligation on a long-term basis than is required for an existing long-term loan for which early repayment might be requested. As discussed in paragraph 7.53, if at financing agreement that permits an entity to refinance a short-term obligation on a long-term basis contains a subjective acceleration clause, its mere presence is enough to preclude long-term classification.

Classification of Long-Term Debt With a Covenant Violation

7.57 Violations of covenants could cause termination of the financing agreement or demand for immediate repayment. Thus, debt covenant violations can affect the balance sheet classification.

7.58 Paragraphs 11–12 of FASB ASC 470-10-45 discuss the classification of long-term obligations that are callable by the creditor because the debtor's violation of a provision of the debt agreement at the balance sheet date either makes the obligation callable or may become callable because the violation, if not cured within a specified grace period, will make the obligation callable. Those paragraphs require that such callable obligations be classified as current liabilities, unless either of the two conditions in FASB ASC 470-10-45-11 is met.

7.59 In summary, those two conditions are as follows:

- a. The creditor has waived or subsequently lost the right to demand repayment more than one year from the balance sheet date.
- b. The long-term obligation contains a grace period within which the debtor may cure the violation, and it is probable that the violation will be cured within that period.

However, the conditions are complex, and the preceding summary is not intended as a substitute for reading paragraphs 11–12 of FASB ASC 470-10-45.

7.60 If neither of those two conditions is met, the debt is classified as short term, regardless of the fact that the creditor has not demanded repayment, and no indication exists that the creditor intends to do so within the next year. Further, no distinction between significant and insignificant violations should be drawn. That is the right of the creditor, and if the violation is considered insignificant by the creditor, the debtor should be able to obtain a waiver.

7.61 Paragraphs 2–6 of FASB ASC 470-10-55 provide examples of classification of long-term debt when a debt covenant violation at the balance sheet date is waived by a lender for a period greater than one year, but the entity must meet the covenant on a quarterly or semiannual basis.

Subsequent Events

7.62 Events occurring subsequent to the balance sheet date but before the financial statements are issued or available to be issued may need to be reflected in the financial statements, either by changing the balance sheet classification of the debt or by disclosure. For example, bond restructuring transactions occurring after the balance sheet date may have an effect on the debtor's current or noncurrent balance sheet classifications as of that balance sheet date, and extinguishing or modifying the terms of a bond issue may require disclosure. Chapter 3, "Unique Financial Statement Considerations for Not-For-Profit Business-Oriented Health Care Entities," of this guide includes

additional information about subsequent events, including a discussion of whether a health care entity evaluates subsequent events through the issuance date of the financial statements or the date that the financial statements are available to be issued.

Assets Limited as to Use

7.63 Debt-financing instruments may require either cash or investments, or both, to be set aside in special accounts that can only be used for debt-related purposes, such as unexpended proceeds of debt issues and funds deposited with a trustee and limited to use in accordance with the requirements of a bond indenture or similar document (for example, sinking funds, debt reserve funds, or defeasance-related escrows). Such assets are usually reported in the balance sheet caption "Assets Limited as to Use." The portion of assets whose use is limited (that is, required for liquidation of current liabilities) is reported as current assets, with the remainder reported as noncurrent assets.

Statement of Operations

7.64 If the proceeds of tax-exempt borrowings are externally restricted to the acquisition of specified qualifying assets or to service the related debt, the amount of interest cost capitalized should be determined in accordance with paragraphs 10–12 of FASB ASC 835-20-30. Those considerations are discussed in chapter 6, "Property and Equipment and Other Assets," of this guide.

7.65 Pursuant to FASB ASC 470-50-40-2, gains or losses on the extinguishment of debt should be recognized currently in income of the period of extinguishment and identified as a separate item.

Disclosures

© Update 7-2 Accounting and Reporting: Recognition and Measurement of Financial Assets and Financial Liabilities

FASB ASU No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, was issued January 2016. The amendments are effective for public business entities for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is not permitted by public business entities; however, the ASU provides for early application of certain specified amendments as of the beginning of the fiscal year of adoption.

For all other entities including not-for-profit entities and employee benefit plans within the scope of Topics 960 through 965 on plan accounting, the amendments in this ASU are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted by entities other than public business entities as of the fiscal years beginning after December 15, 2017, and interim periods within those fiscal years.

The amendments in this ASU address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, the section that follows will be updated in a future edition.

Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU 2016-01, see appendix D, "Accounting for Financial Instruments," of this guide.

7.66 General disclosure requirements for debt, such as description of the debt, collateral, interest rate, covenants, and guarantees, are set forth in FASB ASC 470-10-50. If debt was considered to be extinguished by in-substance defeasance under the provisions of FASB Statement No. 76, *Extinguishment of Debt—an amendment of APB Opinion No. 26*, before the effective date of FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (that is, before December 31, 1996), FASB ASC 470-10-50-1 requires disclosure of the amount of the debt and a description of the transaction as long as the debt remains outstanding.

7.67 If short-term obligations are classified in the balance sheet as a long-term liability because the health care entity has the ability and intent to re-finance the debt on a long-term basis, as discussed in paragraph 7.51, those obligations need to be included in the disclosure of the combined aggregate amount of maturities and sinking fund requirements for all long-term borrowings that is required by FASB ASC 470-10-50-1. In those situations, the health care entity must ensure that disclosure is made of both the debt repayment schedule of the liquidity facility and the stated maturity of the bonds. This can be done by either (a) including one repayment schedule in the table and providing a narrative disclosure related to the other or (b) providing two tabular schedules (one for the liquidity facility payment schedule and the other based on the stated maturity of the bonds).

7.68 As discussed in paragraphs 7.06–.08, additional disclosures are required for entities defined as *public entities*. Generally, *public entities* are those that have debt or equity securities that trade in public markets. Because FASB ASC has multiple definitions for the term *public entity*, careful attention should be paid to such disclosure requirements to determine if their scope includes conduit bond obligors whose bonds trade in public markets.

7.69 Paragraphs 10–19 of FASB ASC 825-10-50 require that public business entities disclose the fair value of all financial instruments, whether recognized or not recognized in the statement of financial position, for which it is practicable to estimate that value; however, not-for-profit health care entities do not have to make those disclosures even if their bonds trade in public markets.

7.70 As discussed in paragraphs 7.09–.11, some health care entities may utilize a credit enhancement to make their bonds more attractive to investors or to allow them to access the market at more favorable rates. FASB ASC 820-10-35-18A states that an entity should not include the effect of an inseparable third-party credit enhancement in the fair value measurement of the liability. For the issuer (obligor), the unit of accounting for a liability measured or disclosed at fair value does not include the third-party credit enhancement. Thus, when disclosing the fair value of debt obligations that have a third-party credit enhancement that is inseparable from the liability, such as bond insurance, the fair value measurement should consider only the credit standing of the health care entity, rather than the credit standing of the guarantor. If fair value is

determined based on the prices at which the bonds are trading in markets, an adjustment needs to be made for the difference between the credit standing of the guarantor (on which the market trades are based) and the credit standing of the health care entity.

7.71 FASB ASC 855-10-55-2 cites the sale of a bond after the balance sheet date but before financial statements are issued or available to be issued as an example of an event that requires disclosure in the notes to the financial statements.

7.72 Other events occurring after the balance sheet date, such as failed auctions, potential or actual cancellation of a liquidity facility, defaults, or a mandatory tender of bonds may also need to be disclosed in the financial statements as subsequent events.

Obligated Group Reporting

7.73 Some debt agreements involving obligated groups require audited financial statements for the obligated group to use in the bond offering document and thereafter to be provided in the continuing disclosure documents, or both, on an annual, ongoing basis. Often, these special purpose financial statements will exclude, based on the contractual agreement, entities otherwise required to be consolidated in a health care entity's general-purpose financial statements. For special purpose financial statements prepared in accordance with the contractual basis of accounting, paragraph .20 of AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* (AICPA, *Professional Standards*), requires that the auditor's report on special purpose financial statements include an other-matter paragraph, under an appropriate heading, that restricts the use of the auditor's report solely to those within the entity and the parties to the contract or agreement.

7.74 Many obligated groups are required to annually submit audited financial statements to the Municipal Securities Rulemaking Board's (MSRB's) Electronic Municipal Market Access (EMMA) system, which is a system for disseminating the information to investors in municipal securities and other interested parties. See the appendix of this chapter for additional information. In practice, frequently the financial statements filed with EMMA are the entity's general-purpose financial statements accompanied by supplemental consolidating schedules that include obligated group members' financial information (in lieu of presenting standalone special purpose financial statements for the obligated group members). However, there are instances where standalone special purpose obligated group financial statements are issued. Because EMMA makes the financial statements and accompanying auditor's report broadly available, it is not advisable to submit standalone special purpose obligated group financial statements that are accompanied by an auditor's restricted-use report. However, standalone special purpose obligated group financial statements, accompanied by an auditor's restricted-use report, may be included with general-purpose external financial statements that are accompanied by an auditor's general-use report.⁶

⁶ See paragraph .A5 of AU-C section 905, *Alert That Restricts the Use of the Auditor's Written Communication* (AICPA, *Professional Standards*).

Interim Financial Reporting

7.75 Often, continuing disclosure agreements entered into by a health care entity in connection with municipal bond financings will require the entity to provide financial information to investors on both a quarterly and an annual basis. In such situations, the entity should consider the requirements of FASB ASC 270, *Interim Reporting*, which provides guidance on accounting and disclosure issues peculiar to interim reporting and sets forth minimum disclosure requirements for interim financial reports of publicly-traded companies. FASB ASC 270-10-50-3 states that it is presumed that users of summarized interim financial data will have read the latest published annual report, including the financial disclosures required by GAAP and management's commentary concerning the annual financial results, and that the summarized interim data will be viewed in that context.

7.76 FASB ASC 270-10-50-1 provides the minimum requirements for summarized financial information at interim dates, including reports on fourth quarters, presented by publicly-traded companies. In addition, FASB ASC 270-10-50-4 encourages publicly-traded companies to publish balance sheet and cash flow data at interim dates because this data often assists users of the interim financial information in their understanding and interpretation of the reported income data. If condensed interim balance sheet information or cash flow data is not presented at interim reporting dates, significant changes since the last reporting period with respect to liquid assets, net working capital, long-term liabilities, and stockholders' equity (net assets) should be disclosed.

Auditing

General

7.77 Auditing objectives and procedures for long-term debt issued by health care entities generally are similar to those of other entities. In obtaining sufficient appropriate audit evidence with respect to long-term debt, the auditor may consider the examples of specific audit objectives, specific control objectives, and substantive audit procedures that are presented in exhibit 7-1.

7.78 The amount, type, and classification of bonds in the financial statements is of interest to investors, bond rating agencies, and others who influence the supply of financial resources, such as financial guarantors. As discussed in the accounting sections of this chapter, many bond-related transactions and accounts involve special accounting measurement, presentation, and disclosure principles that require particular audit attention. The auditor should read financing instruments carefully to be sure that the financing is properly classified and described in the financial statements. Determining whether debt is considered long term or short term for accounting purposes has pervasive implications for financial reporting and compliance with debt covenants. Audit implications of certain other matters are highlighted subsequently, including compliance with debt covenants, credit-related triggers in debt agreements, and implications of transactions related to the issuance, remarketing, and refinancing of debt.

Covenants

7.79 The auditor should consider reviewing restrictive covenants of the various bond-related agreements to evaluate the health care entity's

compliance with covenants and the appropriateness of the presentation and disclosure of covenants in the financial statements. A borrower's failure to comply with financial covenants may be a signal that the borrower is facing financial troubles and that the debt may become callable, changing the historical classification and disclosure requirements associated with its debt. If a default on a bond covenant has occurred, the auditor should evaluate the appropriateness of classification of debt as long term. If several types of financing are outstanding, the auditor should compare transactions in each type with the restrictions and provisions of the others. For example, some debt obligations contain a cross-default provision, which could result in acceleration of the lender's right of repayment because of default under, or violation of, other agreements. The existence of certain types of covenants can have implications for classification of the bonds, even in the absence of a covenant violation.

7.80 The auditor should obtain written waivers of conditions of noncompliance of debt covenants directly from the responsible lending officers or trustees. It is not appropriate for the auditor to rely solely on management's written or oral representations or representations from the client's legal counsel that lenders or trustees have waived the violations. In reviewing a waiver of debt covenant violations to determine whether the liability should be classified as current or long term, the auditor should obtain assurance that the waiver is unconditional for a period greater than one year from the balance sheet date and that it specifically and appropriately addresses each event of noncompliance.

7.81 Some covenants take the form of a subjective acceleration clause in which the creditor may accelerate the scheduled maturities of the obligation under conditions that are not objectively determinable (for example, if the debtor fails to maintain satisfactory operations or a material adverse change occurs). The mere presence of a subjective acceleration clause in a lending document has implications for balance sheet classification, even if it is not in danger of being triggered. In evaluating those implications, the auditor will need to carefully consider whether the underlying debt is considered long term or short term (see paragraphs 7.53 and 7.55–.56).

Credit Ratings

7.82 Credit rating downgrades of material counterparties to debt-related transactions of the health care entity can have implications for the entity's own credit standing. For example, if bonds are credit enhanced, the credit rating on the health care entity's bonds is based on the credit rating of the guarantor or letter of credit provider, rather than the financial stability of the health care entity itself. A downgrade in the credit rating of the credit enhancer will automatically trigger a downgrade of the rating on the health care entity's bonds, even if the health care entity's financial health has not deteriorated. Credit rating downgrades of others may trigger clauses in derivative agreements that result in the automatic termination of a swap, a demand presented to a health care entity for immediate payment of a swap liability, or a requirement for a health care entity to post collateral based on the downgrade of either the derivative counterparty (or its guarantor) or the health care entity.

Debt Restructuring

7.83 Changes in market conditions may cause health care entities to restructure their bonds in various ways. Some may seek to issue new bonds, to change the interest mode on existing bonds, or buy back their own bonds. In

such situations, the auditor may be required to evaluate management's analysis of whether the transaction represented a modification of debt or an extinguishment. In addition, such actions may affect the balance sheet classification of the liabilities. A refinancing from long-term debt to short-term debt (for example, from fixed-rate or auction-rate bonds to variable-rate demand obligations) can potentially cause changes in the balance sheet classification and potentially trigger liquidity covenants. Debt restructuring may result in the discontinuation of hedge accounting for related interest rate swaps, which can also have bond covenant compliance implications.

7.84 An advance refunding transaction that results in defeasance may trigger the need for audit evidence supporting assertions of legal release from liabilities or legal isolation of escrowed assets. Although no direct auditing guidance regarding the form and content of a typical legal letter governing a legal defeasance exists, the principles outlined in Interpretation No. 1, "The Use of Legal Interpretations as Audit Evidence to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraphs 7–14 of Financial Accounting Standards Board *Accounting Standards Codification* 860-10-40" (AICPA, *Professional Standards*, AU-C sec. 9620 par. .01–.21), of AU-C section 620, *Using the Work of an Auditor's Specialist*, may be helpful in determining whether documentation obtained by the health care entity is adequate audit evidence that the debtor has been legally released as the primary obligor of the bonds. Based on the facts and circumstances of a particular defeasance transaction, in the auditor's judgment, a legal opinion obtained by the health care entity may be needed as audit evidence to support the assertion that the assets transferred to the defeasance escrow trust have met the isolation criterion discussed in paragraph 7.26.

7.85 Some bonds (for example, variable-rate demand obligations) may involve the use of remarketing agreements and backup liquidity facilities. Failed remarketings and resulting draws upon liquidity facilities may create or exacerbate liquidity problems for a health care entity. As discussed in paragraph 7.37, if a significant amount of bonds are tendered and ultimately become bank bonds, the health care entity must repay those obligations based on the much shorter debt repayment schedule of the liquidity facility, rather than the expected maturity of the bonds. In some cases, the financial viability of the liquidity provider may be in question. The implications of such matters should be considered when assessing debt covenant compliance, liquidity, and going concern.

Auditor Involvement With Municipal Securities Filings

AU-C section 945, *Auditor Involvement With Exempt Offering Documents* (AICPA, *Professional Standards*), provides guidance about when an auditor is considered involved with an exempt offering document and, when involved, the auditor's responsibilities with regard to the offering. Municipal securities are exempt from the registration requirements of Section 5 of the Securities Act of 1933, thus are within the scope of AU-C section 945. As discussed in paragraph 7.13, the exempt offering document related to a municipal security offering is an official statement.⁷

⁷ AU-C section 945, *Auditor Involvement With Exempt Offering Documents* (AICPA, *Professional Standards*), is effective for municipal securities offering documents with which the auditor is involved that are initially distributed on or after June 15, 2018.

Conditions Establishing Auditor Involvement

7.86 Because there is no SEC requirement for auditor involvement with official statements, an auditor generally is not required to participate in, or undertake any procedures with respect to, a health care entity's official statement.⁸ The auditor may become involved in the following activities with respect to the official statement:

- Assisting in preparing the financial information⁹ included in the official statement
- Reviewing a draft of the official statement at the health care entity's request
- Signing (either manually or electronically) the independent auditor's report for inclusion in a specific official statement¹⁰
- Providing written agreement (for example, through a consent letter or signed authorization form) for the use of the independent auditor's report in a specific official statement (see paragraphs 7.90–.94)
- Providing a revised independent auditor's report¹¹ for inclusion in a specific official statement
- Issuing a comfort letter, the letter described in paragraph .12 of AU-C section 920, *Letters for Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*), or an attestation engagement report in lieu of a comfort or similar letter on information included in the official statement (see paragraphs 7.97–.100)
- Issuing a practitioner's report on an attestation engagement relating to the debt offering (see paragraph 7.104)

Paragraph .08 of AU-C section 945 provides two conditions that both have to exist to establish involvement with an offering:

- a. The auditor's report is included or incorporated by reference in the official statement.
- b. The auditor performs one or more of the following activities with respect to the official statement:
 - i. Assisting the entity in preparing information included in the official statement

⁸ Some auditors require that they become involved with a governmental health care entity's official statements, even though the conditions described in this paragraph establishing involvement would not otherwise exist. See the discussion in paragraph 7.89.

⁹ For the purpose of this requirement, *financial information* does not include the financial statements covered by the auditor's opinion or, for governmental health care entities, the required supplementary information (RSI) or supplementary information other than RSI accompanying those financial statements that the auditor already considered during the audit of the financial statements.

¹⁰ This situation involves an original manual or electronic signature on the auditor's report, not a reproduction of an auditor's report that was manually or electronically signed. For example, the underwriter or bond counsel may require a copy of the auditor's report with an original manual or electronic signature to file with the official closing documents for the offering.

¹¹ A revised report would, for example, eliminate the references made by the auditor in the original report to (a) supplementary information that the auditor reported on in relation to the basic financial statements or (b) the audit and reports required by *Government Auditing Standards* (also referred to as the Yellow Book), issued by the Comptroller General of the United States.

- ii. Reading a draft of the official statement at the entity's request
- iii. Issuing a comfort or similar letter in accordance with AU-C section 920 or an agreed-upon procedures report in accordance with AT-C section 215, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*), in lieu of a comfort or similar letter on information included in the official statement
- iv. Participating in due diligence discussions with underwriters, placement agents, broker-dealers, or other financial intermediaries in connection with the exempt offering
- v. Issuing a practitioner's attestation report on information relating to the exempt offering
- vi. Providing written agreement for the use of the auditor's report in the official statement
- vii. Updating an auditor's report for inclusion in the official statement

Each of the triggering activities is discussed in more depth in this section.

Auditors may become aware of an offering through a communication from an entity or through the receipt of a draft official statement from an underwriter, placement agent, broker-dealer, or the entity. Awareness of an exempt offering by the auditor does not, by itself, constitute involvement. Conversely, there is nothing that precludes the auditor from following the procedures in AU-C section 945 if the conditions are not met. See related discussion in paragraph 7.88.

Assisting in Preparing Information

Assistance in preparing information as described in paragraph 7.86 is predicated upon the auditor being reasonably aware that the information will be included in a specific official statement. For example, an auditor assisting the entity with the preparation of a schedule for the entity's internal purposes that the entity later includes in its official statement would not be considered assisting the entity in preparing information as described in paragraph 7.86.

Information does not include the audited financial statements or interim financial information covered by the auditor's report. Further, information does not include required supplementary information, or other information that accompanied those financial statements that the auditor already considered during the audit of the financial statements or review of interim financial information.

AU-C section 945 highlights that self-review, management participation, and advocacy threats to a covered member's compliance with the AICPA Code of Professional Conduct may exist when a member provides corporate finance consulting services to an entity.¹² A member may assist the entity in drafting its official statement or memorandum without impairing

¹² The "Independence Rule" (AICPA, *Professional Standards*, ET sec. 1.200.001) of the AICPA Code of Professional Conduct.

independence¹³ if the member complies with the AICPA Code of Professional Conduct.^{14,15}

It is important to note that providing written or oral comments to the entity on the official statement is considered assisting the entity in preparing information included in the official statement, regardless of whether the entity requested the auditor to read the document or the auditor did so voluntarily.

Reading a Draft of the Official Statement

Reading a draft of the official statement encompasses situations in which the auditor reads the official statement at the request of the entity even if the auditor does not ultimately provide written or oral comments.

Issuing a Comfort or Similar Letter or an Agreed-Upon Procedures Report in Accordance With AT-C Section 215

Underwriting agreements between an entity and its underwriters may include a request for the entity's auditor to prepare and issue a comfort letter that will assist the underwriters with their due diligence in connection with the exempt offering. Comfort letters may also be requested by parties other than the underwriters. AU-C section 920 addresses the auditor's responsibilities related to the issuance of comfort letters and is further discussed in paragraphs 7.97–103.

Participating in Due Diligence Discussions

As part of their due diligence process, underwriters and their counsel may ask to meet with the entity's auditors and discuss the specific official statement, either formally or informally.¹⁶ Such meetings are often referred to as oral due diligence meetings; however, other communication methods may be used. The discussion typically focuses on the audit engagement, the entity's financial statements, and the entity's system of internal control over financial reporting. Auditors use professional judgment in determining whether to participate in due diligence discussions if the underwriter has not provided the written opinion from external legal counsel or representation letter as described in AU-C section 920.¹⁷ If the auditor agrees to participate, auditors use professional judgment in determining which questions in an oral due diligence meeting can be addressed.

Issuing a Practitioner's Attestation Report on Information Relating to the Official Statement

¹³ Paragraph .02f of the "Corporate Finance Consulting" interpretation (AICPA, *Professional Standards*, ET sec. 1.295.130) of the "Nonattest Services" subtopic under the "Independence Rule" of the AICPA Code of Professional Conduct.

¹⁴ The "General Requirements for Performing Nonattest Services" interpretation (AICPA, *Professional Standards*, ET sec. 1.295.040) of the "Nonattest Services" subtopic under the "Independence Rule."

¹⁵ Paragraph .03 of the "Corporate Finance Consulting" interpretation (AICPA, *Professional Standards*, ET sec. 1.295.130) of the "Nonattest Services" subtopic under the "Independence Rule" also lists examples of types of corporate finance consulting services that would impair a member's independence in connection with an offering.

¹⁶ The "Confidential Client Information Rule" (ET sec 1.700.001) of the AICPA Code of Professional Conduct states that the auditor should not disclose any confidential client information without the specific consent of the client.

¹⁷ Paragraphs .07, .11, and .A92 of AU-C section 920, *Letters for Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*).

During the offering process, management or other parties to the offering may engage a practitioner to perform an attestation engagement on information related to the offering. For example, management or its legal advisers may engage a practitioner to perform agreed-upon procedures on the entity's compliance with the revenue coverage requirements on outstanding debt securities or to recompute the calculation of escrow account requirements for an advance refunding of debt securities. If the practitioner engaged to perform the attestation engagement is the auditor whose report accompanies the financial statements included in the exempt offering document, the auditor is deemed to be involved with the official statement. A practitioner's attestation report relating to an exempt offering need not be referred to or included in the exempt offering document to involve the auditor of the financial statements with the offering.

If the practitioner engaged to perform the attestation engagement is not the financial statement auditor, the practitioner engaged to perform the attestation engagement is not deemed to be involved with the official statement in the manner described in AU-C section 945.

Providing Written Agreement for the Use of the Auditor's Report in the Official Statement

For municipal securities offerings, there is no regulatory requirement for the auditor to provide any type of written agreement to use the auditor's report in the offering. If the auditor is asked to provide written agreement, the auditor may provide an inclusion letter indicating that the auditor agrees to the inclusion of the auditor's report in the official statement. An inclusion letter is a letter requested by and addressed to the entity that is signed and dated by the auditor indicating that the auditor agrees to the inclusion or incorporation by reference of the auditor's report in the official statement. The following example language may be used to indicate that the auditor agrees to inclusion of the auditor's report on financial statements in an official statement:

Independent Auditor's Inclusion Letter

We agree to the inclusion [or incorporation by reference] in the [name of offering document] dated [insert issuance date of offering document] of our report, dated [insert date of auditor's report on the financial statements], on our audit of the financial statements of [name of entity] as of December 31, 20X2 [and 20X1], and for the year[s] then ended.

When the auditor is asked to issue a letter agreeing to the inclusion of the auditor's report in the offering document, the effective date of the letter can be the preliminary official statement date or the official statement date.

Updating an Auditor's Report for Inclusion in the Exempt Offering Document

Updating an auditor's report involves, for example, signing an updated auditor's report when the previously issued financial statements are corrected for an accounting error or reflect a retrospective application of a change in accounting principle.

The following examples would not constitute updating an auditor's report for purposes of paragraph 7.86:

- Providing a copy of or re-signing a previously issued auditor's report

- Revising an originally issued auditor's report to eliminate references made by the auditor in the original report required by *Government Auditing Standards*
- Revising an originally issued report to eliminate references made by the auditor in the original report to supplementary information that the auditor reported on in relation to the basic financial statements

Auditor Responsibilities When Involved in an Offering Document

The objectives of the auditor when involved with an official statement are to perform procedures specified in AU-C section 945 and respond appropriately as follows:

- a. When the auditor determines that information included or incorporated by reference in the official statement could undermine the credibility of the financial statements and the auditor's report thereon
- b. To facts that become known to the auditor after the date of the auditor's report that, had they been known to the auditor at that date, may have caused the auditor to revise the auditor's report.

As discussed in paragraph 7.13, municipal securities offerings have multiple stages. Thus, a single offering could involve multiple applications of the required procedures. Requesting management to keep the auditor advised of the progress of the preparation of the offering document proceedings through the final distribution, circulation, or submission of the final offering statement is important so that the auditor's consideration of events occurring after the date of the auditor's report up to the distribution, circulation, or submission of the final offering statement can be completed.

7.87 Although AU-C section 720, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*), addresses auditor responsibilities with respect to other information contained in documents, such as annual reports, paragraph .02 of AU-C section 720 states that it may be applied, adapted as necessary in the circumstances, to other documents to which the auditor devotes attention. Therefore, if the auditor is involved with an official statement, the guidance in AU-C section 720 may be applied. If the guidance in AU-C section 720 is applied, the auditor should communicate the auditor's responsibility for other information in a document containing audited financial statements, any procedures performed, and the results.

In accordance with paragraph .09 of AU-C section 945, the auditor should perform the procedures described in paragraphs .06–.18 of AU-C section 720 on the official statement. When revision of the other information in the official statement is necessary due to a material inconsistency or a material misstatement of fact that management refuses to correct, AU-C section 720 requires the auditor to notify those charged with governance of the auditor's concerns regarding the other information and take any further appropriate action. With regard to exempt offerings, actions may also include determining whether to withhold the auditor's agreement to include the auditor's report. In such cases, the auditor may consider it appropriate to obtain legal advice.

In addition to the procedures related to other information, paragraph .10 of AU-C section 945 requires the following when the auditor is involved with an official statement of a municipal security offering:

- a. Perform procedures designed to identify events occurring between the date of the auditor's report and the date of the distribution, circulation, or submission of the official statement that, had they been known to the auditor as of the date of the auditor's report, may have caused the auditor to revise the auditor's report (hereafter referred to as "subsequent events" for purposes of this section). Such procedures should include the following:
 - i. Obtaining an understanding of any procedures that management may have performed to identify such events
 - ii. Inquiring of management and, when appropriate, those charged with governance about whether any such events have occurred that might affect the financial statements
 - iii. Reading minutes, if any, of the meetings of the entity's management and those charged with governance that have been held since the date of the auditor's report and inquiring about matters discussed at any such meetings for which minutes are not yet available
 - iv. Reading the entity's most recent subsequent interim financial statements, if any
- b. Obtain updated written representations from management about the following:
 - i. Whether any information has come to management's attention that would cause management to believe that any of the previous representations should be modified
 - ii. Whether any events have occurred subsequent to the date of the auditor's report that would require adjustment to, or disclosure in, the financial statements
 - iii. That management provided complete minutes of the meetings of the entity's management and those charged with governance, or summaries of actions of recent meetings for which minutes have not yet been prepared since previous representations were provided
 - iv. That management provided communications received from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices since previous representations were provided.

Paragraphs .11–.12 of AU-C section 945 provide requirements and guidance when a predecessor auditor's report on a prior period is included in the official statement and when a predecessor auditor of an acquired entity is involved with an official statement.

Paragraph .13 of AU-C section 945 states that if the auditor identifies subsequent events that may require adjustment of, or disclosure in, the audited financial statements or reviewed interim financial information, the auditor should not agree to the inclusion of the auditor's report in the official statement until the auditor's consideration of the subsequent events, including the

effect on the auditor's report, has been satisfactorily evaluated in accordance with AU-C section 560, *Subsequent Events and Subsequently Discovered Facts* (AICPA, *Professional Standards*).¹⁸

As noted in paragraph .14 of AU-C section 945, if the auditor becomes aware of subsequently discovered facts, the auditor should not agree to the inclusion of the auditor's report in the official statement until the auditor's consideration of the subsequently discovered facts, including the effect on the auditor's report, has been satisfactorily evaluated in accordance with AU-C section 560.¹⁹

If management does not revise the financial statements in circumstances in which the auditor believes they need to be revised, in addition to following the requirements in AU-C section 560, paragraph .15 of AU-C section 945 states the auditor should not agree to the inclusion of the auditor's report in the official statement.²⁰

Auditor-Established Involvement

7.88 Although an auditor is not required to become involved with a client's official statements, some auditors include a provision in the terms of the engagement requiring the client to obtain permission from the auditor before using the independent auditor's report in the official statement. Such a provision may be used by the auditor to establish a requirement that the auditor become involved with the client's official statements when the client requests the required permission from the auditor.

The auditor may consider including in the terms of the engagement a provision that any official statements issued by the entity with which the auditor is not involved will clearly indicate the auditor is not involved with the contents of such offering document. An example disclosure related to an official statement may read as follows:

[*Name of firm*], our independent auditor, has not been engaged to perform and has not performed, since the date of its report included herein, any procedures on the financial statements addressed in that report. [*Name of firm*] also has not performed any procedures relating to this official statement.

The Entity may wish to include our report on these financial statements in an official statement. The Entity agrees that the aforementioned auditor's report, or reference to our Firm, will not be included in any such offering document without our prior permission or consent. Any agreement to perform work in connection with an official statement, including an agreement to provide permission or consent, will be a separate engagement.

Clarification in the Official Statement When There Is No Auditor Involvement

7.89 When the auditor and client agree not to include a provision in the terms of the engagement that would require auditor involvement, as discussed

¹⁸ Paragraph .11 of AU-C section 560, *Subsequent Events and Subsequently Discovered Facts* (AICPA, *Professional Standards*).

¹⁹ Paragraphs .15–.18 of AU-C section 560.

²⁰ Paragraphs .17–.18 of AU-C section 560.

in paragraph 7.86, the auditor may include in the terms of the engagement a requirement that any official statements issued by the client with which the auditor is not involved clearly indicate that the auditor is not involved with the contents of such official statements. Such a disclosure could read as follows: "[Name of firm], our independent auditor, has not been engaged to perform and has not performed, since the date of its report included herein, any procedures on the financial statements addressed in that report. [Name of firm] also has not performed any procedures relating to this official statement."

The auditor may consider including in the terms of the engagement a provision that any official statements issued by the entity with which the auditor is not involved will clearly indicate the auditor is not involved with the contents of such offering document. An example disclosure related to an official statement may read as follows:

[Name of firm], our independent auditor, has not been engaged to perform and has not performed, since the date of its report included herein, any procedures on the financial statements addressed in that report. [Name of firm] also has not performed any procedures relating to this official statement.

Auditing Interpretations Regarding Official Statements

7.90 Exhibit A, "Background," of AU-C section 925, *Filings With the U.S. Securities and Exchange Commission Under the Securities Act of 1933 (AICPA, Professional Standards)*, addresses the auditor's agreement²¹ to (a) being named in and (b) the use of an auditor's report in an offering document other than one registered under the of 1933 Act.²²

The preceding paragraph and the heading that precedes it will be deleted upon the effective date of AU-C section 945, which is effective for municipal securities offering documents with which the auditor is involved that are initially distributed on or after June 15, 2018.

7.91 Paragraph 16 of exhibit A in AU-C section 925 states that when a client wishes to make reference to the auditor's role in an offering document in connection with a securities offering that is not registered under the Securities Act of 1933 (such as a municipal securities offering), the caption "Independent Auditors" (or something similar) would generally be used to title that section of the document rather than "Experts" with no reference to the auditor as an "expert" anywhere in the document. Exhibit B, "Illustrative Disclosures and Reports," of AU-C section 925 provides the following example of a typical description of the auditor's role.²³

²¹ The term *consent* is an SEC term that relates to registered securities, and municipal securities are not registered securities. Therefore, this guide uses the term *agreement*, even though the AICPA interpretations discussed refer to consent.

²² Governments generally refer to the offering document or offering circular for municipal securities as an official statement.

²³ As discussed in paragraph 7.90, if the auditor is not involved with the offering document, and the terms of the engagement require disclosure of this fact, additional disclosure similar to that illustrated in paragraph 7.90 should be included here.

Independent Auditors

The financial statements of *[name of entity]* as of December 31, 20XX and for the year then ended, included in this offering circular, have been audited by ABC & Co., independent auditors, as stated in their report(s) appearing herein.

If the client refuses to delete from the offering document the reference to the auditor as an "expert," the auditor should not permit inclusion of the auditor's report in the offering document.

When performing procedures in accordance with AU-C section 945, the auditor should determine that the auditor's role is not described in the official statement in a way that indicates that the auditor's responsibility is greater than the auditor intends. The term *expert* has a specific statutory meaning under the Securities Act of 1933. Outside the Securities Act of 1933 context, the term expert is typically undefined. Accordingly, when an entity wishes to make reference to the auditor's role in connection with an exempt offering, the caption to that section of the document would generally be titled "Independent Auditors" (or something similar) rather than "Experts," with no reference to the auditor as an expert anywhere in the official statement. The following is an example of a typical description of the auditor's role when an entity wishes to make reference to the auditor in an official statement:

Independent Auditors

The financial statements of *[name of entity]* as of December 31, 20X2 [and 20X1], and for the year[s] then ended, included in this official statement, have been audited by *[name of firm]*, independent auditors, as stated in their report appearing herein.

If the entity refuses to delete references to the auditor as an "expert," the auditor may consider whether to withhold permission to include the auditor's report in the official statement, based on the auditor's professional judgment. In such circumstances, the auditor may consider it appropriate to obtain legal advice.

7.92 Paragraphs 19–20 of exhibit A in AU-C section 925 state that when an auditor's report is used in connection with an offering transaction that is not registered under the Securities Act of 1933, it is usually not necessary for the auditor to provide any type of written consent. If the auditor is asked to provide a written consent for use in connection with a document other than a 1933 Act registration statement, then the auditor may provide a letter indicating that the auditor agrees to the inclusion of the auditor's report on the audited financial statements in the offering materials. This letter would not typically be included in the offering materials. The following example language may be used:

We agree to the inclusion in the offering circular of our report, dated February 5, 20XX, on our audit of the financial statements of *[name of entity]*.

As stated in paragraph .08 of AU-C section 925, the auditor should determine that the auditor's name is not being used in a way that indicates that the auditor's responsibility is greater than the auditor intends. Therefore if the client refuses to delete from the offering document the reference to the auditor as an expert, then the auditor should not permit inclusion of the auditor's report in the offering document.

The preceding paragraph will be deleted upon the effective date of AU-C section 945, which is effective for municipal securities offering documents with which the auditor is involved that are initially distributed on or after June 15, 2018. Providing written agreement for the use of the auditor's report in the official statement is a triggering activity for auditor involvement, as discussed in paragraph 7.86.

7.93 When the auditor is asked to issue a letter agreeing to the inclusion of the auditor's report in the offering document, the effective date of the letter can be the preliminary official statement date or the official statement date, as defined in paragraph 7.13.

The preceding paragraph will be deleted upon the effective date of AU-C section 945, which is effective for municipal securities offering documents with which the auditor is involved that are initially distributed on or after June 15, 2018. This content will instead appear under the heading "Providing Written Agreement for the Use of the Auditor's Report in the Official Statement (paragraph 7.86).

Using Government Auditing Standards Reports and References in an Official Statement

7.94 An auditor may be engaged to audit the financial statements of a health care entity that expends federal awards and therefore is subject to an audit in accordance with the Single Audit Act Amendments of 1996 and Office of Management and Budget Title 2 U.S. Code of Federal Regulations (CFR) Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). The Uniform Guidance requires the financial statement audit to be performed in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, which results in the auditor reporting on the entity's financial statements and issuing a report on compliance and internal control over financial reporting. If the auditor is involved with the client's official statement and the audit is performed in accordance with generally accepted auditing standards (GAAS) and *Government Auditing Standards*, it is generally advisable for the official statements to use an auditor's report on the financial statements that does not refer to the *Government Auditing Standards* audit or to those separate reports because those references, without the presentation of the reports in the official statements, could confuse the users of the official statement.

An auditor may be engaged to audit the financial statements of a health care entity that expends federal awards and therefore is subject to an audit in accordance with the Single Audit Act Amendments of 1996 and Office of Management and Budget Title 2 U.S. CFR Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). The Uniform Guidance requires the financial statement audit to be performed in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, which results in the auditor reporting on the entity's financial statements and issuing a report on compliance and internal

control over financial reporting. If the auditor is involved with the client's official statement and the audit is performed in accordance with GAAS and *Government Auditing Standards*, it is generally advisable for the official statements to use an auditor's report on the financial statements that does not refer to the *Government Auditing Standards* audit or to those separate reports because those references, without the presentation of the reports in the official statements, could confuse the users of the official statement. Note that as discussed in paragraph 7.86, revising an originally issued report to eliminate references made by the auditor in the original report to supplementary information that the auditor reported on in relation to the basic financial statements is not considered a triggering activity to establish involvement.

Continuing Disclosure Documents

7.95 The auditor is not required to participate in, or undertake any procedures with respect to, a client's continuing disclosure documents, even though they may include audited financial statements because a client's continuing disclosures are not required to be submitted to or disseminated from the distributing organizations as a single document. Any attention the auditor devotes to other information included with audited financial statements in continuing disclosure documents at the client's request may be considered, as appropriate, a consulting engagement under the provisions of CS section 100, *Consulting Services: Definitions and Standards* (AICPA, *Professional Standards*), or an attestation engagement under the provisions of AT-C section 210, *Review Engagements* (AICPA, *Professional Standards*), or AT-C section 215.

7.96 Many obligated groups are required to annually submit audited financial statements to the MSRB's EMMA system. When obligated group financial statements exclude entities that are required under GAAP to be consolidated, the auditor's reports should restrict the use of the financial statements to specified parties. Because inclusion in the EMMA system of financial statements for such an obligated group would make those financial statements broadly available, it is not advisable to submit standalone special-purpose financial statements accompanied by a restricted-use report (see paragraph 7.74). Instead, consolidating schedules presenting the obligated group as supplemental information to the consolidated financial statements may meet the requirements within the bond contract.

Letters for Underwriters

7.97 Underwriting agreements between a health care entity and its underwriters may require the auditor to prepare a comfort letter addressed to the underwriters. AU-C section 920 defines the term *underwriters* and gives guidance to auditors²⁴ when engaged to issue letters to underwriters and certain other requesting parties in connection with a nonissuer entity's financial statements included in registration statements filed with the SEC under the 1933 Act. An auditor may provide a comfort letter to a broker-dealer or other financial intermediary acting as principal or agent in offerings of securities that are exempt from registration under the 1933 Act only if the broker-dealer or other financial intermediary provides the required representation letter described in

²⁴ Because of its use in SEC literature, certain auditing literature uses the term *accountant* to refer to the auditor; however, this chapter replaces the term *accountant* with the term *auditor*.

paragraph .11 of AU-C section 920. The required elements of the representation letter from the broker-dealer or other financial intermediary are as follows:

- The letter should be addressed to the auditor.
- The letter should contain the following:

The review process applied to the information relating to the issuer is, or will be, substantially consistent with the due diligence process that we would perform if this securities offering were being registered pursuant to the Securities Act of 1933. We are knowledgeable with respect to that due diligence process.

- The letter should be signed by the requesting broker-dealer or other financial intermediary.

7.98 When a party requesting a comfort letter has provided the auditor with the required representation letter, the auditor should refer to the requesting party's representations in the comfort letter. See example A-2 in paragraph .A93 of AU-C section 920, which is a typical comfort letter in a non-1933 Act offering, including the required underwriter representations. If the required representation letter is not provided by the broker-dealer or other financial intermediary, paragraph .12 of AU-C section 920 provides requirements and guidance for auditors. See example Q, "Letter to a Requesting Party That Has Not Provided the Legal Opinion or the Representation Letter Required by Paragraph .11," of exhibit B, "Examples of Comfort Letters," in paragraph .A93-20 of AU-C section 920 for the relevant illustration.

7.99 As discussed in paragraph .13 of AU-C section 920, when a comfort letter is requested by a party other than the underwriter, broker-dealer, or other financial intermediary, the auditor should not provide that party with a comfort letter or the letter described in paragraph .12 of AU-C section 920. Instead, the auditor may provide the party with a practitioner's report on agreed-upon procedures and should refer to AT-C section 215 for additional specific guidance. (See paragraph .A7 of AU-C section 920).

7.100 Auditors may be asked to comment upon information other than audited financial statements. Guidance for the procedures to be performed and the form of the comments is provided by the following paragraphs of AU-C section 920:

- a. Unaudited condensed interim financial information (paragraphs .45–.48)
- b. Capsule financial information (paragraphs .50–.51)
- c. Pro forma financial information (paragraphs .52–.53)
- d. Financial forecasts (paragraphs .54–.57)
- e. Subsequent changes (paragraphs .58–.64)
- f. Tables, statistics, and other financial information (paragraphs .65–.71)

7.101 If the auditor is engaged to provide negative assurance in a comfort letter on interim financial information, paragraph .45 of AU-C section 920 requires the auditor to perform a review, as discussed in AU-C section 930, *Interim Financial Information* (AICPA, *Professional Standards*). A review of interim financial information may be conducted under AU-C section 930 if

- the entity's latest annual financial statements have been audited by the auditor or a predecessor auditor;
- the auditor has been engaged to audit the entity's current year financial statements, or the auditor audited the entity's latest annual financial statements and in situations in which the engagement of another auditor to audit the current year financial statements is not effective prior to the beginning of the period covered by the review;
- the interim information is prepared in accordance with the same financial reporting framework as that used to prepare the annual financial statements; and
- any condensed financial statement
 - purports to be prepared in accordance with an appropriate financial reporting framework which includes appropriate form and content of the interim financial statements;
 - includes a note that the financial information does not represent complete financial statements and is to be read in conjunction with the latest annual audited financial statements; and
 - the condensed interim financial information accompanies the entity's latest audited annual financial statements or such audited annual statements are made readily available by the entity.

If AU-C section 930 is not applicable (for example, the condensed financial statement is presented on a budgetary basis of accounting), the review engagement may be performed under Statements on Standards for Attestation Engagements or Statements on Standards for Accounting and Review Services.

7.102 If the auditor has not performed such a review, paragraphs .45 and .60 of AU-C section 920 prohibit the auditor from giving negative assurance with respect to whether any material modifications should be made to the interim financial information for it to be in accordance with generally accepted accounting principles and from providing negative assurance about subsequent changes in financial statements items from the date of the interim financial information. Instead, the auditor is limited to reporting procedures performed and findings obtained. The letter should specifically state that the auditor has not audited the interim financial information in accordance with GAAS and does not express an opinion concerning such information. An example of that language is in the third statement of example A-1, "Typical Comfort Letter for a 1933 Act Offering," in paragraph .A93-3 of AU-C section 920.

7.103 When the auditor is asked to prepare a letter for the underwriter, the letter can be as of the preliminary official statement date or the official statement date, as defined in paragraph 7.13, with updating letters issued as of the official statement date, if applicable, and the closing date. Paragraphs .A24–.A25 of AU-C section 920 state that the letter ordinarily is dated on, or shortly after, the underwriting agreement is signed, and the underwriting agreement ordinarily specifies the date, often referred to as the cutoff date, to which certain procedures described in the letter are to relate (for example, a date five days before the date of the letter). A factor in considering whether to accept the engagement is whether the period between the cut-off date and the date

of the letter provides sufficient time to allow the auditor to perform the procedures and prepare the letter. The five-day cut-off period in AU-C section 920 is illustrative only and does not set a requirement, but practice generally does not exceed a five-day cut-off period.

Attestation Engagements Related to Securities Issuance

7.104 During the process of issuing municipal securities, health care entities or other involved parties often engage practitioners to provide certain needed information. For example, a health care entity or its bond counsel may engage an auditor to review the health care entity's compliance with the revenue coverage requirements on outstanding bonds or to verify the calculation of escrow account requirements for an advance refunding of bonds. These engagements should be conducted with the appropriate professional attestation standards as agreed to by the engaging government and the practitioner.²⁵ If the auditor of the financial statements included in the official statement also provides a practitioner's report on an attestation engagement relating to a debt offering, that establishes an involvement with the official statement, as indicated in paragraph 7.86. A practitioner's report on an attestation engagement relating to a debt offering need not be referred to or included in the official statement to associate the auditor of the financial statements with the official statement. Sometimes, the practitioner's report on the attestation engagement may only be included in the official closing documents for the offering. Also, if the practitioner providing the report on the attestation engagement is not the auditor of the financial statements included in the official statements, the issuance of the practitioner's report does not, by itself, involve either the auditor of the financial statements or the practitioner who issued the report on the attestation engagement with the official statement.

7.105 A practitioner should not provide any form of assurance, through an examination, review, or agreed-upon procedures engagement, that an entity (a) is not insolvent at the time the debt is incurred or would not be rendered insolvent thereby, (b) does not have unreasonably small capital, or (c) has the ability to pay its debts as they mature, as discussed in Interpretation No. 1, "Responding to Requests for Reports on Matters Relating to Solvency" (AICPA, *Professional Standards*, AT-C sec. 9105 par. .01–.11), of AT-C section 105, *Concepts Common to All Attestation Engagements*.

7.106 SEC Final Rule Release No. 34-70462, *Registration of Municipal Advisors*, amends SEC Rule 15Ba 1-1 to exclude from its definition of municipal adviser, accountants that provide audit or other attest services, prepare financial statements, or issue letters for underwriters for or on behalf of, a municipal entity or obligated person. The types of services described in paragraph 7.104 are considered attest services and would not meet the SEC's definition of municipal adviser, therefore accountants would not be required to register as a municipal adviser for the purposes of those attest services.

²⁵ Generally, these attestation engagements are performed only in accordance with the AICPA Statements on Standards for Attestation Engagements. However, if the auditor is performing the engagement in accordance with *Government Auditing Standards*, the auditor should apply the guidance of *Government Auditing Standards*, including chapter 5, "Standards for Attestation Engagements." Interpretation No. 1, "Reporting on Attestation Engagements Performed in Accordance With *Government Auditing Standards*" (AICPA, *Professional Standards*, AT-C sec. 9205 par. .01–.03), of AT-C section 205, *Examination Engagements*, explains how an examination report should be modified when the engagement is performed in accordance with *Government Auditing Standards*, and it provides an illustrative attestation report. This guidance may be useful in helping a practitioner appropriately modify a report on an attestation engagement pursuant to other AT-C sections.

Exhibit 7-1

The following table illustrates the use of assertions in developing audit objectives and designing substantive tests. The examples are not intended to be all-inclusive nor is it expected that all the procedures are necessarily applied in an audit. Irrespective of the assessed risks of material misstatement, paragraph .18 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), states the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. The use of assertions in assessing risks and designing appropriate audit procedures to obtain audit evidence is described in paragraphs .26–.32 of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*). Various audit procedures and the purposes for which they may be performed are described in paragraphs .A10–.A26 of AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*).

Audit Considerations

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i> ²⁶	<i>Substantive Audit Procedures</i> ²⁷
<i>Bonds Payable</i>			
Presentation and disclosure	Bond liabilities are properly classified in the financial statements, and related disclosures are adequate.	Procedures ensure that the health care entity appropriately classifies debt based on its terms and monitors its compliance with restrictive debt covenants.	Review the terms of the bond indenture for the presence of any put options. Review the terms of lines of credit or other liquidity facilities underlying puttable bonds. Review the debt instruments for the presence of any restrictive debt covenants, including subjective acceleration clauses and cross-default provisions. Test compliance with restrictive debt covenants.

²⁶ The auditor should consider a combination of preventive and detective controls responsive to the control objectives.

²⁷ The auditor should determine the nature, timing, and extent of substantive procedures to perform, considering, for example, the results of tests of controls and risk areas.

7.107

Appendix—Municipal Securities Regulation

A-1 Currently, municipal securities are exempt from all of the provisions of the Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act) except the antifraud provisions of Section 17(a) of the 1933 Act and Section 10(b) of the 1934 Act (and the associated Rule 10b-5). Those antifraud provisions prohibit any person from misrepresenting or omitting material facts in the offering or sale of securities.

A-2 SEC Rule 15c2-12 (Title 17 U.S. *Code of Federal Regulations* Part 240.15c2-12), as amended, and associated SEC releases impose certain requirements on the underwriters of municipal securities.¹ Because of Rule 15c2-12, as amended, obligors of most municipal securities offerings over set dollar amounts and primary issuers of variable demand rate obligation (or VRDO) offerings provide certain disclosure documents when issuing securities (primary market disclosures) as well as at certain times thereafter (continuing disclosures, sometimes referred to as secondary market disclosures).² Primary market disclosures are made by issuing an official statement. Continuing disclosures are made by providing to the Municipal Securities Rulemaking Board (MSRB) (a) annual continuing disclosures as contractually established and (b) events notices. Annual continuing disclosures are financial information, including audited financial statements, which are updated annually. Events notices, which are required for specific events with respect to municipal securities, such as principal and interest payment delinquencies and nonpayment related defaults, are provided on an as-needed basis and do not involve financial statements. Additional information about continuing disclosures is provided beginning at paragraph A-5.

A-3 Rule 15c2-12, as amended, requires the underwriter of a municipal securities offering to reasonably determine that the issuer or obligated person has undertaken in its continuing disclosure agreement to provide continuing disclosure documents (a) solely to the MSRB and (b) in an electronic format and accompanied by identifying information as prescribed by the MSRB. An issuer or obligated person provides continuing disclosure information using the MSRB's Electronic Municipal Market Access (EMMA) system. However, such filings with the MSRB (using the EMMA system) do not affect the legal obligations or contractual disclosure agreements of issuers and obligated persons to provide continuing disclosure documents, along with any other submissions, to the appropriate state information depositories, as required under the appropriate state law. This does not affect the obligation of issuers and obligated persons under outstanding continuing disclosure agreements entered into prior to July 1, 2009, to submit continuing disclosure documents to the appropriate state information depository, if any, as stated in their continuing disclosure agreements, or on their obligation to make any other submissions that may be required under appropriate state law.

¹ For the adopting release, see <https://www.sec.gov/rules/final/adpt6.txt>.

² Electronic Municipal Market Access (EMMA) receives electronic submissions of continuing disclosure documents and related information and makes them publicly available on the EMMA website at <http://emma.msrb.org>.

A-4 In its Release No. 33-7049 and 34-33741,³ *Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others*, the SEC encourages market participants to continue to refer to voluntary guidelines (such as the guidelines prepared by the Government Finance Officers Association) and the SEC's Interpretive Release in preparing official statements and continuing disclosure documents.

SEC's Office of Municipal Securities

A-5 The Office of Municipal Securities (OMS), which is located in the Division of Trading and Markets, coordinates the SEC's municipal securities activities, advises the SEC on policy matters relating to the municipal bond market, and provides technical assistance in the development and implementation of major SEC initiatives in the municipal securities area. In addition, OMS assists the Division of Enforcement and other SEC offices and divisions on a wide array municipal securities matters. OMS works closely with the municipal securities industry to educate state and local officials and conduit borrowers about risk-management issues and foster a thorough understanding of the SEC's policies. OMS maintains a website of helpful information specifically directed to municipal securities issues and conduit obligors (<https://www.sec.gov/municipal>).

Continuing Disclosure Requirements

A-6 As a condition of issuance of debt securities, the SEC requires that the obligor agree to implement a system of continuing disclosure that remains in effect as long as the bonds are outstanding. The core of this system is the continuing disclosure agreement (sometimes referred to as a "15c2-12 contract" or "15c2-12 agreement"). This is a covenant entered into by the obligor in which the obligor agrees to provide certain specified information to bondholders and beneficial owners throughout the life of the bond issue. The terms of the obligor's continuing disclosure agreement are spelled out in the indenture or bond resolution, and also are summarized in the official statement.

A-7 The system is much less prescriptive than the system of periodic reporting required of publicly-traded companies. The primary elements are (1) annual reporting of financial and operating information, and (2) material events reporting. Quarterly reporting is encouraged but not required, (unless agreed to in the continuing disclosure covenant for a particular issue).

A-8 There is no prescribed reporting format (similar to the 10-K) for submission of the annual financial and operating information. The specific list of items to be included in the annual report will be agreed upon by the parties to the financing transaction and enumerated in the continuing disclosure agreement and in an appendix to the official statement. Usually, it consists largely of audited financial statements and updates of specified categories of financial information and operating data or specific sections and charts in the final official statements, or both.

A-9 There is no statutory due date for the filing of annual financial information, as there is with 10-K filings. Instead, the filing deadline is contractually agreed to in the continuing disclosure agreement. If an obligor fails to file information by the agreed-upon deadline and subsequently issues an official statement for

³ Note that the SEC release is one release that has two numbers: one for the Securities Exchange Act of 1933 and one for the Securities Exchange Act of 1934. The release is available at <https://www.sec.gov/rules/interp/1994/33-7049.pdf>.

new bonds, it must disclose its failure to file in that official statement. Failure to disclose this information constitutes a material omission in the official statement.

A-10 The annual report does not have to be submitted all at once, in a single document; it may be submitted as a single document or as separate documents comprising a package.

A-11 The continuing disclosure agreement also requires the obligor to file disclosures related to significant events. The events that must be reported depend upon the issuance date of the securities. Entities obligated under continuing disclosure agreements entered into in connection with primary offerings of municipal securities subject to Rule 15c2-12 that occurred on or before November 30, 2010 are required to notify the MSRB of any of 11 specific events, if determined material, in a timely manner. Entities obligated under continuing disclosure agreements entered into in connection with primary offerings of municipal securities subject to Rule 15c2-12 that occurred on or after December 1, 2010, are required to notify the MSRB of any of 15 events "in a timely manner not in excess of ten business days after the occurrence of the event." For these issuers, certain events are required to be reported without regard to materiality, whereas certain other events are reported based on materiality. Events for which notice is to be provided (that is, that are not subject to a materiality determination) are as follows:

- Principal and interest payment delinquencies
- Unscheduled draws on debt-service reserves reflecting financial difficulties
- Unscheduled draws on credit enhancements reflecting financial difficulties
- Substitution of credit or liquidity providers, or their failure to perform
- Adverse tax opinions or events affecting the tax-exempt status of the security
- Defeasances
- Rating changes
- Tender offers
- Bankruptcy, insolvency, receivership, or a similar event
- Notices of failure to provide annual financial information on or before the date specified on the continuing disclosure agreement

Events that are subject to a materiality determination before triggering a requirement to provide notice are as follows:

- Appointment of successor additional trustees or the change of name of a trustee
- Nonpayment related defaults
- Modifications of rights to security holders
- Bond calls
- Matters affecting collateral (for example, release, substitution, or sale of property securing repayment of the securities)

- Consummation of a merger, consolidation, or acquisition involving an obligated person, or the sale of substantially all of the assets of an obligated person, other than in the ordinary course of business, the entry into definitive agreements to undertake such an action, or the termination of an agreement as it relates to any such sale, other than pursuant to its terms

Electronic Municipal Market Access System

A-12 EMMA is the nationally recognized municipal securities information repository for filing annual reports, material event notices, and voluntarily-submitted information. EMMA is an Internet-based centralized database that provides free public access to disclosure and transaction information about municipal bonds to the municipal market. EMMA also provides access to official statements, advance refunding documents, real-time trade and historical trade information, daily market information, and other educational materials about municipal bonds. Essentially, EMMA makes municipal disclosure information available to the market in a manner similar to the SEC's Electronic Data-Gathering, Analysis, and Retrieval System, or EDGAR, for the disclosures of publicly-traded companies. Rule 15c2-12 requires all continuing disclosure information to be filed using EMMA.

Chapter 8

Contingencies and Other Liabilities

Gray shaded text in this chapter reflects guidance issued but not yet effective as of the date of this guide, September 1, 2017, but becoming effective on or prior to June 30, 2018, exclusive of any option to early adopt ahead of the mandatory effective date. Unless otherwise indicated, all unshaded text reflects guidance that was already effective as of the date of this guide.

© Update 8-1 Accounting and Reporting: FASB Accounting Standards Codification (ASC) 606, Revenue from Contracts With Customers

FASB Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts With Customers*, as amended, provides a framework for revenue recognition and supersedes or amends several of the revenue recognition requirements in FASB ASC 605, *Revenue Recognition*, as well as guidance within the industry-specific topics, including FASB ASC 954, *Health Care Entities*, and FASB ASC 958, *Not-for-Profit Entities*. The standards apply to any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance or lease contracts).

The effective date of the new revenue standards for health care entities is dependent on the type of reporting entity, as follows:

- Health care entities that are either public business entities or not-for-profit entities (NFPs) that have issued, or are conduit bond obligors for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market are required to apply the standards for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Earlier application by those entities is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.
- All other health care entities are required to apply the guidance in FASB ASU No. 2014-09 to annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. Earlier application by those health care entities is permitted only as of an annual reporting period beginning after December 15, 2016, including interim reporting periods within that reporting period, or an annual reporting period beginning after December 15, 2016, and interim reporting periods within annual reporting periods beginning one year after the annual reporting period in which an entity first applies the guidance in FASB ASU No. 2014-09.

Readers are encouraged to consult the full text of FASB ASU No. 2014-09 on FASB's website at www.fasb.org.

The AICPA has formed 16 industry task forces to assist in developing a new accounting guide on revenue recognition that will provide helpful hints and

illustrative examples for how to apply the new standard. Revenue recognition implementation issues identified by the Health Care Entities Revenue Recognition Task Force will be available for informal comment, after review by the AICPA Financial Reporting Executive Committee, at www.aicpa.org/interestareas/frc/accountingfinancialreporting/revenuerecognition/pages/rtrf-healthcare.aspx.

Readers are encouraged to submit comments to revrecomments@aicpa.org.

For more information, see appendix C, "The New Revenue Recognition Standard: FASB ASC 606," of this guide.

This edition of the guide has not been updated to reflect changes as a result of FASB ASC 606, however, the section that follows will be updated in a future edition.

8.01 Health care entities are similar to other industries, in that they record liabilities associated with accounts payable; salaries and payroll taxes; deferred revenue; commitments and contingencies; and other accruals for pension or profit sharing contributions, compensated absences, and income and other taxes. This chapter considers those liabilities that are not discussed elsewhere in this guide. This chapter also discusses certain tax considerations relevant to NFP entities.

Contingencies and Commitments

8.02 Self-insured obligations, other contingencies, and commitments may include the following:

- a. Losses arising from medical malpractice, worker's compensation, and other self-insured claims
- b. Contingencies related to risk contracting
- c. Construction contract commitments
- d. Commitments and guarantees that include contractual agreements with physicians, specialists, and others who perform services by agreement with health care entities
- e. Losses arising from litigation and other regulatory matters, such as Medicare and Medicaid fraud and abuse settlements

The Essentials of Recognition, Measurement, and Disclosure for Contingencies

8.03 The following locations provide the primary standards for contingencies and commitments:

- FASB ASC 440, *Commitments*, which provides general guidance regarding commitments such as those for plant acquisition; unused letters of credit; and obligations to reduce debts, maintain working capital, or restrict dividends
- FASB ASC 450, *Contingencies*, which provides general guidance regarding loss contingencies
- FASB ASC 460, *Guarantees*, which provides general guidance regarding guarantees, including minimum revenue guarantees and guarantees of the indebtedness of others

- FASB ASC 275, *Risks and Uncertainties*, which provides general guidance regarding disclosure of certain significant risks and uncertainties

8.04 FASB ASC 450-20-25 states that when it is probable that a loss has been incurred, and the available information indicates that the loss is within a range of amounts, it follows that some amount of loss has occurred and can be reasonably estimated, and the loss should be recognized. According to FASB ASC 450-20-30-1, if some amount within a range of loss appears at the time to be a better estimate than any other amount within the range, that amount should be accrued. However, when no amount within the range is a better estimate than any other amount, the minimum amount in the range should be accrued. For potentially material items, disclosure should be tailored to facts and circumstances. FASB ASC 450-20-50-3 requires that disclosure of the contingency be made if at least a reasonable possibility exists that a loss or an additional loss may have been incurred, and either an exposure to loss exists in excess of the accrued amount or an accrual is not made for a loss contingency because any of the conditions in FASB ASC 450-20-25-2 are not met.

8.05 According to FASB ASC 954-450-35-1, estimated losses are reviewed and changed, if necessary, at each reporting date. The amounts of the changes are recognized currently as additional expense or a reduction of expense.

8.06 Consistent with the guidance in FASB ASC 210-10-45-6, 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.

Recognition of Insurance Recoveries

8.07 The amount of a contingency should be determined independently from any potential claim for recovery, and an asset relating to the recovery may be recognized only when realization of the claim for recovery is deemed probable.

8.08 In accordance with FASB ASC 954-450-25-2, the liability for malpractice or similar claims should not be presented net of anticipated insurance recoveries. Per FASB ASC 954-450-25-2, to the extent that an entity is indemnified for those liabilities, the entity should recognize an insurance receivable at the same time that it recognizes the liability, measured on the same basis as the liability and subject to the need for a valuation allowance for uncollectible amounts. Per FASB ASC 720-20-25-5, if a purchased insurance contract includes coverage for legal and other costs, the accounting for those costs should be consistent between the asset and liability. If the entity's accounting policy is to accrue legal and other costs, then the insurance receivable should reflect those costs if they are covered under the terms of the insurance policy. If an entity's accounting policy is not to accrue for those costs, then the insurance receivable should not reflect those costs on an accrual basis. See paragraph 8.16 for further discussion on the accrual of legal costs.

8.09 FASB ASC 954-720-25-1 states that insurance recoveries from a retrospectively-rated insurance policy whose ultimate premium is based primarily on the health care entity's loss experience should not be recognized until the estimated losses exceed the stipulated maximum premium. Technical Question and Answer (Q&A) section 6400.52, "Insurance Recoveries From

Certain Retrospectively Rated Insurance Policies" (AICPA, *Technical Questions and Answers*), provides an example of the accounting for insurance recoveries for a health care entity that is insured by a retrospectively-rated insurance policy.

Managing Risk of Loss

8.10 Health care entities typically use commercial insurance to manage some portion of the risk of loss from medical malpractice, workers' compensation, and employee health claims. However, as the cost of commercial insurance has continued to rise, many health care entities are managing their risk through higher deductibles, self-insured retentions, retrospective premiums, and reduced or no coverage under their insurance policies. In some cases, a health care entity will form its own insurance company, known as a captive insurance company, to manage its risk. It is important for the health care entity to identify its risk and the portion of that risk that is insured. Generally, a health care entity uses actuaries to assist in identifying and quantifying the retained risk. An assessment of the risk that is insured is necessary for the determination of anticipated insurance recoveries.

8.11 Insurance policies may be issued on either an occurrence basis or a claims-made basis. Occurrence basis policies provide coverage for insured events occurring during the contract period, regardless of the length of time that passes before the insurance company is notified of the claim. A claims-made policy only covers claims reported to the insurer during the contract period; however, in practice, claims-made policies generally cover claims reported to either the insurer or insured during the contract period. As a result, claims might be reported to the insurer after the contract expires. Even if claims have been reported to the insurer during the contract period, it may take several months for the insurer to investigate and establish a case reserve for reported claims. In practice, most claims-made insurance policies contain extended reporting clauses or endorsements that, in specified circumstances, provide for coverage of claims occurring during the contract period but reported after the expiration of the policy.

8.12 Although paragraphs 8.13–.47 provide specific guidance relating to accounting for medical malpractice, the guidance may be helpful in accounting for other self-insured liabilities, including workers' compensation and employee health insurance.

Medical Malpractice

8.13 According to FASB ASC 954-450-25-2, a health care entity should evaluate its exposure to losses arising from claims and record a liability, if appropriate. The provisions in FASB ASC 720-20-25 and 944-40 discuss the accounting for insurance claims costs, including estimates of costs relating to incurred-but-not-reported (IBNR) claims.

8.14 In accordance with FASB ASC 954-450-25-2, the liability for malpractice or similar claims should not be presented net of anticipated insurance recoveries. Q&A section 6400.49, "Presentation of Claims Liability and Insurance Recoveries—Contingencies Similar to Malpractice" (AICPA, *Technical Questions and Answers*), clarifies that *similar contingent liabilities* include liabilities of a similar nature, such as workers' compensation and director and officers claims. Q&A section 6400.51, "Presentation of Insurance Recoveries When Insurer Pays Claims Directly" (AICPA, *Technical Questions and Answers*),

further explains that unless a health care entity has a valid right of setoff (which is not common), as described in FASB ASC 210-20-45, the health care entity should report the gross amount of its claims liabilities (including legal costs) as its obligations, regardless of whether covered by insurance, and should record a receivable as if it were entitled to receive insurance recoveries to offset those obligations as discussed in FASB ASC 954-450-25-2. It is expected that in most cases, this results in reporting a receivable that mirrors the amount of estimated losses accrued that are covered by insurance.

8.15 In determining the best estimates of the ultimate costs of malpractice claims, health care entities should consider the guidance for contingencies in FASB ASC 450-20 and 954-450. Health care entities should take into consideration how malpractice claims develop over time (for example, the fact that some claims require a number of years before they are settled). FASB ASC 944-40 discusses accounting for claims costs, including estimates of costs relating to IBNR claims. Although health care entities are not required to apply the guidance in FASB ASC 944-40, that guidance may be helpful in estimating loss liabilities. Governmental health care entities should also consider the accounting and disclosure requirements of GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, as amended.

8.16 According to FASB ASC 954-450-25-2, the ultimate costs of malpractice claims, which include costs associated with litigating or settling claims, should be accrued when the incidents that give rise to the claims occur. However, as described in Q&A section 6400.50, "Accrual of Legal Costs Associated With Contingencies Other Than Malpractice" (AICPA, *Technical Questions and Answers*), the guidance in FASB ASC 954-450-25-2A (which requires an accrual of estimated costs associated with settling claims to be included in the accrual for malpractice losses) is applicable only to malpractice claims and is not applicable to other similar contingent liabilities. In accounting for legal costs associated with contingent liabilities other than malpractice, some health care entities follow guidance in FASB ASC 450-20-S99-2, which permits making a policy election to either expense claims-related legal fees in the period(s) in which the costs are actually incurred or to estimate and accrue them in the period in which the associated claim arises.

8.17 FASB ASC 954-450-30-1 states that estimated losses from asserted and unasserted medical malpractice claims should be 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. 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. All relevant information, including industry experience, the entity's own historical experience, the entity's existing asserted claims, and reported incidents should be used in estimating the expected amount of claims.

8.18 FASB ASC 954-450-30-2 states that in estimating losses from malpractice claims, a health care entity may need to modify data drawn from industry experience, so it is relevant to developing an estimate that is specific to the entity. Various factors, such as the nature of operations, size, and the entity's past experience, are considered in assessing comparability. Further, industry data that is not current may not be relevant.

8.19 According to FASB ASC 954-720-25-3, an accrual for malpractice losses should be based on estimated ultimate losses and costs associated with litigating and settling claims.

8.20 FASB ASC 954-450-25-2A indicates that accruals should not be based on recommended funding amounts, which in addition to a provision for the actuarially-determined liability may also include a provision for (a) credit for investment income and (b) an excess margin for risk of adverse deviation. FASB ASC 954-450-25-2B provides the following 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 ASC 450.
- 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 that is 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).

8.21 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 generally accepted accounting principles (GAAP).

8.22 According to FASB ASC 954-450-30-2, in estimating the probability that unreported incidents have occurred, some health care entities may develop a range of possible estimates of the number of unreported incidents, including zero. However, the greater the volume of a health care entity's operations, the greater the likelihood that the entity's minimum estimate of the number of probable unreported incidents will be greater than zero.

8.23 If a health care entity cannot estimate losses from asserted or unasserted malpractice claims, and therefore, an accrual is not made, FASB ASC 450-20-50-3 requires disclosure of the contingency if at least a reasonable possibility exists that a loss or an additional loss may have been incurred.

8.24 Further guidance about specific risk-management approaches is provided as follows:

- Policies written by captive insurance companies are discussed in paragraphs 8.30–.33.

- Claims-made insurance policies are discussed in paragraphs 8.34–.36.
- Retrospectively-rated insurance policies are discussed in paragraphs 8.37–.43.
- Self-funded trust funds are discussed in paragraphs 8.44–.47.

Discounting of Medical Malpractice Liabilities

8.25 FinREC believes that the accrued liabilities for medical malpractice claims may be discounted to reflect the time value of money if all of the following are true: (a) the amount of the liability, individually or in the aggregate, is fixed or reliably determinable; (b) the amount and timing of cash payments for the liability, individually or in the aggregate, based on the health care entity's specific experience, are fixed or reliably determinable; and (c) expected insurance recoveries, if any, are also discounted. FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, provides a useful discussion of general principles governing the use of present value and the objective of present value in accounting measurements. FASB Concepts Statements are not sources of established accounting principles; thus, they do not amend, modify, or justify a change from GAAP currently in effect.

8.26 The objective of discounting loss reserves is to account for the time value of money in a way that accurately reflects the anticipated future cash flows based on the characteristics of the obligation. Reasonable diversity exists regarding what rates should be used for discounting liabilities for unpaid claims and claim adjustment expenses and how they are applied. If an entity decides to discount, it might analogize to the following guidance in determining an appropriate discount rate:

- FASB ASC 340-30-35-6 states that for the insurer or assuming entity, the discount rate used to determine the deposit liability should be the current rate on U.S. government obligations with similar cash flow characteristics.
- FASB ASC 450-20-S99-1 states that the rate used to discount the cash payments should be the rate that will produce an amount at which the environmental or product liability could be settled in an arm's-length transaction with a third party. Further, the discount rate used to discount the cash payments should not exceed the interest rate on monetary assets that are essentially risk free, as described in FASB Concepts Statement No. 7, and have maturities comparable to that of the environmental or product liability.
- FASB ASC 944-20-S99-1 notes that pending authoritative guidance resulting from those efforts, the SEC staff will raise no objection if a registrant follows a policy for GAAP reporting purposes of discounting liabilities for unpaid claims and claim adjustment expenses at the same rate that it uses for reporting to state regulatory authorities with respect to the same claim liabilities.

8.27 Careful consideration of the facts and circumstances surrounding a change in the discount rate for the liabilities for unpaid claims is needed to determine the proper accounting for the change (change in accounting principle or change in accounting estimate). A change from not discounting loss reserves to discounting loss reserves would generally be a change in accounting principle.

8.28 FASB ASC 954-450-50-2 requires that health care entities that discount accrued malpractice claims 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(s) used to discount those claims.

8.29 FinREC recommends that a health care entity that discounts accrued malpractice claims also disclose the following information: (a) its policy concerning the timing of recognition of insurance recoveries; (b) its policy for discounting accrued malpractice claims and, if it has any, recognized insurance recoveries; (c) the interest rate(s) used to discount its insurance recoveries receivable; and (d) the undiscounted amount of accrued malpractice claims that are discounted in the financial statements.

Captive Insurance Companies

8.30 Health care entities may be insured by wholly-owned or multi-provider captive insurance companies. See chapter 12, "The Reporting Entity and Related Entities," of this guide for a discussion of considerations related to consolidation and the use of the equity method for equity interests, including equity interests in captive insurance companies.

8.31 The economic substance of the terms of an insurance policy with a captive insurance company may more closely resemble a claims-funding mechanism than an instrument that provides rights for recovery of loss from an external third party. The health care entity should consider whether the economic substance of a captive insurance company is sufficient that the health care entity can recognize anticipated insurance recoveries. For example, any anticipated insurance recoveries under a policy with a wholly-owned captive insurance company would be eliminated in the consolidation of the entities. Because the captive insurance company is part of the reporting entity, the liability for asserted and unasserted claims is assessed for both the parent and wholly-owned subsidiary at the reporting entity level.

8.32 FASB ASC 954-720-50-3 requires that a health care entity that is insured by a multiprovider captive insurance company disclose in its financial statements (a) that it is insured by such an entity; (b) its ownership percentage in the captive company; and (c) the method of accounting for its investment in, and the operations of, the captive entity.

8.33 Retrospectively-rated policies written by captive insurance companies are discussed in paragraphs 8.41–43.

Claims-Made Insurance

8.34 A claims-made insurance policy provides rights for recovery of losses within the policy limits for asserted claims and incidents reported to the insurance carrier during the policy period. However, the policy does not provide rights for recovery of losses for claims and incidents not reported to the insurance carrier during the policy period. Unless the policy is continually renewed or tail coverage is purchased, the health care entity is uninsured for claims reported after the termination of the policy, even if the event occurred during the period in which the policy was in force.

8.35 As discussed in FASB ASC 720-20-25-14, a health care entity that is insured under a claims-made insurance policy recognizes the estimated cost of those IBNR claims and incidents to the insurance carrier if the loss is both probable and reasonably estimable. The "Claims-Made Contracts" sections of

FASB ASC 720-20 apply if a health care entity purchases a claims-made insurance policy, subject to the measurement guidance in the following paragraph.

8.36 FASB ASC 720-20-30-2 states that for claims-made policies, the estimated cost of purchasing tail coverage is not relevant in determining the loss to be accrued because FASB ASC 210-20-45-1 prohibits netting the insurance receivable against the claim liability. However, if the insured health care entity had the unilateral option to purchase tail coverage at a premium not to exceed a specified fixed maximum, then the entity could record a receivable for expected insurance recoveries, after considering deductibles and policy limits, for the portion of the IBNR liability that is insurable under the tail coverage. In that case, the health care entity would need to record as a cost the expected premium for the coverage. The purchase of tail coverage does not eliminate the need to determine if an additional liability should be accrued because of policy limits or other factors.

Retrospectively-Rated Premium Policies

8.37 An insurance policy with a premium that is adjustable based on actual experience during the policy term is known as a retrospectively-rated premium policy. Under this type of policy, a deposit premium is generally paid to the insurer at the beginning of the coverage period. This usually consists of a minimum premium representing the insurance company's expenses and profits and an additional amount for estimated claims. The portion for estimated claims is adjusted during the term of the policy, subject to any minimums or maximum limitations specified in the policy. The economic substance of the terms of a retrospectively-rated insurance policy may more closely resemble a claims-funding mechanism.

8.38 The "Retroactive Contracts" and "Multiple-Year Retrospectively Rated Contracts" sections of FASB ASC 720-20 provide guidance for those insurance contracts, subject to the guidance in paragraphs 8.39–40. For a multiple-year retrospectively-rated contract accounted for as insurance, FASB ASC 720-20-25-15 states that the health care entity should recognize either of the following:

- A liability to the extent that the insured has an obligation to pay cash or other considerations to the insurer that would not have been required, absent experience under the contract
- An asset to the extent that any cash or other consideration would be payable by the insurer to the insured based on experience to date under the contract

Per FASB ASC 720-20-30-3, the amount to be recognized in the current period should be computed using a with and without method as the difference between the health care entity's total contract costs before and after the experience under the contract as of the reporting date, including costs such as premium adjustments, settlement adjustments, and impairments of coverage. The amount of premium expense related to impairments of coverage should be measured in relation to the original contract terms. Future experience under the contract (that is, future losses and future premiums that would be paid regardless of past experience) should not be considered in measuring the amount to be recognized. The liability would be measured in accordance with FASB ASC 720-20-30-4 if the health care entity could terminate the contract before the end of its term and if termination would change the paid amounts.

8.39 FASB ASC 954-720-25-1 states that a health care entity with a retrospectively-rated insurance policy whose ultimate premium is based primarily on the health care entity's loss experience accounts for the minimum premium as an expense over the period of coverage under the policy.

8.40 FASB ASC 954-720-35-1 requires that a health care entity insured under a retrospectively-rated policy whose ultimate premium is based primarily on the experience of a group of health care entities amortize the initial premium to expense on a pro rata basis over the policy term. FASB ASC 954-720-25-2 states that the health care entity also should accrue 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. FASB ASC 954-720-50-1 requires a health care entity insured under a retrospectively rated policy whose ultimate premium is based primarily on the experience of a group of health care entities disclose 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 entities.

Retrospectively-Rated Policy Written by a Captive Insurance Company

8.41 A health care entity insured by an unconsolidated multiprovider captive insurance company for medical malpractice claims under a retrospectively-rated insurance policy whose ultimate premium is based primarily on the health care entity's experience up to a maximum premium, if any, accounts for such insurance as indicated in paragraph 8.39.

8.42 FASB ASC 954-720-35-2 states that a health care entity insured by an unconsolidated multiprovider captive insurance company for medical malpractice claims under a retrospectively-rated policy, whose ultimate premium is based primarily on the experience of a group of health care entities, accounts for such insurance as indicated in FASB ASC 954-720-25-2 and further discussed in paragraph 8.40.

8.43 According to FASB ASC 954-720-50-2, the health care entity should disclose that (a) it is insured under a retrospectively-rated policy of a multiprovider captive insurance company, and (b) the premiums are accrued based on the captive insurance company's experience to date.

Trust Funds

8.44 Some health care entities establish a medical malpractice self-funded trust fund for the purpose of paying medical malpractice claims.

8.45 FASB ASC 954-810-45-4 states that in general, a trust fund, whether legally revocable or irrevocable, should be included in the financial statements of the health care entity. A portion of 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. In some circumstances, the foregoing may not be possible (for example, if a common trust fund exists for a group of health care entities; if the health care entity 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 entity's financial

statements). In those circumstances, the provisions of FASB ASC 954-450-25-3, 954-720-25-5, and 954-810-50-1 apply; those provisions are included in the following two paragraphs.

8.46 FASB ASC 954-450-25-3 states that estimated losses from asserted and unasserted claims should be accrued and reported, as indicated in paragraphs 1–2 of FASB ASC 954-450-30 (see paragraphs 8.16–.18). The estimated losses are not based on payments to the trust fund. FASB ASC 954-720-25-5 states that an entity that participates in a 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 obtained coverage (for example, occurrence basis, claims made, or retrospectively rated).

8.47 FASB ASC 954-810-50-1 requires that the existence of the trust fund and whether it is irrevocable be disclosed in the financial statements.

Disclosures for Medical Malpractice

8.48 Disclosures about medical malpractice should be consistent with the requirements of FASB ASC 450-20-50. Disclosure of a contingency should be made if at least a reasonable possibility exists that a loss or an additional loss may have been incurred, and an accrual should not be made for a loss contingency because any of the conditions in FASB ASC 450-20-25-2 are not met. The guidance further states that disclosure is preferable to accrual when a reasonable estimate of loss cannot be made.

8.49 In addition to the disclosures required by FASB ASC 450-20-50 and those discussed in paragraphs 8.14, 8.28–.29, 8.32, 8.40, 8.43, and 8.47, FASB ASC 954-450-50-1 requires that a health care entity disclose its program of medical malpractice insurance coverages.

8.50 FinREC recommends that those disclosures include the nature of the insurance coverage (for example, claims made or occurrence); related terms (for example, self-insured retention and excess levels); and expected insurance recoveries and the basis for any related loss accruals.

8.51 If the entity cannot estimate losses relating to a particular category of malpractice claims (for example, asserted claims, reported incidents, or unreported incidents), the potential losses related to that category of claims are not accrued. However, the contingency is disclosed in the notes to the financial statements.

8.52 FinREC recommends that health care entities disclose the reasons for significant changes in the costs of incurred claims recognized in the income statement or statement of operations, including the costs associated with litigating or settling those claims. In addition to medical malpractice, this disclosure is recommended for all significant claims obligations, such as workers' compensation and employee health insurance.

8.53 FASB ASC 275-10-50 requires disclosures regarding an estimate when, based on known information available before the financial statements are issued or available to be issued, as discussed in FASB ASC 855-10-25, it is reasonably possible that the estimate will change in the near term, and the effect of the change will be material. For more information, see paragraphs 8.101–.107 of this guide.

Physician Guarantees and Other Agreements With Physicians

8.54 The physicians practicing at health care entities may be employees of the entity or affiliated entity or independent of the entity. These physicians join the entity's medical staff and agree to abide by those bylaws and govern themselves accordingly. Health care entities enter into a variety of agreements with physicians. Although this section provides accounting guidance relating to certain of these agreements, health care entities and their independent auditors should also consider the associated regulatory issues. See chapter 1, "Overview and Unique Considerations of Health Care Entities," of this guide for a discussion of those regulatory issues.

8.55 Health care entities sometimes guarantee nonemployee physicians that the revenue of the physicians' business or a specific portion of the business for a specified period of time will be at least a specified amount. Some of these guarantees are structured as minimum revenue guarantees (see paragraph 8.56); others are structured as financing transactions (see paragraph 8.57).

8.56 FASB ASC 460 applies to *minimum revenue guarantees*, which the FASB ASC glossary defines as "[a] guarantee granted to a business or its owners that the revenue of the business (or a specific portion of the business) for a specified period of time will be at least a specified minimum amount." FASB ASC 460-10-55-11 provides an example of a minimum revenue guarantee granted to a nonemployee physician by an NFP health care facility. In the example, the health care facility has recruited the physician to move to the facility's geographical area to establish a practice. The health care facility, as the guarantor, has agreed to make payments to the newly arrived physician (the guaranteed party) at the end of specific periods of time if gross revenues (gross receipts) generated by the physician's new practice during that period of time do not equal or exceed a specific dollar amount. FASB ASC 460 applies to minimum revenue guarantees granted to physicians, regardless of whether the physician's practice qualifies as a *business*, as defined in the FASB ASC glossary. FASB ASC 460-10 requires that at the inception of a guarantee, the health care entity, as a guarantor, should recognize in its statement of financial position a liability for that guarantee. The liability should be initially measured at fair value.

8.57 Certain income guarantees are structured as advances whereby the physician is required to repay the outstanding balance of all advances after the end of the guarantee period, although a forgiveness clause may be included in exchange for the physician's commitment to stay in the community for a specified period of time. If the health care entity is tax exempt, the agreement is often structured as an advance to avoid potential problems associated with private inurement. See paragraphs 8.93–.94 for a discussion of private inurement. In determining the appropriate accounting for a physician income guarantee, it is important to evaluate the substance of the agreement. Such agreements may be promissory notes. In those situations, the income guarantee may be a financing arrangement. As noted in Q&A section 6400.45, "Applicability of FASB ASC 460—Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" (AICPA, *Technical Questions and Answers*), financing arrangements are excluded from the scope of FASB ASC 460 and, generally, would be accounted for as loans.

8.58 Another common recruitment incentive is a guarantee of a physician's personal home mortgage for his or her residence in the health care

entity's service area. If the physician is not an employee, Q&A section 6400.46, "Applicability of FASB ASC 460—Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others—Mortgage Guarantees" (AICPA, *Technical Questions and Answers*), notes that the agreement is considered a guarantee under FASB ASC 460. The presence of the health care entity's guarantee, obtained through a local bank, reduces the interest rate on the physician's mortgage loan. At inception, the health care entity would record an obligation to stand ready to perform in an amount equal to the fair value of the guarantee. In the preceding situation, the health care entity typically would be released from risk as the physician's outstanding mortgage obligation is reduced.

8.59 In current practice, most health care entities offset the entry recognizing the liabilities for the guarantees described in paragraphs 8.56 and 8.58 by recognizing an intangible asset. That intangible asset is then amortized over the life of the contract.

8.60 Health care entities need to ensure that they maintain adequate physician coverage to support their operations. This means that the entity needs to have certain specialties available based on the needs of the patients. For example, a patient who arrives at the emergency room may require surgery, and as a result, the entity needs to have physician coverage to provide this service. Historically and in many cases, the physicians have provided this service to the entity free of charge as part of their responsibilities of being on the medical staff; however, this practice has changed. Health care entities are routinely reimbursing physicians to provide emergency room coverage. This might be done through paying stipends, actual claims for services provided to uninsured or Medicaid patients, or through other agreements negotiated with the physicians. These agreements may include settlement provisions based on volumes or the mix of patients. In all cases, these costs should be accrued as incurred by the health care entity.

8.61 In addition, health care entities contract with certain physicians as medical directors to provide clinical oversight. These medical director agreements may be at a specific stipend, hourly rate, or even involve more complex formulas based on the services and needs of the entity. In all cases, these costs should be accrued as incurred by the entity.

Other Liabilities

Asset Retirement Obligations

8.62 An *asset retirement obligation* is an obligation associated with the other-than-temporary removal of a tangible long-lived asset from service. That term encompasses sale, abandonment, recycling, or disposal in some other manner. Chapter 6, "Property and Equipment and Other Assets," provides examples of asset retirements that may cause obligations. The FASB ASC glossary defines *conditional asset retirement obligation* as "[a] legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity." FASB ASC 410-20-25-7 states that an entity should recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. Paragraphs 4–5 of FASB ASC 410-20-25 require an entity to recognize the fair value of a liability for an

asset retirement obligation in the period in which it is incurred, if a reasonable estimate of fair value can be made, and increase the carrying amount of the related long-lived asset by the same amount as the liability. An expected present value technique incorporates uncertainty about the timing and method of settlement into the fair value measurement. Uncertainty is factored into the measurement of the fair value of the liability through assignment of probabilities to cash flows.

8.63 FASB ASC 410-20-25-13 states that if current law, regulation, or contract, including the doctrine of promissory estoppel, requires an entity to perform an asset retirement activity when an asset is sold, abandoned, recycled, dismantled, demolished, or disposed of in some other manner, an unambiguous requirement exists to perform the retirement activity, even if that activity can be indefinitely deferred. At some time, deferral will no longer be possible because no tangible asset will last forever, except land. Therefore, the obligation to perform the asset retirement activity is unconditional, even though uncertainty exists about the timing or method, or both, of settlement.

8.64 The evaluation of the existence of an asset retirement obligation is generally performed on an asset-by-asset basis. The health care industry is capital intensive, and many health care entities have older physical plant facilities. Health care entities may have asset retirement obligations associated with these assets because federal, state, and local regulations typically require one or more specified activities to be performed upon abandonment, disposal, or significant renovation of long-lived assets. These activities typically relate to asbestos removal but may also relate to the disposal of medical waste, certain medical equipment, or underground storage tanks. A provision may even be included to restore a leased asset to its original condition upon termination of a lease.

Compensation and Related Benefits

8.65 Health care entities are usually labor intensive and compete for a limited number of qualified employees. The workforce at some health care entities is unionized, subjecting the entity to collective bargaining agreements that outline the compensation and benefits provided to employees. In many cases, more than one union will be present at the entity, resulting in multiple collective bargaining agreements. In addition, NFPs have additional regulatory restrictions regarding the amount and structure of compensation arrangements and benefit plans for their employees. These environmental factors have resulted in health care entities developing and maintaining multiple compensation and benefit plans.

8.66 Careful consideration of the compensation arrangements is required in order to apply the appropriate standards. FASB ASC 710-10-15 may be helpful in locating the appropriate standards. The following four FASB ASC topics provide guidance for compensation:

- FASB ASC 710, *Compensation—General*
- FASB ASC 712, *Compensation—Nonretirement Postemployment Benefits*
- FASB ASC 715, *Compensation—Retirement Benefits*
- FASB ASC 718, *Compensation—Stock Compensation*

Complex Pay Practices

8.67 For many health care entities, the majority of employees are nonexempt (subject to overtime compensation for hours worked over certain statutory limits) and compensated under complex pay practices. To attract and retain staff in many critical positions, employees may be paid multiple pay differentials, in addition to their base rate. The determination of benefit eligibility or calculation of benefit amounts may relate to only some of the pay practices of the entity. As a result, these practices require entities to develop systems to capture time worked in a manner consistent with the practice or benefit plans, or both.

Incentive and Deferred Compensation Plans

8.68 Health care entities typically maintain an incentive compensation plan for all or certain groups of employees. When compensation is based on attaining a particular goal or set of goals over a period of time, such as achieving a certain operating margin or quality score, it is accrued over the period in relation to the results achieved to date.

8.69 Due to the regulations relating to deferred compensation for NFPs, health care entities utilize a variety of structures to provide deferred compensation benefits to their employees that are competitive with other entities, including for-profit entities. These deferred compensation plans are designed for highly compensated employees and are considered nonqualified plans. Some plans are considered eligible plans by the IRS (for example, 457(b) plans); in other cases, they are considered nonqualified plans. In the simplest form, deferred compensation plans provide that an employee may defer a portion of his or her salary until a later date. That date may be after the employee has left the entity or retired. More complex deferred compensation plans provide for payments of periodic amounts or noncompete arrangements for a specified period of time, or both.

8.70 Although many scope limitations exist, and care should be taken when determining the appropriate standards, in general, guidance for deferred compensation is found in the following locations:

- FASB ASC 715-10 and 715-30 provide guidance for individual deferred compensation contracts if those contracts, taken together, are equivalent to a defined benefit pension plan.
- FASB ASC 715-10 and 715-60 provide guidance for individual deferred compensation contracts if those contracts, taken together, are equivalent to a defined benefit other postretirement benefit plan.
- FASB ASC 710-10 provides guidance for rabbi trusts.
- FASB ASC 710-10 provides guidance for individual deferred compensation arrangements that do not fall within the scope of other topics in FASB ASC.

8.71 Typically, any funding for these deferred compensation arrangements provided by the health care entity is available to its general creditors. An entity may establish a trust to fund compensation for a certain group of management or highly paid executives. In some cases, the executives or management may invest these funds in a select group of securities.

8.72 FASB ASC 710-10-25-18 requires that assets held by a rabbi trust be accounted for in accordance with GAAP for the particular asset and that the

deferred compensation obligation be classified as a liability. Paragraphs 16–17 of FASB ASC 710-10-25 apply if the rabbi trust is invested in the employer's stock.

8.73 In addition, a health care entity may utilize split-dollar life insurance policies to fund its obligation under the deferred compensation agreements. The "Split-Dollar Life Insurance Arrangements" sections of FASB ASC 715-60 provide guidance for accounting for these benefits.

Sabbaticals and Other Compensated Absences

8.74 Health care entities typically provide employees with compensated absences, such as for holidays, vacations, and illness. These liabilities should be accounted for in accordance with FASB ASC 710-10. In addition to these typical compensated absences, FASB ASC 710-10 also provides guidance for health care entities that have a sabbatical program for certain employees.

Postretirement and Postemployment Benefit Plans

8.75 Similar to other industries, health care entities historically have provided pension benefits to their employees. Over the last several years, many health care entities have converted their traditional defined benefit plans to cash balance or defined contribution plans. In addition, some health care entities have agreed to provide postretirement health benefits.

8.76 Although many scope limitations exist, and care should be taken when determining the appropriate standards, in general, guidance for postretirement and postemployment benefits is found in the following locations:

- FASB ASC 715-20 and 715-30 provide guidance for pension benefits provided through defined benefit pension plans.
- FASB ASC 715-20 and 715-60 provide guidance for other postretirement benefits provided through defined benefit plans.
- FASB ASC 715-70 provides guidance for defined contribution plans.
- FASB ASC 715-80 provides guidance for multiemployer pension and other postretirement benefit plans, including those provided pursuant to one or more collective bargaining agreements.
- FASB ASC 712-10 provides guidance for special or contractual termination benefits that are payable before retirement and not payable from a pension or other postretirement plan, including guidance for health care entities that have a formal severance plan as part of their health and welfare plans.
- FASB ASC 712-10 also provides guidance for all types of other postemployment benefits provided to former or inactive employees, their beneficiaries, and covered dependents after employment but before retirement.

Joint and Several Liability Arrangements

8.77 FASB ASC 405-40-15-1 applies to obligations resulting from joint and several liability arrangements for which the total amount under the arrangement is fixed at the reporting date, except for obligations accounted as follows:

- FASB ASC 410, *Asset Retirement and Environmental Obligations*
- FASB ASC 450

- FASB ASC 460
- FASB ASC 715
- FASB ASC 740, *Income Taxes*

For the total amount of an obligation under an arrangement to be considered fixed at the reporting date there can be no measurement uncertainty at the reporting date relating to the total amount of the obligation subject to FASB ASC 405-40-15-1. However, the total amount of the obligation may change subsequently because of factors that are unrelated to measurement uncertainty. For example, the amount may be fixed at the reporting date but change in future periods because an additional amount was borrowed under a line of credit for which an entity is jointly and severally liable or because the interest rate on a joint and several liability arrangement changed.

FASB ASC 405-40-15-1 applies to obligations resulting from joint and several liability arrangements for which the total amount under the arrangement is fixed at the reporting date, except for obligations accounted as follows:

- FASB ASC 410, *Asset Retirement and Environmental Obligations*
- FASB ASC 450
- FASB ASC 460
- FASB ASC 715
- FASB ASC 740, *Income Taxes*

For the total amount of an obligation under an arrangement to be considered fixed at the reporting date there can be no measurement uncertainty at the reporting date relating to the total amount of the obligation subject to FASB ASC 405-40-15-1. Although the total amount of the obligation of the entity and its co-obligors must be fixed at the reporting date to be within the scope of this Subtopic, the amount that the entity expects to pay on behalf of its co-obligors may be uncertain at the reporting date. Additionally, the total amount of the obligation may change subsequently because of factors that are unrelated to measurement uncertainty. For example, the amount may be fixed at the reporting date but change in future periods because an additional amount was borrowed under a line of credit for which an entity is jointly and severally liable or because the interest rate on a joint and several liability arrangement changed.¹

8.78 A health care entity should recognize obligations resulting from joint and several liability arrangements subject to FASB ASC 405-40-15-1 at the inception of the arrangement (for example, a debt arrangement) or after the inception of the arrangement (for example, when the total amount of the obligation becomes fixed). The corresponding entry or entries depend on facts and circumstances of the obligation, examples of which are as follows:

- Cash for proceeds from a debt arrangement
- An expense for a legal settlement

¹ FASB Accounting Standards Update (ASU) No. 2016-19, *Technical Corrections and Improvements*, was issued in December 2016. The amendments for joint and several liability in this ASU are effective for all entities for fiscal years beginning after December 15, 2016. Early application of the amendments is permitted for all entities whose financial statements have not been issued or are not yet available for issue.

- A receivable (that is assessed for impairment) for a contractual right
- An equity transaction with an entity under common control

8.79 Obligations resulting from joint and several liability arrangements subject to FASB ASC 405-40-15-1 initially should be measured as the sum of the following:

- The amount the reporting entity agreed to pay on the basis of its arrangement among its co-obligors.
- Any additional amount the reporting entity expects to pay on behalf of its co-obligors. If some amount within a range of the additional amount the reporting entity expects to pay is a better estimate than any other amount within the range, that amount should be the additional amount included in the measurement of the obligation. If no amount within the range is a better estimate than any other amount, then the minimum amount in the range should be the additional amount included in the measurement of the obligation.

8.80 Obligations resulting from joint and several liability arrangements subject to FASB ASC 405-40-15-1 subsequently should be measured using the guidance in FASB ASC 405-40-30.

8.81 A health care entity should disclose the following information about each obligation, or each group of similar obligations, resulting from joint and several liability arrangements subject to FASB ASC 405-40-15-1:

- The nature of the arrangement, including
 - how the liability arose
 - the relationship with other co-obligors
 - the terms and conditions of the arrangement
- The total outstanding amount under the arrangement, which should not be reduced by the effect of any amounts that may be recoverable from other entities
- The carrying amount, if any, of an entity's liability and the carrying amount of a receivable recognized, if any
- The nature of any recourse provisions that would enable recovery from other entities of the amounts paid, including any limitations on the amounts that might be recovered
- In the period the liability is initially recognized and measured or in a period the measurement changes significantly, the corresponding entry and where the entry was recorded in the financial statements

These disclosures do not affect the related-party disclosure requirements in FASB ASC 850, *Related Party Disclosures*.

Agency Funds

8.82 As described in FASB ASC 954-305-45-4, health care entities may receive and hold assets owned by others under agency relationships. For example, they may perform billing and collection services for physicians. In accepting responsibility for those assets, the health care entity incurs a liability to

the principal under the agency relationship to return the assets in the future or, if authorized, disburse them to another party on behalf of the principal. If held by NFP business-oriented health care entities, such agency funds shall be reported as unrestricted assets.

8.83 As a result, physician fees collected by the health care entity as a conduit are reported as a liability to the physicians and not recognized in the statement of income or operations and changes in net assets.

Fees Paid to the Federal Government by Health Insurers

8.84 On or after January 1, 2014, if an entity provides health insurance, it is required to pay a fee to the federal government in accordance with the Patient Protection and Affordable Care Act as amended by the Health Care and Education Reconciliation Act (the acts).

8.85 In accordance with FASB ASC 720-50, health insurers should record a liability for the annual fee. It should be estimated and recorded in full once the entity provides qualifying health insurance in the applicable calendar year in which the fee is payable with a corresponding deferred cost that is amortized to expense using a straight-line method of allocation, unless another method better allocates the fee over the calendar year that it is payable. The annual fee imposed on health insurers does not represent a cost related to the acquisition of policies that is consistent with the definition of an *acquisition cost* in FASB ASC 944-30.

Tax Considerations for NFP Health Care Entities

8.86 NFP health care entities generally are exempt from taxation. Tax exemption is a privilege and not a right. At the federal level, the IRS has the authority to revoke an entity's exempt status for any one of several reasons. Furthermore, individual states have regulatory bodies that oversee NFPs and can revoke their state tax-exempt status without regard to their federal tax-exempt status and even prevent them from operating. Many potential threats exist to an entity's federal tax-exempt status, of which the following are particularly important:

- Material changes in the entity's character, purpose, or method of operation
- Private inurement
- Private benefit
- Commerciality
- Lobbying
- Political campaign activities
- Unrelated business income
- Failure of the entity to meet the commensurate test
- Violation of public policy by the entity

8.87 NFPs should be aware of relevant federal and state tax laws and regulations and their potential impact on the entity and its financial statements. An entity's failure to maintain its tax-exempt status could have serious financial consequences. As discussed in chapter 2, "General Auditing Considerations," of this guide, failure to comply with tax laws and regulations could be

an illegal act that may have either a direct and material effect on the determination of financial statement amounts (for example, the result of an incorrect accrual for taxes on unrelated business income) or a material indirect effect on the financial statements that would require appropriate disclosures (for example, the result of a potential loss of tax-exempt status).

8.88 NFP health care entities usually seek exemption from federal income tax under IRC Section 501(a). Under IRC Section 501(a), entities organized and operated exclusively for religious, charitable, or educational purposes, as described in IRC Section 501(c)(3), are exempt from federal income taxes. The following are additional requirements for such entities:

- No part of the organization's net earnings, either directly or indirectly, inures to any private shareholder or individual.
- No substantial part of the organization's activities consists of carrying on propaganda or otherwise attempting to influence legislation. IRC Section 501(h) provides a limited exception to the general rule that public charities may not incur expenditures to influence legislation.
- The organization does not participate or intervene in any political campaign on behalf of, or in opposition to, any candidate for public office.

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

8.90 Final regulations under IRC Section 501(r)² impose new requirements and clarify certain existing requirements applicable to IRC Section 501(c)(3) hospitals. The new obligations include conducting a community health needs assessment at least once every three years and adopting an implementation strategy to respond to the needs identified by the assessment, establishing a financial assistance policy, meeting requirements related to limitation of charges and complying with billing and collection practices requirement. Non-compliance with these regulations can result in fines and loss of tax-exempt status.

8.91 FASB ASC 954-740-50-1 requires that an NFP health care entity disclose its tax-exempt status.

8.92 Health care entities must file annual information returns (Form 990) with the IRS. Most states also have their own registration and filing requirements, some of which include using Form 990 as part of an annual report. In 2008, the IRS issued a completely revised Form 990 with expanded reporting requirements in the areas of governance and compensation of officers, directors, and other key employees. Other changes include an increased focus on the determination of public charity status and public support, supplemental financial statement reporting, and fundraising. Separately, the *IRS Exempt Organizations (TE/GE) Hospital Compliance Project Final Report*, issued in February 2009, places increased emphasis on community benefit reporting and executive

² Refer to Internal Revenue Bulletin 2015-5 at www.irs.gov/irb/2015-5_irb/ar08.html.

compensation. Additional changes are expected because of health care reform, which is discussed further in chapter 1 of this guide.

Private Inurement and Intermediate Sanctions

8.93 Under IRC Section 501(c)(3), no part of the net earnings of the charitable organization shall inure to the benefit of any private shareholder, individual, or insider. A private shareholder, individual, or insider refers to a person(s) having a private or personal interest in the activities of the organization. *Insiders* are individuals with a personal or private interest in the organization, such as governing board members, officers, certain employees, and substantial contributors. The IRS has stated that physicians have a personal or private interest in the activities of a health care organization and could be subject to the private inurement proscription. Transactions between insiders and NFPs are permitted, but the NFP has the burden of proving that the transactions do not result in private inurement. The NFP must be able to satisfy the IRS that the transaction was reasonable, was adequately documented, had independent approval, and did not violate any law or regulation. Employee compensation can create an inurement problem if it is judged to be unreasonably high.

8.94 The IRS instituted intermediate sanctions regulations that allow the IRS to penalize the individuals who received and approved the excess benefit transactions. The intermediate sanctions regulations are designed to curtail excess benefits (private inurement) provided to individuals with substantial influence over the affairs of the NFP (organizational insiders). The intermediate sanctions regulations provide the IRS with the ability to punish those who participate in private inurement (excess benefit) transactions. An insider (generally, certain members of management, officers, physicians, and board members) is subject to a 25 percent tax or up to 200 percent if the amount of an excess benefit is not repaid within a certain period of time. However, even if an insider does not benefit from the transaction, he or she may be subject to the 10 percent tax if he or she knowingly and willfully approved a transaction subsequently determined by the IRS to be an excess benefit transaction.

Unrelated Business Income

8.95 Although NFPs may be exempt from federal income tax, they 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 organization'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, qualifications and exceptions exist.

State and Local Taxes

8.96 Tax-exempt entities may also be subject to property taxes or other state and local business and occupancy taxes. Exemptions from state and local sales, real estate, and other taxes vary from jurisdiction to jurisdiction and may be different than for federal taxes. Entities are generally subject to the laws of the state of incorporation, as well as the laws of states in which they conduct

significant activities. Each state's laws govern exemption from its taxes and should be consulted for the applicable definitions and requirements.

Tax Positions

8.97 The tax considerations discussed in this chapter often result in an entity or its for-profit or NFP subsidiaries making a determination about whether a transaction or event must be reported in a tax return. The term *tax position* refers to a position in a previously-filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods. The term *tax position* encompasses, but is not limited to, the following:

- An entity's status, including its status as a tax-exempt NFP
- A decision to classify a transaction, entity, or other position in a tax return as tax exempt or subject to a lower rate of tax
- A decision not to file a tax return, such as a decision that Form 990-T need not be filed
- The characterization of income, such as a characterization of income as passive, or a decision to exclude reporting taxable income in a tax return
- An allocation or a shift of income between jurisdictions (federal, state, local, or foreign)

8.98 The validity of a tax position is a matter of tax law. It is not controversial to recognize the benefit of a tax position in financial statements when the degree of confidence is high that the tax position will be sustained upon examination by a taxing authority. However, in some cases, the law is subject to varied interpretation, and whether a tax position will ultimately be sustained may be uncertain. FASB ASC 740-10-25-6 limits the recognition of uncertain tax positions to only those positions that are more likely than not, based on the technical merits, to be sustained upon examination.

Medicaid Voluntary Contribution or Taxation Programs

8.99 The Medicaid program is set up on a state-by-state basis to provide medical assistance to the indigent. Although state administered, the program is actually a joint federal and state program for which the federal government funds a portion of the cost. Under this arrangement, the federal government matches a percentage of the total amount paid by the state to health care entities. This matching is referred to as federal financial participation. States have attempted to increase the amount of federal matching funds for which they are eligible by increasing the amount of medical assistance they provide. In order to pay for the increased medical assistance, some states have imposed a tax on health care entities or sought donations or other voluntary payments from them, or both. As a result, the states have been able to generate additional federal matching funds without expending additional state funds.

8.100 Q&A section 6400.30, "Accounting for Transactions Involving Medicaid Voluntary Contribution or Taxation Programs" (AICPA, *Technical Questions and Answers*), notes that the accounting for these types of programs is dependent on the individual facts and circumstances. For example, if a guarantee exists that specific monies given to the state by the health care entity will be returned to the entity from the state, those amounts should be recorded

as receivables. In addition, if the health care entity has met all the requirements to be legally entitled to additional funds from the state, the revenue or gain should be recognized. However, if the monies go into a pool with other contributions that are then disbursed based on factors over which the health care entity has little or no control, the payments should be recognized as an expense. Any subsequent reimbursements would be recognized as revenue or gain when the entity is entitled to them and payment is assured. Care should be taken to avoid delayed recognition of expenses or improperly recognizing contingent gains. Because of the complexities that are involved, it may be necessary for the health care entity to consult with legal counsel.

Risks and Uncertainties

8.101 FASB ASC 275-10-50-1 requires entities to include in their financial statements information about risks and uncertainties in the following areas as of the date of those statements:

- The nature of their operations, including the activities in which the entity is currently engaged if principal operations have not commenced
- Use of estimates in the preparation of financial estimates
- Certain significant estimates
- Current vulnerability due to certain concentrations

8.102 FASB ASC 275-10-50-6 requires discussion of estimates when, based on known information available before the financial statements are issued or available to be issued, as discussed in FASB ASC 855-10-25, it is reasonably possible that the estimate will change in the near term, and the effect of the change will be material. The estimate of the effect of a change in a condition, situation, or set of circumstances that existed at the date of the financial statements should be disclosed, and the evaluation should be based on known information available before the financial statements are issued or available to be issued.

8.103 Examples of estimates that may be included in financial statements of health care entities that are particularly sensitive to changes in the near term include, but are not limited to, the following:

- Third-party revenue and related receivables
- Provision for bad debts
- Obligation by continuing care retirement communities to provide future services and the use of facilities to current residents
- IBNR relating to medical malpractice and prepaid health care services liabilities
- Accruals for loss contracts under managed care agreements
- 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 amounts reported for pensions and postemployment benefits³
- Estimated net proceeds recoverable or the provisions for expected loss to be incurred, or both, on the disposition of a business or assets

8.104 In the health care environment, it is almost always 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). Paragraph .07 of Statement of Position (SOP) 00-1, *Auditing Health Care Third-Party Revenues and Related Receivables* (AICPA, *Professional Standards*, AUD sec. 20), provides examples of risks unique to the government-contracting environment that make it difficult to estimate net realizable third-party revenues and receivables. For most entities with significant third-party revenues, the effect of the change could be material to the financial statements. When material exposure exists, the uncertainty regarding revenue realization is disclosed in the notes to the financial statements. A sample disclosure is presented in paragraph .37 of SOP 00-1. Among other things, the sample disclosure indicates that laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, at least a reasonable possibility exists that recorded estimates will change by a material amount in the near term.⁴

8.105 FASB ASC 275-10-50-16 requires that financial statements disclose certain concentrations (those described in the following paragraph) if, based on information known to management before the financial statements are issued or available to be issued, as discussed in FASB ASC 855-10-25, all of the following criteria are met:

- The concentration exists at the date of the financial statements.
- The concentration makes the entity vulnerable to the risk of a near-term severe impact.
- It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

8.106 Examples of concentrations that may meet those criteria and that require disclosure in the financial statements of health care entities include the following:

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

³ The American Society of Actuaries (ASA) annually updates the mortality improvement scale by releasing new Mortality Tables incorporating additional years of Social Security Administration Data. Using data from these tables may represent a change in assumption that materially affects the reported amounts related to pensions and post-employment benefits. Defined benefit plan sponsors are responsible for determining plan assumptions including mortality rates. FASB *Accounting Standards Codification* (ASC) 715-30-35-42 and FASB ASC 715-60-35-71 require that each significant assumption used shall reflect the "best estimate" with respect to that individual assumption. Auditors should consider whether the assumptions used by management and actuaries represent best estimates appropriate to the mortality tables issued by the ASA.

⁴ Statement of Position (SOP) 00-1, *Auditing Health Care Third-Party Revenues and Related Receivables* (AICPA, *Professional Standards*, AUD sec. 20), provides guidance to independent auditors regarding uncertainties inherent in health care revenue recognition. SOP 00-1 is included as supplement A, "Statement of Position 00-1, *Auditing Health Care Third-Party Revenues and Related Receivables*," of 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 licenses or other rights used in the entity's operations
- Concentrations in the market or geographic area in which an entity conducts its operations

8.107 FASB ASC 275-10-50-20 requires health care entities to disclose the percentage of the labor force covered by a collective bargaining agreement and the percentage of labor force covered by a collective bargaining agreement that will expire within one year.

Auditing Contingencies and Other Liabilities

8.108 Auditing objectives and procedures for contingencies and other liabilities generally are similar to those of other entities. The independent auditor may need to consider the specific auditing objectives, selected control activities, and auditing procedures presented in exhibit 8-1.

Auditing Medical Malpractice Loss Contingencies

8.109 Although this chapter focuses on medical malpractice loss contingencies, the auditing objectives and procedures that are discussed also are relevant to other self-insured obligations. The existence of an insurance policy, by itself, is no assurance that malpractice contingencies are assumed by others. The independent auditor should review the insurance contracts and determine the extent of the risk retained by the entity. 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 that the entity has obtained.
- Determine if the coverage actually provides for the recovery of losses from 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 retained risk is understood, the independent auditor will be able to determine the nature, extent, and timing of other auditing procedures.

8.110 Paragraph 8.36 discusses the conditions for which an insured health care entity can recognize a receivable for expected insurance recoveries, even though tail coverage has not been purchased at the balance sheet date. In evaluating the amount of the receivable, the independent auditor should consider the extent to which the claim liability is insurable under the coverage. The receivable cannot be recognized if the insured entity did not have the unilateral option to purchase the tail coverage at the balance sheet date and record as an expense the premium for the tail coverage. See paragraphs 8.34–.36 for a discussion of accounting for claims-made insurance policies and tail coverage.

8.111 Management's intent to renew a claims-made policy is not sufficient to recognize a receivable for expected insurance recoveries 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 purchase and expense tail coverage applies even if state regulations require that renewal of claims-made coverage be offered continually.

8.112 If the health care entity discounts accrued malpractice claims, the auditor should consider whether that discounting is appropriate (for example, that the conditions in paragraph 8.25 are met). The auditor should consider tests of the estimates of the amount and timing of cash payments based on the health care entity's specific experience. The auditor should also consider whether the discount rate is reasonable. Paragraph 41 of FASB Concepts Statement No. 7 and paragraphs 12–13 of FASB ASC 835-30-25 provide general principles for present value measurements and determining an appropriate discount rate. Also, see paragraph 8.26 for additional discussion on determining an appropriate discount rate.

Auditing Accounting Estimates

8.113 Management is responsible for making the accounting estimates that are included in the financial statements. Management is also responsible for providing proper disclosure of (a) the use of estimates in the preparation of financial statements and (b) certain significant estimates.⁵ The independent auditor is responsible for evaluating the reasonableness of management's estimates and the adequacy of the related disclosures. AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (AICPA, *Professional Standards*), provides guidance to auditors on obtaining and evaluating sufficient appropriate audit evidence to support significant accounting estimates in an audit of financial statements in the context of the applicable financial reporting framework. Based on the assessed risks of material misstatement, paragraph .12 of AU-C section 540 states that the auditor should determine

- a. whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate and
- b. whether the methods for making the accounting estimates are appropriate and have been applied consistently and whether changes from the prior period, if any, in accounting estimates or the method for making them are appropriate in the circumstances.

8.114 In evaluating management's estimates of asserted and unasserted claims, the independent auditor should consider factors such as management's description and evaluation of asserted 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 and unasserted claims arising from reported and unreported incidents.

8.115 Paragraph .15 of AU-C section 580, *Written Representations* (AICPA, *Professional Standards*), requires the auditor request management to provide written representations that all known actual or possible litigation and claims

⁵ See paragraphs 8.62–.76.

whose effects should be considered by management when preparing the financial statements have been disclosed to the auditor and accounted for in accordance with the applicable financial reporting framework.

8.116 Paragraph .16 of AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items* (AICPA, *Professional Standards*), states the auditor should design and perform audit procedures to identify litigation, claims, and assessments involving the entity that may give rise to a risk of material misstatement, including

- a. inquiring of management and, when applicable, others within the entity, including in-house legal counsel;
- b. obtaining from management a description and evaluation of litigation, claims, and assessments that existed at the date of the financial statements being reported on and during the period from the date of the financial statements to the date the information is furnished, including an identification of those matters referred to legal counsel;⁶
- c. reviewing minutes of meetings of those charged with governance; documents obtained from management concerning litigation, claims, and assessments; and correspondence between the entity and its external legal counsel; and
- d. reviewing legal expense accounts and invoices from external legal counsel.

8.117 Unless the audit procedures required by paragraph .16 of AU-C section 501 indicate that no actual or potential litigation, claims, or assessments that may give rise to a risk of material misstatement exist, the auditor should, in addition to the procedures required by other AU-C sections, seek direct communication with the entity's external legal counsel. The auditor should do so through a letter of inquiry prepared by management and sent by the auditor requesting the entity's external legal counsel to communicate directly with the auditor. 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. 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 potential range of loss. Paragraph .24 of AU-C section 501 requires the auditor to modify the opinion in the auditor's report, in accordance with AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report* (AICPA, *Professional Standards*), if (a) the entity's legal counsel refuses to respond appropriately to the letter of inquiry and the auditor is unable to obtain sufficient appropriate audit evidence by performing alternative audit procedures or (b) management refuses to give the auditor permission to communicate or meet with the entity's external legal counsel.

8.118 The independent 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 a basis for an accrual exists, the independent

⁶ For purposes of this section, the term *legal counsel* refers to the entity's in-house legal counsel and external legal counsel.

auditor should then determine whether the entity's prior history supports the estimation of the number of claims and probable settlement value.

Use of Actuaries and Actuarial Methods

8.119 Developing the estimate of the medical malpractice loss amount often requires special skill or knowledge. In the auditor's judgment, the work of a specialist may be required to obtain appropriate audit evidence. An actuary may be engaged by management to help prepare or review management's 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 skill or knowledge is required to estimate the claim liability.

8.120 If an actuary is involved in a substantial way in determining the amount of an entity's malpractice self-insurance liability, the independent auditor should follow the requirements of AU-C section 620, *Using the Work of an Auditor's Specialist* (AICPA, *Professional Standards*). Paragraph .09 of AU-C section 620 states the auditor should evaluate whether the auditor's specialist has the necessary competence, capabilities, and objectivity for the auditor's purposes. In the case of an auditor's external specialist, the evaluation of objectivity should include inquiry regarding interests and relationships that may create a threat to the objectivity of the auditor's specialist. Based on the guidance in paragraph .11 of AU-C section 620, the auditor should agree, in writing when appropriate, with the auditor's specialist regarding

- a. the nature, scope, and objectives of the work of the auditor's specialist;
- b. the respective roles and responsibilities of the auditor and the auditor's specialist;
- c. the nature, timing, and extent of communication between the auditor and the auditor's specialist, including the form of any report to be provided by the auditor's specialist; and
- d. the need for the auditor's specialist to observe confidentiality requirements.

8.121 Paragraph .12 of AU-C section 620 requires the auditor to evaluate the adequacy of the work of the auditor's specialist for the auditor's purposes, including

- a. the relevance and reasonableness of the findings and conclusions of the auditor's specialist and their consistency with other audit evidence.
- b. if the work of the auditor's specialist involves the use of significant assumptions and methods,
 - i. obtaining an understanding of those assumptions and methods and
 - ii. evaluating the relevance and reasonableness of those assumptions and methods in the circumstances, giving consideration to the rationale and support provided by the specialist, and in relation to the auditor's other findings and conclusions.

- c. if the work of the auditor's specialist involves the use of source data that is significant to the work of the auditor's specialist, the relevance, completeness, and accuracy of that source data.

If the auditor determines that the work of the auditor's specialist is not adequate for the auditor's purposes, the auditor should

- a. agree with the auditor's specialist on the nature and extent of further work to be performed by the auditor's specialist or
- b. perform additional audit procedures appropriate to the circumstances.

8.122 The independent auditor should perform an appropriate test of the accounting data provided to the actuary by the client. 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. Other factors that might be considered include inflation rates, judicial decisions assessing liability and noneconomic damages, changes in legislation affecting payment levels and settlement practices, changes in the entity's experience or trends in loss reporting and settlements, divergence in an entity's experience relative to industry experience, reinsurance programs and changes therein, and recent catastrophic occurrences.

Evaluating Lawyers' Responses

8.123 Determining the outcome of pending or threatened litigation, claims, and assessments, including unasserted claims and assessments, normally is beyond the independent auditor's professional competence. Accordingly, the independent 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 independent auditors' inquiries. However, the ABA statement is not enforceable by the ABA in the same way that 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.

8.124 Paragraph .A65 of AU-C section 501 includes the following examples of evaluations concerning litigation that may be considered to provide sufficient clarity that the likelihood of an unfavorable outcome is remote, even though they do not use that term, are the following:

- "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."

8.125 On the other hand, the lawyer may use terms, such as *meritorious defenses*, that have different meanings to different lawyers. Paragraph .A65 of AU-C section 501 includes the following examples of legal counsel's 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 counsel'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 client's counsel, 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," and similar terms indicate more uncertainty than an opinion that the company will prevail.)

8.126 If the auditor is uncertain about the meaning of the legal counsel's evaluation, clarification either in a follow-up letter or conference with the legal counsel and entity, appropriately documented, may be appropriate. If the legal counsel is still unable to give an unequivocal evaluation of the likelihood of an unfavorable outcome in writing or orally, the auditor is required by AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*), to determine the effect, if any, of the legal counsel's response on the auditor's report.

Income Taxes

8.127 The auditor should perform procedures to determine whether the health care entity has obtained a qualifying income tax exemption from the appropriate governmental authority and whether disclosures relating to the entity's tax-exempt status are appropriate.

Auditing Considerations

8.128 The auditor may need to consider the examples of specific audit objectives, specific control objectives, and substantive audit procedures for contingencies and other liabilities that are presented in exhibit 8-1.

Exhibit 8-1

The following table illustrates the use of assertions in developing audit objectives and designing substantive tests. The examples are not intended to be all-inclusive nor is it expected that all the procedures are necessarily applied in an audit. Irrespective of the assessed risks of material misstatement, paragraph .18 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), states the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. The use of assertions in assessing risks and designing appropriate audit procedures to obtain audit evidence is described in paragraphs .26–.32 of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*). Various audit procedures and the purposes for which they may be performed are described in paragraphs .A10–.A26 of AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*).

Audit Considerations

Financial Statement Assertions	Specific Audit Objectives	Specific Control Objectives⁷	Substantive Audit Procedures⁸
Malpractice Loss Contingencies			
Existence and occurrence, completeness, rights and obligations, and valuation	The liability for malpractice claims is properly reported in the balance sheet.	Insurance coverage is reviewed regularly, including the financial viability of the insurer. The risk-management system identifies and monitors malpractice incidents and evaluates associated losses.	Review the amount of insurance coverage, the type of coverage (claims made or occurrence), the deductible provisions, and so on to determine the level of risk that is retained by the entity. Consider the financial viability of the insurance carrier.

(continued)

⁷ The auditor should consider a combination of preventive and detective controls responsive to the control objectives.

⁸ The auditor should determine the nature, timing, and extent of substantive procedures to perform, considering, for example, the results of tests of controls and risk areas.

Audit Considerations—continued

Financial Statement Assertions	Specific Audit Objectives	Specific Control Objectives	Substantive Audit Procedures
		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 AU-C section 501, <i>Audit Evidence—Specific Considerations for Selected Items</i> (AICPA, <i>Professional Standards</i>).
		The adequacy of malpractice accruals is regularly reviewed 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 generally accepted accounting principles.	Review and test the method of estimating accruals (for example, review actuarial reports and prior historical loss experience). If the accrual is discounted, review and test the present value calculation, including the reasonableness of the inputs. Determine that additional premiums charged by insurers for retrospectively-related policies are reported as a liability.
		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 independent auditor's report.

Audit Considerations—continued

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
Presentation and disclosure	The program of medical malpractice insurance coverage and the basis for any loss accruals are adequately disclosed in the financial statements.		
<i>Income Taxes</i>			
Rights and obligations	The NFP has obtained a qualifying income tax exemption from the appropriate governmental authority.	Management monitors compliance with applicable tax regulations. Transactions are reviewed for their effect on the tax status and tax liabilities, including IRC Section 4958.	Determine that the NFP has obtained a determination of its tax-exempt status. Consider the effect of new, expanded, or unusual activities on the NFP's tax status. Inquire if tax returns have been filed on a timely basis. Determine the status of the tax returns under examination. Read the prior year's tax returns. Read the minutes and accounting for evidence of significant unrelated business activities. Review for reasonableness the unrelated business income tax liability. Review transactions with <i>disqualified persons</i> , as defined in IRC Section 4958.

(continued)

Audit Considerations—continued

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
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 9

Net Assets (Equity)

Investor-Owned Health Care Entities

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

Not-for-Profit Entities

© Update 9-1 *Accounting and Reporting: Presentation of Financial Statements for Not-for-Profit Entities*

FASB Accounting Standards Update (ASU) No. 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*, issued in August 2016, is effective for annual financial statements issued for fiscal years beginning after December 15, 2017, and for interim periods within fiscal years beginning after December 15, 2018. Early application of the amendments is permitted.

FASB ASU No. 2016-14 makes significant changes to the reporting model for not-for-profit (NFP) health care entities. This edition of the guide has not been updated to reflect changes as a result of this ASU, however, the sections that follow will be updated in a future edition.

Refer to appendix H, "The New Not-for-Profit Financial Reporting Model Standards: FASB ASU No. 2016-14," of this guide for more information on this ASU. Readers are also encouraged to consult the full text of the ASU on FASB's website at www.fasb.org.

9.02 The FASB ASC glossary defines *net assets* as "[t]he excess or deficiency of assets over liabilities of a not-for-profit (NFP) entity, which is classified into three mutually exclusive classes according to the existence or absence of donor-imposed restrictions."¹

9.03 As a residual interest, net assets cannot be measured independently of an NFP's assets and liabilities. Changes in net assets result from transactions and other events and circumstances in which total assets and total liabilities change by different amounts. In many NFPs, such changes include nonreciprocal transfers of assets received from donors who do not expect to receive either repayment or proportionate economic benefit in return. See chapter 11, "Contributions Received and Made," of this guide for further discussion. Display of, and disclosures about, net assets and changes in them are intended to assist donors and other users in assessing an entity's efforts to provide goods and services to its constituencies, its efficiency and effectiveness in providing such services, and its continuing ability to do so.

9.04 Changes in net assets result from revenue, expenses, gains, losses, and equity transfers; those changes are discussed in other chapters of this

¹ Although some health care entities may use other terms, such as *equity*, this guide uses the term *net assets* to describe the residual interest.

guide. This chapter describes the principles for reporting total net assets in statements of financial position and changes in total net assets in statements of operations, as well as related disclosures.

Net Asset Classes

9.05 Paragraphs 9–11 of FASB ASC 958-210-45 provide guidance for the classification of net assets. According to FASB ASC 958-210-45-1, the statement of financial position (balance sheet) of an NFP health care entity should focus on the entity as a whole and report separate amounts for each of three classes of net assets: (a) permanently-restricted net assets, (b) temporarily-restricted net assets, and (c) unrestricted net assets.² Net assets are included in one of the three classes depending on the presence and type of donor-imposed restrictions.

9.06 The FASB ASC glossary defines a *donor-imposed restriction* as

[a] donor stipulation that specifies a use for a contributed asset that is more specific than the broad limits resulting from the following:

- a. The nature of the not-for-profit entity (NFP)
- b. The environment in which it operates
- c. The purposes specified in its articles of incorporation or bylaws or comparable documents for an unincorporated association.

A donor-imposed restriction on an NFP's use of the asset contributed may be temporary or permanent. Some donor-imposed restrictions impose limits that are permanent, for example, stipulating that resources be invested in perpetuity (not used up). Others are temporary, for example, stipulating that resources may be used only after a specified date, for particular programs or services, or to acquire buildings and equipment.

9.07 In addition to the three classes of net assets—permanently restricted, temporarily restricted, and unrestricted—further disaggregation of total net assets may also be reported. For example, unrestricted net assets may be subdivided into board-designated net assets and undesignated net assets. Donor-imposed restrictions limit an NFP health care entity's ability to use or dispose of specific contributed assets or the economic benefits embodied in those assets. Donor stipulations should not be considered restrictions, unless they include limitations on the use of contributed assets that are more specific than the broad limits imposed by the NFP health care entity's purpose, the environment in which it operates, and its nature.

9.08 As explained in FASB ASC 958-210-45-6, generally, restrictions apply to net assets, not specific assets. However, assets may be restricted by donors. For example, land could be restricted to use as a public park.

Permanently-Restricted Net Assets

9.09 The FASB ASC glossary defines *permanently restricted net assets* as

² As explained in FASB *Accounting Standards Codification* (ASC) 958-210-55-3, FASB ASC 958, *Not-for-Profit Entities*, encourages the use of the terms *unrestricted*, *temporarily restricted*, and *permanently restricted net assets*; however, other labels exist. For example, *equity* may be used for net assets, and *other* or *not donor restricted* may be used with care to distinguish unrestricted net assets from the temporarily and permanently restricted classes of net assets.

[t]he part of net assets of a not-for-profit entity (NFP) resulting from the following:

- a. Contributions and other inflows of assets whose use by the NFP is limited by donor-imposed stipulations that neither expire by passage of time nor can be fulfilled or otherwise removed by the actions of the NFP
- b. Other asset enhancements and diminishments subject to the same kinds of stipulations
- c. Reclassifications from or to other classes of net assets as a consequence of donor-imposed stipulations.

9.10 Permanently-restricted net assets must be maintained by the NFP health care entity in perpetuity. For example, contributions of cash or securities restricted by the donor with the stipulation that they be invested in perpetuity (donor-restricted endowment funds) are recognized as increases in permanently-restricted net assets.

9.11 Permanently-restricted net assets also may change as a result of increases and decreases in assets that are subject to permanent restrictions. FASB ASC 958-205-45-18 provides the following examples. If a donor stipulates that net gains be added to the principal of its gift until that endowed gift plus accumulated gains increases to a specified dollar level, the gains are permanently restricted. Similarly, if a donor states that a specific investment security must be held in perpetuity, the gains and losses on that security are subject to that same permanent restriction, unless the donor specifies otherwise. However, if a donor allows the NFP to choose suitable investments, the gains are not permanently restricted, unless the donor or law requires that an amount be permanently retained.

Temporarily-Restricted Net Assets

9.12 The FASB ASC glossary defines *temporarily restricted net assets* as [t]he part of the net assets of a not-for-profit entity (NFP) resulting from the following:

- a. Contributions and other inflows of assets whose use by the NFP is limited by donor-imposed stipulations that either expire by passage of time or can be fulfilled and removed by actions of the NFP pursuant to those stipulations
- b. Other asset enhancements and diminishments subject to the same kinds of stipulations
- c. Reclassification from or to 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 NFP pursuant to those stipulations.

9.13 Temporarily-restricted net assets are those net assets whose use by the NFP health care entity have been limited by donors to (a) later periods or after specified dates or (b) specified purposes.³ For example, contributions restricted by the donor to be used by the entity over the next five years or

³ As described in paragraph 11.13 of this guide, contributions received with restrictions that are met in the same reporting period may be reported as unrestricted if the health care entity discloses its policy and consistently reports from period to period.

support a specific future program are recognized as increases in temporarily-restricted net assets. Contributions of assets, such as equipment or buildings, that by their nature are used up over time and that the donor stipulates must be used by the entity also are recognized as increases in temporarily-restricted net assets. Paragraphs 9.25–.31 discuss the temporarily-restricted net assets of endowment funds.

9.14 Temporarily-restricted net assets also may change as a result of increases and decreases in assets or the economic benefits embodied in those assets that are subject to donor-imposed temporary restrictions. For example, as explained in paragraphs 9.28–.29, if a donor has stipulated that assets be held in perpetuity as a donor-restricted endowment fund, the net appreciation of those assets and their income are temporarily restricted until appropriated for expenditure by the NFP health care entity.

Unrestricted Net Assets

9.15 The FASB ASC glossary defines *unrestricted net assets* as

[t]he part of net assets of a not-for-profit entity (NFP) that is neither permanently restricted nor temporarily restricted by donor-imposed stipulations. The only limits on the use of unrestricted net assets are the broad limits resulting from the following:

- a. The nature of the NFP
- b. The environment in which the NFP operates
- c. The purposes specified in the NFP's articles of incorporation or bylaws
- d. Limits resulting from contractual agreements with suppliers, creditors, and others entered into by the NFP in the course of its business.

Unrestricted net assets generally result from revenues from providing services, producing and delivering goods, receiving unrestricted contributions, and receiving dividends or interest from investing in income-producing assets, less expenses incurred in providing services, producing and delivering goods, raising contributions, and performing administrative functions.

9.16 In accordance with FASB ASC 958-210-50-2, information about significant limits resulting from contractual agreements with suppliers, creditors, and others, including the existence of loan covenants, generally is provided in the notes to the financial statements. FASB ASC 958-210-45-11 states that information about self-imposed limits also may be useful, including information about voluntary resolutions by the governing board of an entity to designate a portion of its unrestricted net assets to function as an endowment (sometimes called a board-designated endowment). That information may be presented in notes to, or on the face of, the financial statements.

9.17 For example, a health care entity might include information about voluntary resolutions to designate a portion of its unrestricted net assets for funded depreciation.

9.18 FASB ASC 958-810-45-1 states that non-controlling interests⁴ in the equity (net assets) of consolidated subsidiaries should be reported as a separate component of the appropriate class of net assets in the consolidated statement of financial position of an NFP. That amount should be clearly identified and described (for example, as non-controlling ownership interest in subsidiaries) to distinguish it from the components of net assets of the parent, which includes the parent's controlling financial interest in its subsidiaries. The effects of donor-imposed restrictions, if any, on a partially-owned subsidiary's net assets should be reported in accordance with FASB ASC 958-205 and 958-320. Paragraphs 17–25 of FASB ASC 958-810-55 illustrate one way in which the consolidated financial statements of a hospital might satisfy the presentation and disclosure requirements for non-controlling interests in a consolidated subsidiary and subsequent changes in ownership interests of that subsidiary.

Reclassifications

9.19 FASB ASC 958-225-45-13 states that reclassifications of net assets (that is, simultaneous increases in one net asset class and decreases in another) should be made if any of the following events occur: (a) the NFP fulfills the purposes for which the net assets were restricted, (b) donor-imposed restrictions expire with the passage of time or death of a split-interest agreement beneficiary⁵ (if the net assets are not otherwise restricted), (c) a donor withdraws or court action removes previously-imposed restrictions, or (d) donors impose restrictions on otherwise unrestricted net assets.

9.20 For example, the amount of a donor's contribution that must be used by the health care entity for a specified program would be reclassified from temporarily-restricted to unrestricted net assets in the period in which the health care entity conducts the program. A purpose restriction is often fulfilled when the entity incurs an expense or recognizes a liability to a vendor to acquire goods or services that satisfies the restriction.

9.21 FASB ASC 958-205-45-9 states that if two or more temporary restrictions are imposed on a contribution, the effect of the expiration of those restrictions should be recognized in the period in which the last remaining restriction has expired. Expirations of donor-imposed restrictions are reported as reclassifications, decreasing temporarily-restricted net assets and increasing unrestricted net assets. In accordance with FASB ASC 958-225-45-3, reclassifications of amounts between net asset classes are reported separately from other transactions in the statement of operations.

9.22 As explained in FASB ASC 958-205-45-11, if an expense is incurred for a purpose for which both unrestricted and temporarily-restricted net assets are available, a donor-imposed restriction is fulfilled to the extent of the incurred expense, unless the expense is for a purpose that is directly attributable

⁴ A *non-controlling interest* is the portion of equity in a subsidiary that is not directly or indirectly attributable to a parent.

⁵ FASB ASC 958-30 provides guidance for reporting arrangements under which a not-for-profit (NFP) shares the benefits of assets with other beneficiaries (a split-interest agreement). Those other beneficiaries generally are not NFPs. For example, a donor may give an NFP the right to receive all or a portion of the specified cash flows from a charitable trust or other identifiable pool of assets that is held either by the NFP or an unrelated third party, such as a bank, trust company, foundation, or private individual. Chapter 6, "Split-Interest Agreements and Beneficial Interests in Trusts," of the Audit and Accounting Guide *Not-for-Profit Entities* provides additional guidance on split-interest gifts.

to another specific external source of revenue. Temporarily-restricted net assets with time restrictions are not available to support expenses until the time restrictions have expired.

9.23 For example, an employee's salary may meet donor-imposed restrictions to support the activity on which the employee is working. In that situation, the restriction is met to the extent of the incurred salary expense, unless incurring the salary will lead to inflows of revenue from a specific external source, such as revenue from a cost reimbursement contract or a conditional promise to give that becomes unconditional when the health care entity incurs the salary expense.

9.24 As explained in FASB ASC 954-210-50-1 and 954-205-45-9, health care entities are prohibited from implying a time restriction that expires over the useful life of a donated long-lived asset. Thus, if contributions of long-lived assets with explicit donor restrictions are reported as temporarily-restricted support, a health care entity reports expirations of those donor restrictions when the stipulation is fulfilled, and the assets are placed in service. Similarly, donations of cash or other assets that must be used to acquire long-lived assets are reported as temporarily-restricted support in the period that they are received, and expirations of those donor restrictions are reported when the acquired long-lived assets are placed in service, and donor-imposed restrictions are satisfied.

9.25 In some circumstances, NFPs correct net asset classifications previously reported in prior years' financial statements due to an error in recognition, measurement, or classification resulting from mathematical mistakes, mistakes in the application of accounting principles generally accepted in the United States of America, or oversight or misuse of facts that existed at the time the financial statements were prepared. Technical Question and Answer (Q&A) section 6140.23, "Changing Net Asset Classifications Reported in a Prior Year" (AICPA, *Technical Questions and Answers*), states that the individual net asset classes, rather than net assets in the aggregate (total net assets), are relevant in determining whether an entity's correction of net asset classifications previously reported in prior years' financial statements is an error in previously issued financial statements. Q&A section 6140.23 quotes paragraph 106 of FASB Concepts Statement No. 6, *Elements of Financial Statements*, and paragraph 74 of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations* (which was not codified in FASB ASC), noting that "[s]ince donor-imposed restrictions affect the types and levels of service a not-for-profit organization can provide, whether an organization has maintained certain classes of net assets may be more significant than whether it has maintained net assets in the aggregate."

Classification of Donor-Restricted Endowment Funds

9.26 The FASB ASC glossary defines a *donor-restricted endowment fund* as "[a]n endowment fund that is created by a donor stipulation requiring investment of the gift 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." FASB ASC 958-205-45-14 states that when classifying an endowment fund, each source—original gift, gains and losses, and interest and dividends—must be evaluated separately. Each source is unrestricted, unless its use is temporarily or permanently restricted by explicit donor

stipulations or law. Thus, an endowment fund that is created by a governing board from unrestricted net assets is classified as unrestricted because all three sources are free of donor restrictions. If an endowment fund is created by a donor, the donor may have placed different restrictions on each of the three sources. Classification of the original gifts and the income earned by endowments generally is straightforward because, usually, donors explicitly state any time or purpose restrictions on those two sources. Determining how to classify gains on endowments may not be as easy because agreements with donors often are silent on how gains should be used and whether losses must be restored immediately from future gains or not at all.

9.27 FASB ASC 958-205-05-9 notes that because donor stipulations and laws vary, NFPs must assess the relevant facts and circumstances for their endowment gifts and relevant laws to determine if net appreciation on endowments is available for spending or permanently restricted. Paragraphs 13–35 of FASB ASC 958-205-45 provide guidance for reporting the net assets of endowment funds and the changes in those net assets. The guidance for states that have enacted a version of the Uniform Prudent Management of Institutional Funds Act (UPMIFA) is summarized in the following four paragraphs, but it is not intended as a substitute for reading the standards themselves.

9.28 An NFP that is subject to an enacted version of UPMIFA should classify a portion of a donor-restricted endowment fund of perpetual duration as permanently-restricted net assets. The amount classified as permanently restricted should be either (a) the amount of the fund that must be permanently retained in accordance with explicit donor stipulations, as explained in paragraphs 3–4 of FASB ASC 958-605-45, or (b) the amount of the fund that, in the absence of explicit donor stipulations, the NFP's governing board determines must be permanently retained (preserved), consistent with the relevant law or regulation, as explained in FASB ASC 958-205-45-21.

9.29 The relevant law of a state that has enacted a version of UPMIFA may include the limitation "[u]nless stated otherwise in the gift instrument, the assets in an endowment fund are donor-restricted assets until appropriated for expenditure by the institution," which is from subsection 4(a) of UPMIFA. For each donor-restricted endowment fund for which the restriction described in subsection 4(a) of UPMIFA applies, an NFP should classify the portion of the fund that is not classified as permanently-restricted net assets as temporarily-restricted net assets (time restricted) until appropriated for expenditure by the NFP.

9.30 Upon appropriation for expenditure, the time restriction expires to the extent of the amount appropriated and, in the absence of any purpose restrictions, results in a reclassification of that amount to unrestricted net assets. If the fund is also subject to a purpose restriction, the reclassification of the appropriated amount to unrestricted net assets would not occur until that purpose restriction also has been met, in accordance with the guidance beginning in FASB ASC 958-205-45-9. Pursuant to FASB ASC 958-205-45-11, temporarily-restricted net assets with time restrictions are not available to support expenses until the time restrictions have expired.

9.31 In the absence of donor stipulations or law to the contrary, losses on the investments of a donor-restricted endowment fund should reduce temporarily-restricted net assets to the extent that donor-imposed temporary restrictions on net appreciation of the fund have not been met before a loss

occurs. Any remaining loss should reduce unrestricted net assets. The amount of permanently-restricted net assets is not reduced by losses on the investments of the fund or an NFP's appropriations from the fund. If losses or, as UPMIFA states, appropriations 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 should be classified as increases in unrestricted net assets. After the fair value of the assets of the endowment fund equals the required level, gains that are restricted by the donor should be classified as increases in temporarily-restricted or permanently-restricted net assets, depending on the donor's restrictions on the endowment fund.

9.32 Paragraphs 3.16, 4.21, and 4.30 of this guide provide information about whether the income, gains, and losses of donor-restricted endowment funds are included or excluded from the performance indicator.

Disclosure

9.33 FASB ASC 958-210-45-9 requires that information about the nature and amounts of different types of permanent or temporary restrictions be provided either by reporting their amounts on the face of the financial statements or including relative details in the notes to financial statements.

9.34 For example, information about the following would be shown on the face of the financial statements or in the notes:

- Different kinds of permanent restrictions, such as specific assets to be held in perpetuity and assets that have been contributed by donors with stipulations that they be invested in perpetuity
- Different kinds of temporary restrictions, such as those concerning the support of specific operating activities, use in specific future periods, or acquisition of long-term assets

9.35 Separate disclosures of significant limitations other than those imposed by donors, such as those imposed by governing boards or regulatory bodies, are permitted to be made on the face of the financial statements or in the notes to the financial statements.

9.36 Paragraphs 1A–2A of FASB ASC 958-205-50 require disclosures for both donor-restricted and board-designated endowment funds. A health care entity should disclose information about net asset classification, net asset composition, changes in net asset composition, spending policies, and related investment policies.

9.37 FASB ASC 958-810-50-1 requires that if consolidated financial statements are presented, the reporting entity (parent) should disclose any restrictions made by entities outside of the reporting entity on distributions from the controlled NFP (subsidiary) to the parent and any resulting unavailability of the net assets of the subsidiary for use by the parent.

Auditing

9.38 The independent auditor may need to consider the examples of specific audit objectives, specific control objectives, and substantive audit procedures relating to net assets (equity) that are presented in exhibit 9-1.

Exhibit 9-1

The following table illustrates the use of assertions in developing audit objectives and designing substantive tests. The examples are not intended to be all-inclusive nor is it expected that all the procedures are necessarily applied in an audit. Irrespective of the assessed risks of material misstatement, paragraph .18 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), states the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. The use of assertions in assessing risks and designing appropriate audit procedures to obtain audit evidence is described in paragraphs .26–.32 of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*). Various audit procedures and the purposes for which they may be performed are described in paragraphs .A10–.A26 of AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*).

Audit Considerations

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i> ⁶	<i>Substantive Audit Procedures</i> ⁷
Net Assets (Equity)			
Account Balances			
Rights and obligations	Resources are used and accounted for in accordance with donor and grantor restrictions.	Management monitors compliance with these restrictions.	Review donor agreements and other documentation supporting recognition of contribution revenues noting information such as whether the donor imposed any conditions or restrictions or whether the entity

(continued)

⁶ The auditor should consider a combination of preventative and detective controls responsive to the control objectives.

⁷ The auditor should determine the nature, timing, and extent of substantive procedures to perform, considering, for example, the results of the tests of controls and risk areas.

Audit Considerations—continued

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
			might be acting as an agent. Also review the minutes of board and board committee meetings for evidence of donor restrictions. Examine expenses and expenditures to determine whether restrictions on net assets have been released when used in accordance with donor restrictions.
<i>Presentation and Disclosure</i>			
Classification and understandability	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.
	Temporarily-restricted net assets are reclassified as unrestricted net assets when donor-imposed restrictions have been fulfilled.	Controls ensure that reclassification of temporarily-restricted net assets occurs when donor-imposed restrictions have been fulfilled.	Determine compliance with donor and grantor restrictions. Test expenditures to determine that restricted net assets are used for their restricted purposes.
			Determine that appropriate reclassifications are reported in the statement of activities when donor-imposed restrictions have been fulfilled.

Chapter 10

Health Care Service Revenue and Related Receivables

© Update 10-1 *Accounting and Reporting: FASB Accounting Standards Codification (ASC) 606, Revenue from Contracts with Customers*

FASB Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers*, as amended, provides a framework for revenue recognition and supersedes or amends several of the revenue recognition requirements in FASB ASC 605, *Revenue Recognition*, as well as guidance within the industry-specific topics, including FASB ASC 954, *Health Care Entities*, and FASB ASC 958, *Not-for-Profit Entities*. The standards apply to any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance or lease contracts).

The effective date of the new revenue standards for health care entities is dependent on the type of reporting entity, as follows:

- Health care entities that are either public business entities or not-for-profit entities (NFPs) that have issued, or are conduit bond obligors for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market are required to apply the standards for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Earlier application by those entities is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.
- All other health care entities are required to apply the guidance in FASB ASU No. 2014-09 to annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. Earlier application by those health care entities is permitted only as of an annual reporting period beginning after December 15, 2016, including interim reporting periods within that reporting period, or an annual reporting period beginning after December 15, 2016, and interim reporting periods within annual reporting periods beginning one year after the annual reporting period in which an entity first applies the guidance in FASB ASU No. 2014-09.

Readers are encouraged to consult the full text of FASB ASU No. 2014-09 on FASB's website at www.fasb.org.

The AICPA has formed 16 industry task forces to assist in developing a new accounting guide on revenue recognition that will provide helpful hints and illustrative examples for how to apply the new standard. Revenue recognition implementation issues identified by the Health Care Entities Revenue Recognition Task Force will be available for informal comment, after review

by the AICPA Financial Reporting Executive Committee, at www.aicpa.org/interestareas/frc/accountingfinancialreporting/revenuerecognition/pages/rrtf-healthcare.aspx. Readers are encouraged to submit comments to revrecomments@aicpa.org.

For more information, see appendix C, "The New Revenue Recognition Standard: FASB ASC 606," of this guide.

This edition of the guide has not been updated to reflect changes as a result of FASB ASC 606, however, the section that follows will be updated in a future edition.

Overview of the Health Care Environment

10.01 A unique aspect of the health care industry is the involvement of multiple parties in the provision of, and payment for, health care services. Multiple parties may be involved in a health care service transaction, including the following:

- The patient who receives the care
- The physician who orders the services on behalf of the patient
- The health care entity that provides the setting or administers the treatment (for example, hospital or home health company)
- The third-party payor(s) that provides payment to the health care entity on behalf of the patient

10.02 The third-party payor may be a government program, such as Medicare or Medicaid; a health maintenance organization (HMO), a commercial insurer, such as a managed care plan or company; a preferred provider organization (PPO); a religious healthcare aid fund, or a self-funded employer plan. In managed care entities, the physician, health care entity, and third-party payor may all be part of the same reporting entity.

10.03 The extent to which third-party payors are involved in paying for services varies by type of health care entity. For hospitals, rehabilitation facilities, and home health companies, third-party payors generally pay for the majority of services provided to patients. In the nursing home sector, a portion of the patients are considered private pay (that is, the patient or his or her family pays for the care), and Medicaid is the dominant third-party payor for care provided to low-income individuals. Minimal commercial insurance coverage exists for nursing home care, and Medicare provides limited nursing home benefits for short stays. In continuing care retirement communities (CCRCs), the residents generally pay entrance and monthly service fees, and third-party payor involvement is limited to the payment of some services provided in the nursing care portion of the facility.

10.04 Revenue recognition and the valuation of related receivables of health care entities are subject to inherent uncertainties and complexities, including the following:

- Rate setting with third-party payors, including settlements that are not known with certainty until after a considerable period of time has elapsed after the related services were rendered
- The regulations and laws that governmental third-party payments are based on
- The determination of what constitutes charity care

Rate Setting With Third-Party Payors

10.05 Third-party payors generally do not pay the health care entity's full established rates. The paid amount may be based on government regulations for Medicare, Medicaid, and other government programs or contractual arrangements for PPOs, HMOs, workers' compensation insurers, and commercial insurers. Further, payment rates and coverages vary by payor.

10.06 As noted in FASB ASC 954-605-05-5, payment rates established by regulations or contractual agreements may be determined either prospectively or retrospectively. Some rate-setting methods described as prospective, such as the Medicare Prospective Payment System (PPS), may include provisions for retrospective adjustments (for example, billing denials, coding changes, and cost report settlements with third-party payors). Some third-party payors pay prospective rates for certain services and retrospective rates for other services.

10.07 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-party payors 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 payor, 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.

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

10.09 When rates are subject to retrospective adjustments, the amounts of the final settlements may not be known with certainty until a considerable period of time has elapsed from when the related services were rendered. Reasonable estimates of such settlements are central to the revenue recognition process in health care in order to avoid recognizing revenue that the health care entity will not ultimately realize or failing to recognize revenues that will ultimately be realized. 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 events. The estimation process is further complicated by the complexities of billing and reimbursement regulations. Estimating revenues from third-party payors is discussed in paragraphs 10.20–24.

10.10 FASB ASC 954-605-25-9 requires that rate-setting methods that are described as prospective but provide for retrospective adjustments be accounted for as retrospective rate-setting systems for the services to which they apply.

The Government Payor Environment

10.11 The largest third-party payor in the United States is the federal government, which pays for health care services through its Medicare, Medicaid, TRICARE, and Federal Employees Health Benefits programs. Most institutional health care providers and many managed care plans serve Medicare or Medicaid beneficiaries, or both, to some extent. The provider's relationship with the government is defined by regulations written by government agencies and enforced by an elaborate oversight network of government auditors and

contract administrators. For example, Medicare administers its own contracts and subcontracts audits and claims processing functions to private-sector Medicare Administrative Contractors (MACs) and Recovery Audit Contractors (RACs). The laws and regulations on which they are based are inherently political and subject to frequent change and differing interpretations.

10.12 Health care entities doing business with governmental payors (for example, Medicare and Medicaid) are subject to the following risks that are unique to the government payor environment, that are hard to anticipate and quantify, and that may vary from entity to entity:

- A health care entity's revenues and allowable costs may be subject to adjustment as a result of examination by government agencies or contractors. The audit process and 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 MACs and RACs (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.
- Otherwise valid claims may subsequently be determined to be nonallowable due to differing opinions on medical necessity.
- Claims for rendered services may be nonallowable if they are later determined to have been based on inappropriate referrals.
- Government agencies may make changes in program interpretations, requirements, or conditions of participation, some of which may have implications for previously-estimated amounts.
- Certain states determine rates of payment for Medicaid payments in accordance with the statewide rate-setting method, which is different from the method used by the federal government.
- Government agencies have the right to withhold or reduce contract payments for an extended period of time.
- Health care entities may receive add-on payments for serving a disproportionately high percentage of low-income patients.
- Extensive and complex reimbursement methodologies exist for teaching institutions.
- New regulations have introduced a number of complex value-based and risk-based reimbursement programs.

10.13 As a result of such risks, retrospective adjustments can be difficult to estimate with respect to governmental payors. The delay between rendering services and reaching final settlement, as well as the complexities and ambiguities of billing and reimbursement regulations, make it difficult to estimate net patient service revenue associated with government programs. However, despite the difficulty, health care entities paid through programs subject to retrospective adjustments need to estimate amounts that ultimately will be realized in order for revenues associated with those payment systems to be fairly stated in accordance with generally accepted accounting principles (GAAP). Estimating revenues from government programs is discussed in paragraphs 10.20–.24.

10.14 In addition, risks may result from the applicability of certain laws that provide for potentially significant penalties to be assessed if the health care provider violates them. For example, a health care provider that submits a false claim to the government may be subject to penalties ranging from a monetary penalty for each submitted false claim to suspension or exclusion from the program. Thus, noncompliance could result in a material contingent liability, a material loss of future revenue, or cause the health care entity to be unable to continue as a going concern.

Charity Care

10.15 The FASB ASC glossary states that "[c]harity care represents health care services that are provided but are never expected to result in cash flows. Charity care is provided to a patient with demonstrated inability to pay. Each entity establishes its own criteria for charity care consistent with its mission statement and financial ability." Distinguishing charity care from bad debt requires appropriate policies and procedures to evaluate the facts of a particular patient account and the exercise of judgment. Charity care is discussed further in paragraphs 10.25–.29.

Types of Health Care Revenue

10.16 In accordance with FASB ASC 954-605-45-1, health care revenue should be classified based on the type of services rendered or contracted to be rendered. Examples include the following:

- Patient service revenue, which is derived from amounts earned in exchange for providing services to patients
- Resident service revenue, which is derived from amounts charged to residents of a long-term care facility, such as a skilled nursing facility or CCRC¹
- Capitation revenue, which is derived from capitation-type arrangements with third-party payors by which amounts are earned by agreeing to provide services to qualified beneficiaries, not necessarily as a result of actually providing the care²
- Premium revenue, which is the primary source of revenue of prepaid health care plans³
- Refundable and nonrefundable advance fees received by certain types of CCRCs⁴

Types of Payment Methodologies

10.17 Common payment methodologies utilized by third-party payors include the following:

- *Fee-for-service*. Under fee-for-service arrangements, payment is based on the specific services that are provided to the patient;

¹ Refer to chapter 14, "Financial Accounting and Reporting by Continuing Care Retirement Communities," of this guide for additional information.

² Refer to chapter 13, "Financial Accounting and Reporting for Managed Care Services," of this guide for additional information.

³ See footnote 2.

⁴ See footnote 1.

therefore, the health care entity earns revenue as a result of providing those services. Payment may be based on the health care entity's full established rates, with a predetermined discounted rate (for example, percent of charges), or based on a fee schedule agreed to by the health care entity and third-party payor.

- *Per diem.* Under a per diem arrangement, the health care entity is paid a flat rate per day of inpatient care, regardless of the level of intensity of the care provided. Therefore, revenue is earned as a result of the patient occupying an inpatient bed for a particular day. The Medicare PPS for skilled nursing facility services is an example of a per diem methodology. The arrangement specifies the manner in which partial days of care, such as the day of admission or discharge, will be paid, and revenue for those days is recognized accordingly. A prorated payment may be made for a partial day of care. Alternatively, the terms of the payor's policy may provide for a full payment for the day of admission and pay nothing for the day of discharge.
- *Per case.* When payment is made on a per-case basis, the health care entity is paid a predetermined amount based on the patient's discharge category. The Medicare PPS for hospital inpatient services is an example of a per-case payment methodology. Under per-case payment, revenue is earned as a result of the patient receiving treatment from the health care entity. If the contract calls for payment on a per-case basis, and the patient is hospitalized at the end of the reporting period, a portion of the total revenue for the case will be earned in one period, with the balance earned in the next period. In such situations, the total revenue for the case is allocated between the two accounting periods using an allocation method that fairly apportions the revenue between periods.
- *Episodic.* Under an episodic payment methodology, the health care entity is paid a predetermined amount for services provided to patients during an episode of care (for example, a stipulated period of time). Generally, revenue is earned based on the passage of time. Medicare's PPS for home health services is an example of an episodic payment methodology. Certain episodic payments are referred to as *bundled payments*. A bundled payment is a single payment to providers or health care facilities (or jointly to both) for all services to treat a given condition or provide a given treatment. In a bundled payment methodology, a single, bundled payment covers services delivered by two or more providers during a single episode of care or over a specific period of time. Bundled payment arrangements are a type of risk-contracting (see risk-based contracts within this bulleted list.)
- *Capitation.* Generally, capitation payments are received at the beginning of each month and obligate the health care entity to stand ready to render covered services during the month. Capitation revenue is earned as a result of agreeing to provide services to qualified beneficiaries, not as a result of actually providing the care. If the health care entity's accounting system records patient charges and establishes patient receivables as services are rendered,

appropriate valuation allowances or adjustments are recorded, so only the amount of capitation revenue is reported.

- *Risk-based contracts.* Under a risk-based contract, the provider agrees to furnish specified health care services for a negotiated price, which may be an amount per episode, case, bundle, service, or day. The price may vary based on the volume of services furnished during the contract period. As an alternative, the provider may contract to provide all defined health care services to a specific beneficiary group in return for a predetermined fee. A risk-based contract may also provide for a sharing of risk, designed to create financial incentives to the providers and, in some instances, to the third-party payor, to improve quality and control costs. Examples of risk-based contracts can be shared savings/shared loss contracts, risk pools and pay-for-performance contracts. Other risk-based contracts may be any combination of the preceding examples.

Patient (or Resident) Service Revenue

Revenue Recognition

10.18 Paragraph 83 of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, provides a general rule that revenue is earned when an entity has substantially accomplished what it must do to be entitled to those revenues.

10.19 With respect to third-party payor arrangements, governmental regulations or contractual terms will specify the performance requirements or conditions that the health care entity must meet in order to be entitled to revenue under the contract or provider agreement. Regulations or contracts also will address payment terms and the degree of risk that is to be assumed by the health care entity. Consequently, a thorough understanding of the terms of the health care entity's arrangements with significant third-party payors is important for appropriate revenue recognition.

Estimating Revenue Related to Government Programs and Other Third-Party Payors

10.20 The amount of revenue earned under arrangements with government programs is determined under complex rules and regulations that subject the health care entity to the potential for retrospective adjustments in future years. Several years may elapse before all potential adjustments related to a particular fiscal year are known and before the amount of revenue to which the health care entity is entitled is known with certainty. As noted in paragraph .10 of Statement of Position (SOP) 00-1, *Auditing Health Care Third-Party Revenues and Related Receivables* (AICPA, *Professional Standards*, AUD sec. 20), management makes a reasonable estimate of amounts that ultimately will be realized, considering, among other things, adjustments associated with regulatory reviews, future program audits, billing reviews, investigations, or other proceedings. In making these estimates, management also considers the potential for regulatory investigations that may result in the denial of otherwise valid claims for payment. These matters are discussed in SOP 00-1, which, among

other matters, provides guidance to auditors regarding uncertainties inherent in third-party revenue recognition.⁵

10.21 As noted in paragraph .06 of SOP 00-1, health care entities need to estimate amounts that ultimately will be realizable in order for revenues to be fairly stated in accordance with GAAP. Thus, in the period in which services are rendered, health care entities estimate the amount to which they ultimately will be entitled for providing those services and report that amount as revenue. The difference between that estimated amount and the amount of payments received prior to the balance sheet date is reflected as a receivable or payable in the balance sheet. The difference between gross patient service revenues and the estimated realizable amount includes contractual adjustments, policy discounts and other discounts, and adjustments that adjust gross service revenues, excluding charity care, to arrive at net patient service revenue in the statement of operations. The relationship between various amounts can be depicted as follows:⁶

Gross charges	XXX,XXX
Less charges associated with charity patients	(XX,XXX)
Gross patient service revenue	<u>XXX,XXX</u>
Less deductions from revenue:	
Contractual adjustments	(XXX,XXX)
Policy and other discounts	(XX,XXX)
Patient service revenue (net of contractual adjustments and discounts)	<u>XXX,XXX</u>
Less provision for bad debts	(XX,XXX)
Net patient service revenue less provision for bad debts ⁷	<u><u>XXX,XXX</u></u>

10.22 Management's estimates relating to third-party contractual adjustments are based on subjective, as well as objective, factors. This requires judgment that normally is based on management's knowledge of, and experience with, past and current events and its assumptions about conditions that it expects to exist and courses of action that it expects to take.

10.23 Approaches for making estimates of third-party contractual adjustments vary from entity to entity, depending on individual facts and circumstances. Some entities with significant prior experience may attempt to quantify the effects of individual potential intermediary or other governmental (for example, Office of Inspector General or Department of Justice) or private payor

⁵ Statement of Position (SOP) 00-1, *Auditing Health Care Third-Party Revenues and Related Receivables* (AICPA, *Professional Standards*, AUD sec. 20), is included as supplement A, "Statement of Position 00-1, *Auditing Health Care Third-Party Revenues and Related Receivables*," of this guide.

⁶ This example assumes the health care entity recognizes significant amounts of patient service revenue at the time the services are rendered even though it does not assess the patient's ability to pay, in accordance with FASB *Accounting Standards Codification* (ASC) 954-605-45-4. An illustration of presentation in the statement of operations appears in FASB ASC 954-605-55-2. See paragraph 10.34 of this guide.

⁷ See paragraph 10.34 of this guide.

adjustments based on detailed calculations and assumptions regarding potential future adjustments. Some entities may prepare cost report analyses⁸ to estimate the effect of potential adjustments. Other entities 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.

10.24 In some situations (for example, Medicare or Medicaid provider agreements), payments received under contracts with third-party payors are subject to adjustment after the contract term is completed, based on findings of audits, reviews, or investigations. In such cases, net service revenue also includes a provision for estimated future retrospective adjustments. Such provisions are recorded on an estimated basis in the period that the related services are rendered and adjusted in future periods as additional information is obtained or adjustments become known, or both. The provision is subsequently adjusted as events occur that change the estimate of realized revenue. Such adjustments have the potential to materially affect the health care entity's financial position and results of operations. Accounting for the subsequent adjustments is discussed beginning at paragraph 10.46.

Charity Care

10.25 Each health care entity establishes its own criteria for charity care consistent with its mission statement, its financial ability, the current economy, and other circumstances. In some instances, prior to any care being provided, a health care entity is able to obtain information regarding a patient's financial status and determine whether that patient meets the health care entity's criteria for uncompensated care. If so, the patient is classified as charity prior to receiving treatment. In other cases, such as trauma care, patient financial information may not be available at the time service is provided to the patient. A health care entity may provide care because it either is required to do so by law (for example, emergency care) or chooses to do so, with the understanding that a charity care application will be completed in the future.

10.26 FASB ASC 954-605-25-10 states that charity care does not qualify for recognition as revenue in the financial statements. Distinguishing charity care from bad-debt expense requires the exercise of judgment. Only the portion of a patient's account that meets the health care entity's charity care criteria is recorded as charity. As noted in FASB ASC 954-605-25-11, although it is not necessary for the entity to make this determination upon admission or registration of an individual, the entity determines at some point whether the individual meets the established criteria for charity care.

10.27 This determination is made as quickly as practicably possible, generally before any substantial collection effort is initiated. Charity care does not include contractual adjustments that result from third-party arrangements, such as Medicare, Medicaid, government funding programs, or other third-party arrangements, because the health care entity has accepted the payment terms for the services provided. In addition, charity care does not include

⁸ 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 Administrative Contractors. To estimate the effects of potential adjustments, some health care entities prepare a cost report based on alternative assumptions.

discounts given to uninsured or underinsured patients if those patients do not qualify under the health care entity's charity care policy.

10.28 Pursuant to FASB ASC 954-605-50-3, management's policy for providing charity care, as well as the level of charity care provided, should be disclosed in the financial statements. The level of charity care provided should be measured based on the health care entity's direct and indirect costs of providing charity care services. If costs cannot be specifically attributed to services provided to charity care patients (for example, based on a cost accounting system), management may estimate the costs of those services using reasonable techniques. For example, one such estimation technique might involve calculating a ratio of cost to gross charges and then multiplying that ratio by the gross uncompensated charges associated with providing care to charity patients. Other reasonable techniques also are permitted. The method used to identify or estimate such costs should be disclosed. Funds received to offset or subsidize charity services provided (for example, from gifts or grants restricted for charity care or from an uncompensated care fund) also should be separately disclosed.

Estimating Revenue Related to Care Not Covered by Third-Party Payors

10.29 A patient is generally responsible for the portion of a health care entity's charges not paid by third-party payors, after any contractual adjustments have been applied. This self-pay portion of revenue comprises revenue for services provided to uninsured patients, insurance copays and deductibles, as well as noncovered services (for example, cosmetic surgery). Estimating revenue for the self-pay portion may be challenging, but as noted in paragraph .06 of SOP 00-1, health care entities need to estimate amounts that ultimately will be realizable in order for revenues to be fairly stated in accordance with GAAP. The predominant industry practice for reporting revenue from self-pay patients is to recognize gross service revenue for those patients at the health care entity's gross charges (that is, full established billing rates) when the services are provided less any discounts provided and adjust for bad debts based on collection assessments. If the health care entity offers a discount to uninsured patients, those discounts are recorded as a reduction to gross service revenues, so that the resulting net service revenue is recorded in the statement of operations. The provision for bad debts is recognized based on collection assessments and presented as discussed in the following paragraphs. No revenue is recognized for patients identified as receiving charity care services.

Accounting and Financial Reporting Requirements

10.30 Per FASB ASC 954-605-25-3, in general, gross service revenue is recorded in the accounting records on an accrual basis at the health care entity's established rates, regardless of whether the health care entity expects to collect that amount.

10.31 Gross service revenues are internally recorded as services are rendered. Any difference between the established rates for provided services and amounts agreed to under agreements with third-party payors is accounted for as a contractual adjustment. An estimate of the contractual adjustment is recorded in the same period that the services were provided. In addition, some health care entities offer discounts (for example, a discount to uninsured patients who do not qualify for charity care, prompt pay, or employee discounts). The discount also is recorded in the same period that the services are provided.

Thus, internal records will generally reflect the gross patient service revenues offset by the contractual adjustments and discounts.

10.32 Per FASB ASC 954-605-25-4, the provision for contractual adjustments (that is, the difference between established rates and third-party payors' payments) and discounts (that is, the difference between established rates and the amount billable) are recognized on an accrual basis and deducted from gross services revenue to determine net service revenue. For financial reporting purposes, FASB ASC 954-605-45 requires that revenue be classified based on the type of rendered service and that service revenue, including patient service revenue, be reported net of contractual and other adjustments in the statement of operations.

10.33 In accordance with FASB ASC 954-605-25-6, estimates of contractual adjustments, other adjustments, and the allowance for uncollectibles should be 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 any one of the following: (a) when the patient 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. Also, as discussed in paragraph 10.26, charity care does not qualify for recognition as revenue in the financial statements.

10.34 As set forth in FASB ASC 954-605-45-4, some health care entities may perform services for patients for which the ultimate collection of all or a portion of the amounts billed or billable cannot be determined at the time services are rendered. For example, some health care entities have a policy of providing services to patients and recording patient service revenue regardless of their ability to pay and, in some cases (for example, hospital emergency departments), are required by law to treat emergency conditions regardless of a patient's ability to pay. As a result, those health care entities might record revenue along with a relatively high bad debt provision in the period of service. A health care entity that recognizes significant amounts of patient service revenue at the time the services are rendered even though it does not assess the patient's ability to pay should present all of the following as separate line items on the face of the statement of operations:

- a. Patient service revenue (net of contractual allowances and discounts)
- b. The provision for bad debts⁹ (the amount related to patient service revenue and included as a deduction from patient service revenue)
- c. The resulting net patient service revenue less the provision for bad debts

10.35 As further stated in FASB ASC 954-605-45-5, bad debts that should continue to be presented as an operating expense in the statement of operations are the following:

- a. Bad debts related to receivables from revenue other than patient service revenue

⁹ For presentation of bad debts in consolidated financial statements, refer to Technical Question and Answer (Q&A) section 6400.47, "Application of Accounting Standards Update No. 2011-07, *Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities*, in *Consolidated Financial Statements*" (AICPA, *Technical Questions and Answers*).

- b.* Bad debts related to receivables from patient service revenue if the entity only recognizes revenue to the extent it expects to collect that amount

10.36 FASB ASC 954-310-50-3 also states a health care entity that recognizes significant amounts of patient service revenue at the time the services are rendered even though it does not assess the patient's ability to pay should disclose both of the following for interim and annual periods:

- a.* Its policy for assessing the timing and amount of uncollectible patient service revenue recognized as bad debts by major payor source of revenue. Major payor sources of revenue should be identified by the entity and be consistent with how the entity manages its business (for example, how it assesses credit risk). For example, one entity's accounting system may classify patient accounts receivables arising from deductibles and coinsurance as part of third-party receivables, another may classify deductibles and coinsurance as self-pay receivables, and another may classify deductibles and coinsurance as either third-party or self-pay receivables on the basis of which party has the primary remaining financial responsibility.
- b.* Qualitative and quantitative information about significant changes in the allowance for doubtful accounts related to patient accounts receivable. This may include information such as significant changes in estimates and underlying assumptions, the amount of self-pay writeoffs, the amount of third-party payor writeoffs, and other unusual transactions impacting the allowance for doubtful accounts.

Premium and Capitation Revenues

10.37 As noted in FASB ASC 954-605-05-6, 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. These revenues are premium revenues, not patient service revenues, because they are earned by agreeing to provide care, regardless of whether services are rendered.

10.38 FASB ASC 954-405-25-1 states that if a capitation contract obligates the health care entity to assume the risk of physician referrals and other outside services, a liability for unpaid claims, including incurred but not reported claims, should be established. A lag analysis may be helpful in estimating the liability.

10.39 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.

10.40 In accordance with FASB ASC 954-605-45-3, significant revenue earned under capitation arrangements should be reported separately.

Patient Receivables

© Update 10-2 *Accounting and Reporting: Financial Instruments—Credit Losses*

FASB ASU No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, issued June 2016, is effective for public business entities that are SEC filers for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. For all other public business entities, the amendments are effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years.

For all other health care entities, including NFP health care entities, the amendments are effective for fiscal years beginning after December 15, 2021.

All entities may adopt the amendments earlier as of the fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

The amendments in this ASU replace the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, the section that follows will be updated in a future edition.

Readers are encouraged to consult the full text of the ASU on FASB's website at www.fasb.org.

10.41 Patient receivables may include amounts due (a) from patients, third-party payors, and employers for provided health care services and (b) for premiums and stop-loss insurance recoveries. Premiums and stop-loss insurance recoveries are discussed in chapter 13, "Financial Accounting and Reporting for Managed Care Services," of this guide.

10.42 In accordance with FASB ASC 954-310-30-1, contractual adjustments, discounts, and an allowance for uncollectibles should be recorded to initially measure the receivables for health care services at net realizable value. FASB ASC 954-605-25-6 explains that estimates of contractual adjustments, other adjustments, and the allowance for uncollectibles should be reported in the period during which the services are provided, even though the actual amounts may become known at a later date. FASB ASC 954-310-45-1 states that 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 should be reported separately in the financial statements.

10.43 Accounts receivable of health care entities generally are subject to the same financial disclosure requirements as those of other business entities. Health care entities with loans and trade receivables follow the presentation and disclosure guidance in FASB ASC 310-10 to the extent that guidance is applicable.

10.44 Paragraphs 20–22 of FASB ASC 825-10-50 set forth disclosure requirements concerning 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 entities tend to treat patients from their local or surrounding communities. Accordingly, disclosure is made of the primary service area of patients. It should be noted that concentrations of credit risk may be a significant issue in stand-alone financial statements issued for a member hospital of a large, national multihospital 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.

10.45 Off-balance-sheet risk exists when the potential accounting loss from a financial instrument is not reflected on the balance sheet. Health care entities (most notably hospitals) may enter into arrangements to factor or securitize their patient accounts receivable as a cash flow management strategy or to manage their concentrations of customer credit risk. These arrangements may not qualify for sale transactions under the criteria of FASB ASC 860, *Transfers and Servicing*. Consequently, the patient accounts receivable and the corresponding financing obligation should be reflected on the balance sheet of the health care entity. Health care entities should follow the presentation and disclosure guidance in paragraphs 9–10 of FASB ASC 310-10-50 regarding credit losses on off-balance-sheet instruments to the extent that guidance is applicable.

Estimated Final Settlements

10.46 Under a retrospective rate-setting system, a health care entity may be entitled to receive additional payments or required to refund amounts received in excess of amounts earned under the system. Although final settlements are not made until a subsequent period, as discussed in paragraphs 10.20–24, they are generally subject to reasonable estimation and reported in the financial statements in the period in which services are rendered.

10.47 For example, as noted in FASB ASC 954-310-05-3, some third-party payors retrospectively determine final amounts that are reimbursable for services rendered to their beneficiaries based on allowable costs. These payors reimburse the health care entity 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 that are different from the interim payment rates. Final settlements are determined after the close of the fiscal periods to which they apply.

10.48 The balance sheet accounts "Settlements Due to Third-Party Payors" and "Settlements Due From Third-Party Payors" reflect management's best estimate of amounts expected to be payable or receivable. As a result of the complex nature of government reimbursement rules and the fact that settlements may occur years after the services are provided, it is not unusual for actual settlement amounts to differ significantly from estimated amounts.

10.49 FASB ASC 954-605-35-1 requires that differences between original estimates and subsequent revisions, including final settlements, be included

in the period in which the revisions are made. FASB ASC 954-605-50-2 states that those differences should be disclosed. Those differences are not treated as restatements of prior periods, unless they meet the definition of an *error in previously issued financial statements*, as defined in FASB ASC 250, *Accounting Changes and Error Corrections*.

10.50 As explained in paragraphs .15 and .17 of SOP 00-1, the fairness or reasonableness of the financial statement presentation of estimates is not dependent on the outcome of the uncertainty (for example, management's ability to predict the future with accuracy) but, rather, on the quality and nature of the evidence supporting management's assertions at the time that the estimate is made. The fact that future events may differ materially from management's assumptions or estimates does not necessarily mean that management's estimates were not reasonable or valid at the time that they were made.

10.51 The likelihood for subsequent revisions of estimates, coupled with their potential material effect on the financial statements, generally requires disclosure in accordance with FASB ASC 275-10-50. Such disclosures might include the significance of government program revenues to the entity's overall revenues and a description of the complex nature of applicable laws and regulations indicating that the possibility of future government review and interpretation exists. Paragraph .37 of SOP 00-1 provides a sample disclosure for the possibility of material differences between an original estimate and subsequent revisions.

10.52 FASB ASC 275-10-50-6 states that a discussion of estimates is required when, based on known information available before the financial statements are issued or available to be issued, it is reasonably possible that the estimate will change in the near term, and the effect of the change will be material. The estimate of the effect of a change in a condition, situation, or set of circumstances that existed at the date of the financial statements should be disclosed, and the evaluation should be based on known information available before the financial statements are issued or available to be issued. In addition, FASB ASC 954-405-50-1 states that, with regard to contractual adjustments and third-party settlements, identification and explanation of the estimated amounts that are payable by the entity should be disclosed.

10.53 FinREC recommends that the following additional disclosures also be included in the financial statements:

- Disclose settlement amounts due to and from each significant third-party payor.
- For each significant third-party payor, provide a summary of activity for each operating period. The summary would distinguish settlements relating to prior years from those relating to the current year's activity and would identify current-year changes to settlement amounts estimated in prior periods.
- Disclose the status of third-party settlement claims.

10.54 Settlements due to or from third-party payors should be classified as current or noncurrent, depending on the expected timing of the settlements based on the guidance in FASB ASC 210-10-45. Settlements can be netted only if a right of setoff exists, as described in FASB ASC 210-20-45.

Auditing

10.55 In general, receivables, arising from the provision of health care services, are material to the financial position of health care entities. Examples of specific auditing objectives, specific control objectives, and substantive audit procedures that may be considered by the independent auditor as they relate to the major components of receivables of health care entities are presented in exhibit 10-1.

10.56 SOP 00-1 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. SOP 00-1 is included as supplement A, "Statement of Position 00-1, *Auditing Health Care Third-Party Revenues and Related Receivables*," of this guide.

Considerations for Audits Performed in Accordance With PCAOB Standards

PCAOB Staff Audit Practice Alert No. 12, *Matters Related to Auditing Revenue in an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.12), highlights certain requirements of PCAOB standards related to aspects of auditing revenue. PCAOB Staff Audit Practice Alerts are neither rules of the PCAOB nor have they been approved by the PCAOB.

10.57 Paragraphs .17–.18 of SOP 00-1 state that the auditor's judgment regarding the sufficiency and appropriateness of the evidence is based on the evidence 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 the evidence is sufficient and appropriate and supports management's assertions about the valuation of revenues and receivables and of bad debts versus charity care and their respective presentation and disclosure in the financial statements, an unmodified opinion is generally appropriate. The inability to obtain relevant audit evidence may require the auditor to express a qualified opinion or disclaim an opinion because of a scope limitation.

Accounts Receivable Confirmations

10.58 Generally, the amount receivable for a patient's care is not determinable until the medical coding process is complete; thus, alternative procedures, rather than confirmation, are performed for receivables from patients for whom care is continuing. Further, 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 or final billed may be impracticable because those patients may not yet know the amount of their indebtedness. However, there may be instances in which direct confirmation may be an appropriate audit procedure to obtain evidence about the existence and accuracy of receivable amounts.

10.59 Paragraph .20 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), states that the auditor should use external confirmation procedures for accounts receivable, except when one or more of the

following is applicable: (a) the overall account balance is immaterial, (b) external confirmation procedures for accounts receivable would be ineffective, or (c) the auditor's assessed level of risk of material misstatement at the relevant assertion level is low, and the other planned substantive procedures address the assessed risk. In many situations, the use of external confirmation procedures for accounts receivable and the performance of other substantive procedures are necessary to reduce the assessed risk of material misstatement to an acceptably low level.

10.60 If confirmation of amounts that are due from patients and third-party payors is determined to be ineffective, the independent auditor should document this decision in accordance with AU-C section 330 and should perform alternative procedures such as the following:

- Performing an analytical procedure or testing the details of subsequent cash receipts
- Reviewing third-party contracts or payment agreements
- Comparing billings with documentation in medical records and census data
- Reviewing the results of third-party payor audits and, if available, independent review or internal audit reports
- Examining or confirming interim payments with third-party payors

Exhibit 10-1

The following table illustrates the use of assertions in developing audit objectives and designing substantive tests. The examples are not intended to be all-inclusive nor is it expected that all the procedures be necessarily applied in an audit. Irrespective of the assessed risks of material misstatement, paragraph .18 of AU-C section 330 states the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. The use of assertions in assessing risks and designing appropriate audit procedures to obtain audit evidence is described in paragraphs .26–.32 of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*). Various audit procedures and the purposes for which they may be performed are described in paragraphs .A10–.A26 of AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*).

Audit Considerations¹⁰

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i> ¹¹	<i>Substantive Audit Procedures</i> ¹²
Receivables for Health Care Services			
<i>Account Balances</i>			
Existence	Amounts reported in the financial statements represent valid receivables, and exclude charity care balances.	Charges are generated automatically when services are performed.	Review and test subsequent cash receipts.
		A medical record is prepared.	Compare billing information to the documentation contained in the medical records or census records.

¹⁰ SOP 00-1 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 supplement A of this guide.

¹¹ The auditor should consider a combination of preventative and detective controls responsive to the control objectives.

¹² The auditor should determine the nature, timing, and extent of substantive procedures, considering the results of tests of controls and identified risks.

Audit Considerations—continued

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
		Procedures ensure that amounts due from third-party payors for individual accounts are properly supported.	Review the independent review or internal audit, if any, and insurance company medical record 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 that charity care balances are identified and excluded from receivables.	Review the management policy for determining charity care. Review the reasonableness of charity care measurement.
Completeness	Amounts reported in the financial statements are complete and properly calculated and accumulated.	Procedures ensure that (a) detailed accounts receivable records are routinely compared with control accounts and third-party payor logs; (b) differences are investigated and reconciled; and (c) adjustments, if necessary, are promptly made.	Compare detailed accounts receivable records with control accounts and third-party payor logs, and investigate reconciling items.

(continued)

Audit Considerations—continued

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
Valuation and allocation	Receivables are reported in the financial statements at net realizable value.	Allowances for uncollectibles and contractual adjustments are periodically reviewed 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 appropriately classified by payor (for example, Medicare or self-pay) to evaluate collectibility.
			Test and analyze aged accounts receivable trial balances, collection trends, delinquent accounts, subsequent period write-offs, and economic or other factors to evaluate the reasonableness of the allowance for uncollectible accounts.

Audit Considerations—continued

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
Presentation and Disclosure			
Classification and understandability	Significant contractual arrangements with third-party payors are disclosed.	Process for preparing the financial statements includes a review for required disclosures.	Determine that significant contractual arrangements with third-party payors are disclosed.
	Policies for assessing uncollectible patient service revenue and significant changes in estimates are disclosed.		Determine that disclosures include policies for assessing uncollectible patient service revenue and significant changes in estimates of uncollectibles.
Estimated Third-Party Settlements			
Account Balances			
Existence	Amounts reported in the financial statements represent valid receivables or payables, or both.	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.

(continued)

Audit Considerations—continued

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
<i>Transactions</i>			
Completeness and accuracy and valuation and allocation	Amounts included in the financial statements are accurate and complete.	Procedures ensure that estimated third-party settlements are reasonably calculated and reported.	Test the reasonableness of settlement amounts, including valuation allowances, in light of the involved payors, 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 properly reported 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 cost report years are adequate.

Audit Considerations—continued

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
<i>Presentation and Disclosure</i>			
Classification and understandability	Amounts reported in the financial statements are properly presented, and all required disclosures are made.	Process for preparing the financial statements includes a review for required disclosures.	Determine that the retrospective nature of third-party settlement amounts is properly disclosed.
			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.
Revenue for Health Care Services			
<i>Transactions, Account Balances, Presentation, and Disclosure</i>			
Existence and occurrence, completeness, and classification and understandability	Revenue is reported in the proper period using the accrual basis of accounting and is properly classified by the type of service rendered.	Procedures help ensure that revenue is accrued as services are performed or contractual obligations are satisfied.	Compare the current period's disaggregated revenue with prior periods' revenue or budgets, or both, and obtain explanations for large or unusual variances.

(continued)

Audit Considerations—continued

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
Valuation and allocation	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 properly classified.	Controls ensure that deductions from revenue are recorded in the proper period and properly classified. Contractual and other adjustments are authorized and properly recorded. Charity care, bad-debt write-offs, and policy discounts are authorized and properly recorded.	Review the financial statements to determine that revenue is reported net of contractual adjustments and other adjustments and the provision for bad debts (the amount related to patient service revenue if health care entity that recognizes significant amounts of patient service revenue at the time the services are rendered even though it does not assess the patient's ability to pay). Test contractual adjustments, other adjustments, and bad debts to determine that they are accounted for both in accordance with the respective contracts and the entity's policy. 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

Contributions Received and Made

© Update 11-1 *Accounting and Reporting: Presentation of Financial Statements for Not-for-Profit Entities*

FASB Accounting Standards Update (ASU) No. 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*, issued in August 2016, is effective for annual financial statements for fiscal years beginning after December 15, 2017, and for interim periods within fiscal years beginning after December 15, 2018. Early application of the amendments is permitted.

FASB ASU No. 2016-14 makes significant changes to the reporting model for not-for-profit (NFP) health care entities. This edition of the guide has not been updated to reflect changes as a result of this ASU, however, the sections that follow will be updated in a future edition.

Refer to appendix H, "The New Not-for-Profit Financial Reporting Model Standards: FASB ASU No. 2016-14," of this guide for more information on this ASU. Readers are also encouraged to consult the full text of the ASU on FASB's website at www.fasb.org.

11.01 Health care entities that receive contributions are subject to the requirements of the "Contributions Received" sections of FASB ASC 958-605. Health care entities that make contributions are subject to the requirements of FASB ASC 720-25.

11.02 This chapter summarizes some of the key concepts of contributions received and made as they relate to health care entities. For a complete discussion on this topic, readers should refer to chapter 5, "Contributions Received and Agency Transactions," of the Audit and Accounting Guide *Not-for-Profit Entities*.

Distinguishing Contributions From Other Transactions

11.03 A contribution, by definition, must be a voluntary nonreciprocal transfer. Some resource providers may be required to transfer assets or provide services to health care entities involuntarily; for example, to settle legal disputes or to pay fines. Those transactions are not contributions. Accounting for contributions is different from accounting for other kinds of voluntary transfers, such as conditional transfers, agency transactions, and exchange transactions.

11.04 To determine the accounting for transactions in which an entity voluntarily transfers assets to a health care entity, it is necessary to assess the extent of discretion the health care entity has over the use of the assets that are received. If the health care entity has little or no discretion, the transaction will require evaluation to determine whether it is a donor-restricted contribution or an agency transaction. If the health care entity has discretion over the

assets' use, the transaction is a contribution, an exchange, or a combination of the two.

11.05 FASB ASC 958-605-55-4 states that foundations, business entities, and other types of entities may provide resources to health care entities 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 transferred assets or if the value received by the resource provider is incidental to the potential public benefit from using the transferred assets.

11.06 Because some exchange transactions may appear to be contributions, a careful assessment of the characteristics of the transaction from the perspectives of both the resource provider and recipient is required to determine whether the recipient of a transfer of assets has given up an asset or incurred a liability of commensurate value. Table 11-1 contains a list of indicators that may be helpful in determining whether individual asset transfers are contributions, exchange transactions, or a combination of both. Depending on the facts and circumstances, some indicators may be more significant than others; however, no single indicator is determinative of the classification of a particular transaction. Indicators of a contribution tend to describe transactions in which the value, if any, returned to the resource provider is incidental to potential public benefits. Indicators of an exchange tend to describe transactions in which the potential public benefits are secondary to the potential proprietary benefits to the resource provider.

Table 11-1

Indicators Useful in Distinguishing Contributions From Exchange Transactions

<i>Indicator</i>	<i>Contribution</i>	<i>Exchange Transaction</i>
Recipient not-for-profit entity's (NFP's) intent in soliciting the asset ^(a)	Recipient NFP asserts that it is soliciting the asset as a contribution.	Recipient NFP asserts that it is seeking resources in exchange for specified benefits.
Resource provider's expressed intent about the purpose of the asset to be provided by recipient NFP	Resource provider asserts that it is making a donation to support the NFP's programs.	Resource provider asserts that it is transferring resources in exchange for specified benefits
Method of delivery	The time or place of delivery of the asset to be provided by the recipient NFP to third-party recipients is at the discretion of the NFP.	The method of delivery of the asset to be provided by the recipient NFP to third-party recipients is specified by the resource provider.
Method of determining amount of the payment	The resource provider determines the amount of the payment.	Payment by the resource provider equals the value of the assets to be provided by the recipient NFP, or the assets' cost plus markup; the total payment is based on the quantity of assets to be provided.

Table 11-1**Indicators Useful in Distinguishing Contributions From Exchange Transactions—continued**

<i>Indicator</i>	<i>Contribution</i>	<i>Exchange Transaction</i>
Penalties assessed if NFP fails to make timely delivery of assets	Penalties are limited to the delivery of assets already produced and the return of the unspent amount. (The NFP is not penalized for nonperformance.)	Provisions for economic penalties exist beyond the amount of payment. (The NFP is penalized for nonperformance.)
Delivery of assets to be provided by the recipient NFP	Assets are to be delivered to individuals or organizations other than the resource provider.	Assets are to be delivered to the resource provider or to individuals or organizations closely connected to the resource provider.
(a) This table refers to assets. Assets may include services. The terms <i>assets</i> and <i>services</i> are used interchangeably in this table.		

11.07 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. However, if the grant is made by a pharmaceutical manufacturer that provides potential new medications to be tested in the hospital's research facilities and the manufacturer retains the right to any patents or other results, the grant would likely be an exchange transaction.

11.08 As noted in FASB ASC 958-605-55-6, a single transaction may be in part an exchange and in part a contribution. For example, if a donor transfers a building to an entity at a price significantly lower than its fair value, and no unstated rights or privileges are involved, the transaction is in part an exchange of assets and in part a contribution to be accounted for as required by the "Contributions Received" sections of FASB ASC 958-605. The Financial Reporting Executive Committee (FinREC) believes that in circumstances in which the transaction is in part a contribution and in part an exchange, NFP entities should first determine the fair value of the exchange portion of the transaction, with the residual (excess of the resources received over the fair value of the exchange portion of the transaction) reported as a contribution.

Contributions Received

11.09 FASB ASC 958-605-25-2 states that except for contributed services and art collections, contributions received should be recognized as revenues or gains in the period received and as assets, decreases of liabilities, or expenses depending on the form of the benefits received. FASB ASC 958-605-55-26 observes that contributions are received in several different forms. Generally, the contributed item is an asset, but it also can be forgiveness of a liability. The types of assets commonly contributed include cash, marketable securities, land, buildings, the use of facilities or utilities, materials and supplies, intangible assets, other goods or services, and unconditional promises to give those items in the future. FASB ASC 958-605-30-2 requires that contributions received be measured at their fair values. FASB ASC 820, *Fair Value Measurement*, establishes a framework for measuring fair value.

11.10 Accounting for contributions depends on whether the transfer of assets is received by the NFP with donor-imposed conditions, donor-imposed restrictions, or both. Donor-imposed conditions create a barrier that must be overcome before a contribution can be recognized (by definition, a contribution is unconditional). Donor-imposed restrictions do not affect recognition; instead, they affect the classification of the contribution revenue.

11.11 Contributions received without restrictions are reported as unrestricted support in the statement of operations within the performance indicator, unless they are contributions of long-lived assets. Contributions with explicit donor restrictions are reported as restricted support. Some restrictions permanently limit the NFP's use of contributed assets (for example, permanent endowments). Other restrictions are temporary in nature, limiting the NFP's use of contributed assets to (a) later periods or after specific dates (time restrictions), (b) specific purposes (purpose restrictions), or (c) both. As noted in paragraph 3.17 of this guide, items that reflect increases or decreases in temporarily-restricted or permanently-restricted net assets are reported in the statement of changes in net assets.

Expiration of Donor-Imposed Restrictions

11.12 Paragraphs 9–12 of FASB ASC 958-205-45 and FASB ASC 958-225-45-13 provide guidance for reporting reclassifications for the expiration of donor-imposed restrictions. A restriction expires when the stipulated time has elapsed, when the stipulated purpose for which the resource was restricted has been fulfilled, or both. If two or more temporary restrictions are imposed on a contribution, the effect of the expiration of those restrictions should be recognized in the period in which the last remaining restriction has expired. As explained by the example in FASB ASC 958-205-45-10A, when determining when the last of two or more temporary restrictions has expired, explicit donor stipulations generally carry more weight than implied restrictions. 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." In accordance with FASB ASC 958-225-45-3, reclassifications are presented as separate items. FASB ASC 954-225-45-7 provides guidance on the presentation of these items within or outside of the performance indicator.

11.13 FASB ASC 958-605-45-4 states that donor-restricted contributions whose restrictions are met in the same reporting period may be reported as unrestricted support, provided that an NFP has a similar policy for reporting investment gains and income as explained in FASB ASC 958-320-45-3, reports consistently from period to period, and discloses its accounting policy.

11.14 Paragraph 11.21 provides guidance for the expiration of restrictions on unconditional promises to give. Paragraphs 9.19–.24 of this guide provide guidance for the expiration of other donor-imposed restrictions.

Promises to Give in Future Periods (Pledges)

11.15 Health care entities involved in fund-raising campaigns frequently are the recipients of promises to give, with payments due in future periods. Pledge drives are a common example of these campaigns. Health care entities may also be the beneficiaries of fund-raising campaigns conducted by others.

11.16 FASB ASC 958-310 and 958-605 provide accounting and financial reporting guidance for promises to give (contributions receivable). A general summary of those standards is presented in this chapter but is not intended to be a substitute for reading the standards. Additional guidance is provided in chapter 5 of the Audit and Accounting Guide *Not-for-Profit Entities*.

11.17 The recognition guidance in paragraphs 7–15 of FASB ASC 958-605-25 depends on whether the promise to give is unconditional or conditional.

11.18 Conditional promises to give, which depend on the occurrence of a specified future and uncertain event, should be recognized as contributions if the likelihood of not meeting the conditions is remote. Consistent with paragraph 62 of the basis for conclusions of superseded FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, FinREC believes that conditions as described in FASB ASC 958-605 are similar to those described in federal income tax laws and regulations. Those regulations provide, in part, that "if a transfer for charitable purposes is dependent upon the performance of some act or the happening of a preceding event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible." For example, a stipulation that an annual report must be provided by the donee to receive subsequent annual payments on a multiyear promise is not a condition if the possibility of not meeting that administrative requirement is remote.

11.19 A challenge (or matching) grant is a common form of conditional promise to give. For example, a transfer of cash with a stipulation that a certain amount of new gifts be raised from others within a specified period of time and a provision that the cash be returned if the gifts are not raised imposes a condition on the gift. A transfer of assets with a condition should be accounted for as a refundable advance (that is, a liability) until the condition has been substantially met or explicitly waived by the donor.¹

11.20 An unconditional promise to give should be recognized when it is received. However, to be recognized, there must be sufficient evidence in the form of verifiable documentation that a promise was made and received. According to FASB 958-605-45-5, contributions of unconditional promises to give, with payments due in future periods, should be reported as restricted support, unless explicit donor stipulations or circumstances surrounding the receipt of a promise make clear that the donor intended it to be used to support activities of the current period. It is reasonable to assume that by specifying future payment dates, donors intend for their gift to support activities in the period in which a payment is scheduled. Therefore, receipts of unconditional promises to give cash in future years generally increase temporarily-restricted net assets.

11.21 The expiration of those restrictions or the expiration of a portion of the restriction is recognized as the donor makes the future payment(s). If the promise is to be paid in one future payment, the related temporarily-restricted net assets will be reclassified to unrestricted net assets in the period in which

¹ According to FASB *Accounting Standards Codification* (ASC) 958-605-25-12, a conditional promise to give is considered unconditional if the possibility that the condition will not be met is remote. FASB ASC 958-605-25-14 states that in cases of ambiguous donor stipulations, a promise containing stipulations that are not clearly unconditional should be presumed to be a conditional promise. Additional guidance on distinguishing conditional from unconditional promises is provided in paragraphs 14–15 of FASB ASC 958-605-25 and paragraphs 15–17 of FASB ASC 958-605-55.

that payment is due. If the donor sets forth a schedule of future payments, a reclassification from temporarily-restricted net assets to unrestricted net assets is made in each period that a payment is due. In the period(s) in which the restrictions expire, temporarily-restricted net assets or the portion of the temporarily-restricted net assets that relate to the particular payment installment are reclassified to unrestricted net assets and reported in the statement of operations as net assets released from restriction. If other explicit donor restrictions are attached to the promise, such as that the gift be used for a specific purpose, the NFP should consider the facts and circumstances surrounding the promise to give and whether those facts and circumstances indicated that the donor intended the contribution to be used to support activities of the current period, even if scheduled future payments extend beyond the current period. For example, an NFP hospital may have a capital campaign to support construction of a new building over the next two years, although promises to give may be accepted with scheduled payments over a period of five years. In the absence of donor restrictions other than construction of the building, it may be reasonable to presume that a time restriction does not exist beyond the date that the constructed building is placed into service.

11.22 Paragraphs 4–7 of FASB ASC 958-605-30 provide guidance for initially measuring unconditional promises to give. If present value techniques are used to measure the fair value of unconditional promises to give, an NFP should determine the amount and timing of the future cash flows of unconditional promises to give cash or, for promises to give noncash assets, the quantity and nature of assets expected to be received. In determining the estimated future cash flows of unconditional promises to give cash, NFPs should consider all the elements in FASB ASC 820-10-55-5, including the following: (a) when the receivable is expected to be collected; (b) the creditworthiness of the other parties; (c) the entity's past collection experience and its policies concerning the enforcement of promises to give; (d) expectations about possible variations in the amount or timing of the cash flows (that is, the uncertainty inherent in the cash flows); and (e) other factors concerning the receivable's collectability. Unconditional promises to give that are expected to be collected in less than one year may be measured at their net realizable value because those amounts result in a reasonable estimate of fair value.

11.23 Paragraphs 4–13 of FASB 958-310-35 discuss the subsequent measurement of contributions receivable. According to FASB ASC 958-310-35-7, if the value of a contribution receivable decreases because of changes in the quantity or nature of assets expected to be received, the decrease should be recognized in the period(s) in which the expectation changes. That decrease should be reported as an expense or a loss (bad debt), in accordance with FASB ASC 958-310-45-3.² According to FASB ASC 958-310-35-6, if an unconditional promise to give cash is initially measured using a present value technique, subsequent accruals of the interest element should be accounted for as contribution revenue by donees, pursuant to FASB ASC 835-30-35.

11.24 If a health care entity routinely conducts fund drives, an estimate of the future cash flows of a portfolio of short-term unconditional promises to give resulting from a mass fund-raising appeal may be made based on experience gained from similar appeals in prior years.

² According to FASB ASC 958-310-45-3, because all expenses are reported as decreases in the unrestricted net asset class, those decreases should be reported as losses if they are decreases in temporarily-restricted or permanently-restricted net assets.

Contributions of Long-Lived Assets, the Use of Long-Lived Assets, or Resources to Acquire Them

11.25 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 contribution is measured at its fair value. In accordance with FASB ASC 958-605-45-6, in the absence of donor-imposed restrictions on the use of the asset, gifts of long-lived assets should be reported as unrestricted support. Contributions of long-lived assets with explicit donor restrictions are reported as temporarily- or permanently-restricted support.

11.26 Contributions of cash or other assets that must be used to acquire long-lived assets are reported as temporarily-restricted support in the period received. In accordance with FASB ASC 958-210-45-6, cash or other assets received with a donor-imposed restriction that limits their use to long-term purposes should not be classified with cash or other assets that are unrestricted and available for current use. Consistent with FASB ASC 958-205-55-7, those items are reported as assets restricted to investment in land, buildings, and equipment and are sequenced closer to land, buildings, and equipment. See paragraph 4.08 of this guide for additional discussion of restricted assets. Pursuant to FASB ASC 958-210-50-3, when the title "Assets Whose Use Is Limited" is used on the face of the statement of financial position, the kind of asset (that is, cash, receivables, investments, and so forth) is required to be described in the notes to the financial statements because its nature is not clear from the description on the face of the statement of financial position.

11.27 FASB ASC 954-205-45-9 states 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 ASC 958-205-45-12. Thus, if contributions of long-lived assets with explicit donor restrictions are reported as temporarily-restricted support, an NFP health care entity reports expirations of those donor restrictions when the stipulation is fulfilled, and the assets are placed in service. Similarly, contributions of cash or other assets that must be used to acquire long-lived assets are reported as temporarily-restricted support in the period received, and expirations of those donor restrictions are reported when the acquired long-lived assets are placed in service, and donor-imposed restrictions are satisfied.

Contributed Services

11.28 The nature and extent of contributed services received by health care entities varies and can range from the limited participation of many people in fund-raising activities to active participation in the entity's service programs.

11.29 FASB ASC 958-605-25-16 requires that contributions of services be recognized if the services received meet any of the following criteria:

- a. They create or enhance a nonfinancial asset. The FASB ASC glossary defines a *nonfinancial asset* as "[a]n asset that is not a financial asset. Nonfinancial assets include land, buildings, use of facilities or utilities, materials and supplies, intangible assets, or services."
- b. They require specialized skills, are provided by individuals possessing those skills, and would typically need to be purchased if they are not provided by contribution. Services requiring specialized skills are provided by accountants, architects, carpenters, doctors,

electricians, lawyers, nurses, plumbers, teachers, and other professionals and craftspeople.

11.30 FASB ASC 958-605-25-16 states that contributed services and promises to give services that do not meet these criteria should not be recognized. Additional guidance for the accounting and reporting of contributed services is provided in paragraphs 52–68 of FASB ASC 958-605-55.

11.31 FASB ASC 958-605 addresses the recognition of services received from personnel of an affiliate that directly benefit the recipient NFP and for which the affiliate does not charge the recipient NFP. The services received are recognized as contributions received. The corresponding accounting entry either increases assets if an asset is enhanced, or increases other expenses. In accordance with FASB ASC 958-720, the recipient entity should measure and disclose its method for measurement of the received services at the cost to the affiliate providing the service. If recording the service at cost will significantly overstate or understate the value of the service received, the NFP may elect to recognize the service at either (a) the cost recognized by the affiliate for the personnel providing that service or (b) the fair value of that service.

11.32 NFP health care entities that receive services from personnel of an affiliate, that directly benefit the health care entity, and are within the scope of FASB ASC 954, *Health Care Entities*, and required to present a performance indicator, should report the increase in net assets as an equity transfer, regardless of whether those services are performed by personnel of an NFP affiliate or any other affiliate.

Reporting the Cost of Special Events and Other Fund-Raising Activities

11.33 Some health care entities conduct fund-raising or joint activities, 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).

11.34 FASB ASC 958-225-45-17 states that an NFP entity may report net amounts for its special events if they result from peripheral or incidental transactions. However, so-called special events often are ongoing and major activities; if so, an NFP entity should report the gross amounts of revenues and expenses of those activities. Costs netted against receipts from peripheral or incidental special events should be limited to direct costs.

11.35 Paragraphs 11–15 of FASB ASC 958-225-55 illustrate three possible methods to display a special event that is an ongoing and major activity. Health care entities may report the gross revenues of special events and other fund-raising activities, and the cost of direct benefits to donors (for example, meals and facilities rental) displayed either (a) as a line item deducted from the special event revenues or (b) in the same section of the statement of operations as other programs or supporting services, allocated, if necessary, among those various functions. Alternatively, the health care entity could consider revenue from special events and other fund-raising activities as part exchange (for the fair value of the good or service provided to the participant) and part contribution (for the excess of the resources received over that fair value) and report the two components separately.

Naming Opportunities

11.36 Health care entities may publicly recognize resource providers (individuals, foundations, corporate entities, and others) through what are commonly referred to as *naming opportunities*. *Naming opportunities*, which may be accompanied by additional rights and privileges, may be either an acknowledgment of a gift or what is effectively advertising (or other benefits) provided by the health care entity in exchange for the resources provided, or a combination of both. For example, naming opportunities might include the following:

- A health care entity gives resource providers the opportunity to name or sponsor a building or a portion thereof, based on receiving certain monetary amounts. Such naming opportunities may result in the sponsorship being publicized through name and logo placement at the building, in addition to other benefits that may be provided.
- A health care entity gives a resource provider the opportunity to sponsor a particular event, with that sponsorship being publicized through logo placement at the event and in any publications or advertisements connected with the event.
- A health care entity conducts a multiyear capital campaign (or similar fund-raiser), with different levels of commitment resulting in an escalating variety of sponsorship or advertising benefits to the resource provider. The benefits include future naming opportunities (either temporary or permanent), as well as other items of significant value being delivered to the resource provider.

11.37 Health care entities should consider whether naming opportunities are contributions, exchange transactions, or a combination of both. FinREC believes that if public recognition and accompanying rights and privileges result in only nominal value to the resource provider, the health care entity has received a contribution. However, a health care entity should consider the specific facts and circumstances of the naming opportunity and accompanying rights and privileges, such as the type of resource provider (individual or corporation), the length of time that the naming benefit is provided, control over name and logo use, and other contract stipulations. For example, the right to name an endowed research fund "The Jane Doe Cancer Research Fund," is by itself considered of nominal value to Jane Doe. In contrast, the right to name the cancer wing of the hospital may have value to a local corporation if that corporation includes terms similar to the following in its agreement with the hospital: the number of years the cancer wing will carry its name, the location of the sign in relation to the nearby highway, the font used for the sign, and the right to re-name the cancer wing if the corporation's name changes during the agreement's term.

11.38 Table 11-2 contains a list of indicators that may be helpful in determining whether naming opportunities are contributions, exchange transactions, or a combination of both. Depending on the facts and circumstances, some indicators may be more significant than others; however, no single indicator is determinative of the classification of a particular transaction.

11.39 In determining the value of a naming opportunity and accompanying rights and privileges, if any, FinREC believes that the exchange portion of the transaction should be recognized at fair value, and any residual would be recognized as a contribution. FinREC believes that the health care entity

should consider stipulations placed on the use of the resources provided, if any, in determining the nature of the contribution received (for example, unrestricted or restricted). If multiple deliverables spanning a period of years are part of the exchange transaction, it is possible that the contribution element would be reflected in current year's revenues but some or all portions of the exchange transaction components could be deferred.

Table 11-2

**Naming Opportunities Indicators Useful in Distinguishing
Contributions From Exchange Transactions**

<i>Indicator</i>	<i>Contribution</i>	<i>Exchange Transaction</i>
Value of public recognition	Resource provider receives nominal value related to the public recognition and there are no direct benefits provided to the resource provider.	Resource provider receives significant value related to the public recognition or there are direct benefits provided to the resource provider.
Length of time that the naming benefit is provided	Naming benefit is provided for a relatively short time, or the health care entity has the right to change the name at its discretion.	Naming benefit is provided for relatively long time, and the name cannot be changed solely at the health care entity's discretion.
Control over name and logo use	Party receiving the naming opportunity cannot change the name.	Party receiving the naming opportunity can change the name, such as if a corporate donor changes its name and requires a corresponding name change by the health care entity.
Other rights and privileges	The named party receives no other rights or privileges in connection with the naming opportunity transaction.	The named party receives other rights and privileges in connection with the naming opportunity transaction, such as an exclusive right to sell, exclusive recruitment opportunities, and so forth.

Investments Gain or Loss Related to Donor-Restricted Contributions

11.40 Chapter 4, "Cash, Cash Equivalents, and Investments," of this guide discusses the classification of dividend, interest and other investment income, and gains and losses. Chapter 9, "Net Assets (Equity)," of this guide discusses the classification of the net assets of donor-restricted endowment funds.

Transfers of Assets to an NFP or Charitable Trust That Raises or Holds Contributions for Others

11.41 The "Transfers of Assets to a Not-for-Profit Entity or Charitable Trust That Raises or Holds Contributions for Others" sections of FASB ASC 958-605 establish standards for transactions in which an entity (donor) makes a contribution by transferring assets to an NFP or charitable trust (recipient entity) that accepts the assets from the donor and agrees to use the assets on behalf of another entity or transfer those assets, the return on investment of those assets, or both to another entity (the beneficiary) that is specified by the donor.³

11.42 Federated fund-raising organizations, community foundations, and institutionally-related entities are examples of NFPs that commonly serve as recipient entities, such as agents, trustees, or intermediaries, but any NFP or charitable trust can function in that capacity. NFP health care entities often are the ultimate recipients (that is, they are specified beneficiaries of the contribution or grant).

11.43 Paragraphs 28–30 of FASB ASC 958-605-25 provide guidance for recognition by the specified beneficiary of the transfer of assets from the donor. A specified beneficiary should recognize its rights to the financial or nonfinancial assets held by a recipient entity as an asset, unless the recipient entity is explicitly granted variance power, as discussed in paragraph 11.44. Those rights are any one of the following:

- a. An interest in the net assets of the recipient entity, as discussed in paragraph 11.45
- b. A beneficial interest, as discussed in paragraph 11.46
- c. A receivable, as discussed in paragraph 11.47

11.44 The FASB ASC glossary defines *variance power* as

[t]he unilateral power to redirect the use of the transferred assets to another beneficiary. A donor explicitly grants variance power if the recipient entity's unilateral power to redirect the use of the assets is explicitly referred to in the instrument transferring the assets. Unilateral power means that the recipient entity can override the donor's instructions without approval from the donor, the specified beneficiary, or any other interested party.

As discussed in FASB ASC 958-605-25-31, if the donor explicitly grants variance power to a recipient entity, and the specified beneficiary is not an affiliate of the recipient entity or the donor, the specified beneficiary (for example, the NFP health care entity) should not recognize its rights to the future distributions from the assets held by the recipient entity. Those future distributions, if they occur, should be recognized as contributions by the specified beneficiary

³ The "Transfers of Assets to a Not-for-Profit Entity or Charitable Trust that Raises or Holds Contributions for Others" sections of FASB ASC 958-605 also establish 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 reciprocal transactions are discussed in chapters 4, "Cash, Cash Equivalents, and Investments," and 12, "The Reporting Entity and Related Entities," of this guide.

(for example, the NFP health care entity) when received or unconditionally promised.

11.45 If a recipient entity and specified beneficiary are financially interrelated entities (see paragraph 12.82 of this guide), and the recipient entity is not a trustee, FASB ASC 958-605-25-27 states that the recipient entity should recognize a contribution received when it receives assets (financial or nonfinancial) from the donor that are specified for the beneficiary. FASB ASC 958-20-25 provides the following example. A foundation that exists to raise, hold, and invest assets for the specified beneficiary or a group of affiliates of which the specified beneficiary is a member generally is financially interrelated with the NFP(s) it supports. The foundation should recognize contribution revenue when it receives assets from the donor. Pursuant to FASB ASC 958-20-25-2, the beneficiary should recognize its interest in the net assets of the recipient entity and adjust that interest for its share of the change in net assets of the recipient entity using a method similar to the equity method of accounting for investments in common stock.⁴ Examples 1–3 in paragraphs 3–17 of FASB ASC 958-20-55 provide examples of this guidance. The appendix, "Q&A Section 6400, *Health Care Entities*," of this chapter provides guidance for the classification of a beneficiary's interest in the net assets of a financially-interrelated fund-raising foundation.

11.46 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 should recognize that beneficial interest. Pursuant to FASB ASC 958-605-30-14 and 958-605-35-3, the beneficiary recognizes the beneficial interest as an asset and a contribution received, measuring and subsequently remeasuring the beneficial interest at fair value.

11.47 FASB ASC 958-605-25-30 states that if the beneficiary's rights are neither an interest in the net assets of the recipient entity nor a beneficial interest, the beneficiary should recognize its rights to the assets held by a recipient entity as a receivable and contribution revenue, in accordance with paragraphs 8–10 of FASB ASC 958-605-25 and FASB ASC 958-605-45-5 for unconditional promises to give. Paragraphs 11.15–.24 discuss the recognition of promises to give.

11.48 Additional information about transfers of assets to an NFP or charitable trust that raises or holds contributions for others is found in chapter 4, "Cash, Cash Equivalents, and Investments" (for investments held by others), and chapter 5 (for accounting and reporting by the recipient entity) of the Audit and Accounting Guide *Not-for-Profit Entities*.

Contributions Made

11.49 FASB ASC 720-25 states that contributions made should be recognized as expenses in the period made and as decreases of assets or increases of liabilities, depending on the form of the benefits given. For example, gifts of items from inventory held for sale are recognized as decreases of inventory and contribution expenses, and unconditional promises to give cash are recognized as payables and contribution expenses. For guidance on conditional promises to give and determining whether a promise is conditional or unconditional, see

⁴ FASB ASC 958-20-55-11 states that an interest in the net assets of an affiliate would be eliminated if that affiliate was included in consolidated financial statements of the interest holder.

paragraphs 11–15 of FASB ASC 958-605-25 and FASB ASC 958-605-25-33. See paragraphs 45–48 of FASB ASC 958-605-55 for an example that illustrates a donor's accounting for an unconditional promise to give. Contributions made are measured at fair value. If the fair value of a transferred asset differs from its carrying amount, a gain or loss should be recognized on the disposition of the asset, as discussed in paragraphs 1–2 of FASB 845-10-30.

Other Considerations

11.50 A *split-interest agreement* is a form of contribution in which an NFP receives benefits that are shared with other beneficiaries designated by the donor. Common kinds of such agreements include charitable lead and remainder trusts, charitable gift annuities, and pooled (life) income funds. The special accounting for split-interest agreements is discussed in FASB ASC 958-30 and chapter 6, "Split-Interest Agreements and Beneficial Interests in Trusts," of the Audit and Accounting Guide *Not-for-Profit Entities*.

11.51 The presentation and disclosure requirements for contributions receivable and transfers of assets to an NFP that raises or holds contributions for others are located in FASB ASC 958-310-50, 958-605-45, and 958-605-50. The following paragraphs discuss the financial statement presentation and some of those disclosures but are not intended as a substitute for the "Other Presentation Matters" and "Disclosures" sections of FASB ASC 958.

11.52 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 entity's past collection experience and its policies concerning the enforcement of promises to give, and other factors concerning the receivable's collectability. 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.

11.53 In accordance with FASB ASC 958-310-45-1, contributions receivable should be reported net of the discount that arises if measuring a promise to give at present value. The discount should be separately disclosed by reporting it as a deduction from contributions receivable either on the face of the statement of financial position or in the notes to financial statements.

11.54 FASB ASC 958-310-50-1 requires that an NFP that is the recipient of unconditional pledges (promises to give in future periods) disclose the following:

- 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
- c. The discount that arises if measuring a promise to give at present value, if that discount is not separately disclosed by reporting it as a deduction from contributions receivable on the face of the statement of financial position, pursuant to FASB ASC 958-310-45-1

11.55 FASB ASC 958-310-50-4 requires that an NFP that is the recipient of conditional pledges (promises to give in future periods) disclose both of the following:

- 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

11.56 Pursuant to FASB ASC 958-205-50-3, if an NFP discloses in its financial statements a ratio of fund-raising expenses to amounts raised, it also should disclose how it computes that ratio.

11.57 When reporting unrestricted contributions, NFP health care entities should apply the standards in paragraphs 4–7 of FASB ASC 954-225-45 to determine whether contributions are reported within or outside the performance indicator.

11.58 Pursuant to FASB ASC 958-805-25-31, an NFP acquirer should recognize an inherent contribution received, measured in accordance with paragraph 8 of FASB ASC 958-805-30, as a separate credit in its statement of activities as of the acquisition date. Refer to FASB ASC 958-805-45 for additional information regarding the classification of the inherent contribution within the statement of activities. Refer to paragraphs 2–3 of FASB ASC 954-805-45 for guidance relating to presentation of inherent contributions in the statement of operations of an NFP business-oriented health care entity.

Auditing

11.59 Because investor-owned entities generally do not receive contributions or enter into agency transactions, the specific audit objectives, selected controls, and auditing procedures related to contributions, contributions receivable, and agency transactions are unique to NFPs and presented in the following paragraphs.

11.60 An NFP health care entity that receives a significant amount of contributions may have an increased risk of material misstatement if it does not have proper internal controls in place. Paragraph .02 of AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*), states that the auditor is required to obtain an understanding of internal control relevant to the audit when identifying and assessing the risks of material misstatement.⁵ In making those risk assessments, the auditor considers internal control in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of internal control. The auditor may identify deficiencies in internal control not only during this risk assessment process but also at any other stage of the audit. According to paragraph .08 of AU-C section 265, the auditor should determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control. As provided in paragraph .12 of AU-C section 265, the auditor should communicate in writing to those charged with governance on a timely basis significant deficiencies and material weaknesses identified during the audit, including those that were remediated during the audit.

11.61 In order to have an effective system of internal control, an NFP health care entity that receives significant amounts of contributions should

⁵ Paragraphs .13 and .A61–.A67 of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), provide guidance on obtaining an understanding of internal control relevant to the audit.

have an internal control system that provides effective controls to ensure that all contributions received are recorded, and suitable collection efforts are pursued for unconditional promises to give. The internal control system also should provide effective controls to ensure that revenues arising from conditional promises to give are recognized when the conditions have been substantially met, and restrictions on contributions are recognized in the appropriate net asset class.

11.62 Contributions received are measured at fair value. AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (AICPA, *Professional Standards*), addresses audit considerations relating to the measurement and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements.

11.63 Paragraph .20 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), states that the auditor should use external confirmation procedures for accounts receivable, except when one or more of the following is applicable (a) the overall account balance is immaterial, (b) external confirmation procedures for accounts receivable would be ineffective, or (c) the auditor's assessed level of risk of material misstatement at the relevant assertion level is low, and the other planned substantive procedures address the assessed risk. In many situations, the use of external confirmation procedures for accounts receivable and the performance of other substantive procedures are necessary to reduce the assessed risk of material misstatement to an acceptably low level. For purposes of applying AU-C section 330, paragraph .A55 states that *accounts receivable* means (a) the entity's claims against customers that have arisen from the sale of goods or services in the normal course of business and (b) a financial institution's loans. Although contributions receivable are not accounts receivable, as defined in AU-C section 330, the auditor may nevertheless decide to request confirmation of contributions receivable. If the auditor decides to confirm promises to give, he or she may consider communicating this approach to the fund-raising or donor relations department of the auditee due to the potential sensitive nature of donor-donee relationships.

11.64 Receivables are generally confirmed to provide evidence about the existence assertion. FASB ASC 958-605-25-8 specifies that for a promise to give to be recognized in financial statements, there must be sufficient evidence in the form of verifiable documentation that a promise was made and received. If the documentation is not present, an asset should not be recognized. The available documentation for recognition of promises to give may not be sufficient evidence concerning the existence assertion. Confirming recorded promises to give (contributions receivable) may provide additional evidence about the existence of promises to give, the existence or absence of restrictions or conditions, and the periods over which the promises to give become due. If the auditor confirms promises to give, AU-C section 505, *External Confirmations* (AICPA, *Professional Standards*), provides guidance concerning the confirmation process.

11.65 In obtaining sufficient appropriate audit evidence with respect to contributions received and contributions made, the auditor may consider the examples of specific audit objectives, specific control objectives, and substantive audit procedures that are presented in exhibit 11-1.

Exhibit 11-1

The following table illustrates the use of assertions in developing audit objectives and designing substantive tests. The examples are not intended to be all-inclusive nor is it expected that all the procedures are necessarily applied in an audit. Irrespective of the assessed risks of material misstatement, paragraph .18 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), states the auditor should design and perform audit substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. The use of assertions in assessing risks and designing appropriate procedures to obtain audit evidence is described in paragraphs .26–.32 of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*). Various audit procedures and the purposes for which they may be performed are described in paragraphs .A10–.A26 of AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*).

Audit Considerations

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives⁶</i>	<i>Substantive Audit Procedures⁷</i>
Transactions			
Contributions Received			
Occurrence	Amounts recognized as contribution revenues represent valid unconditional contributions.	Controls ensure that only unconditional contributions are recognized in the financial statements.	Examine documentation supporting the recognition of contribution revenues, noting information such as the absence of conditions.
Completeness	All unconditional contributions are recognized.	Controls ensure that all unconditional contributions are recognized in the financial statements. Controls ensure that revenue is recognized when the conditions on conditional promises to give have been substantially met.	Select from data accumulated and maintained by the fund-raising function, and determine whether a contribution should have been recognized and, if so, vouch it to a recognized contribution, investigating reconciling items.

⁶ The auditor should consider a combination of preventative and detective controls responsive to the control objectives.

⁷ The auditor should determine the nature, timing, and extent of substantive procedures to perform, considering, for example, the results of tests of controls and risk areas.

Audit Considerations—continued

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
Valuation and allocation	Contributions received are measured at fair value at initial recognition.	Controls ensure the appropriate valuation of contribution revenue at the time of initial recognition.	Review and test the methods and assumptions used to measure contribution revenue at the time of initial recognition.
Cut-off	Contributions are reported in the period in which an unconditional promise was made.	Controls ensure that contributions occurring near fiscal period-end are recorded in the proper period.	Examine contributions reported before and after fiscal period-end to determine if they are reported in the appropriate period.
<i>Contributed Services, Utilities, Facilities, and Use of Long-Lived Assets</i>			
Occurrence, completeness, valuation and allocation	Assets, expenses, and revenues from contributed services, utilities, facilities, and use of long-lived assets meet the appropriate recognition criteria; contributions that meet the recognition criteria are recognized and appropriately measured.	Controls ensure that only contributed services, utilities, facilities, and use of long-lived assets that meet the appropriate recognition criteria are recognized; controls ensure that all such contributions that meet the recognition criteria are recognized and appropriately measured.	Review the documentation underlying the recognition of contributed services, utilities, facilities, and use of long-lived assets for completeness and propriety of recognized amounts.
<i>Contributions Made</i>			
Occurrence	Amounts recognized as contributions made are properly authorized and reported in the period in which they become unconditional.	Controls ensure that only unconditional contributions made and promises to give are recognized in the financial statements.	Examine documentation supporting the recognition of contributions made, including notification of the donee and whether the contribution is conditional or unconditional.
Completeness	All unconditional contributions made are recognized.	Controls ensure that all unconditional contributions made are recognized in the financial statements.	Review minutes of governing board and governing board committee meetings for information about contributions made.
Valuation and allocation	Contributions made are measured at fair value at initial recognition.	Controls ensure the appropriate valuation of contributions made, including promises to give, at the time of initial recognition.	Review and test the method used for valuing contributions made, including promises to give.

(continued)

Audit Considerations—continued

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
Account Balances			
Contributions Receivable			
Existence	Amounts recognized as contributions receivable represent valid unconditional promises to give.	Controls ensure that only unconditional promises to give are recognized in the financial statements.	Examine documentation supporting the recognition of promises to give, noting information such as the absence of conditions and the periods over which the promises to give become due.
Completeness	All unconditional promises to give are recognized.	Controls ensure that all unconditional promises to give are recognized in the financial statements. Controls ensure that conditional promises to give are recognized when the conditions have been substantially met.	Compare the detail of contributions receivable with data accumulated and maintained by the fund-raising function, and investigate reconciling items.
Valuation and allocation	Contributions receivable are appropriately valued.	Controls ensure the appropriate valuation of promises to give at the time of initial recognition.	Review and test the methods and assumptions used to measure promises to give at the time of initial recognition.
		The valuation of promises to give is periodically reviewed by management.	Review promises to give for collectability.
		Write-offs of uncollectible promises to give are identified and approved in accordance with the entity's established policy.	Review write-offs and recoveries of uncollectible promises to give.
Promises to Give			
Occurrence	Amounts recognized as contributions payable represent valid unconditional promises to give.	Controls ensure that only unconditional promises to give are recognized in the financial statements.	Examine documentation supporting recognition of contributions payable, including information such as the absence of conditions and the periods over which the promises to give become due.

Audit Considerations—continued

Financial Statement Assertions	Specific Audit Objectives	Specific Control Objectives	Substantive Audit Procedures
Completeness	All unconditional promises to give are recognized.	Controls ensure that all unconditional promises to give are recognized in the financial statements.	Review minutes of governing board and governing board committee meetings for information about promises to give.
Cut-off	All unconditional promises to give are recognized in the proper period.	Controls ensure that contributions made near fiscal period-end are recorded in the appropriate period.	Review cash disbursements subsequent to year-end to ascertain that contributions made were recorded in the proper period.
Valuation and allocation	Contributions made and related liabilities expected to be paid beyond one year are measured using the method elected by the NFP.	Controls ensure the appropriate valuation of promises to give at the end of the fiscal period.	Review and test the method used for valuing promises to give that are payable more than one year from the date of the financial statements.
Agency Transactions			
Occurrence and completeness	Assets and liabilities from agency transactions meet the criteria for classification and recognition as agency transactions.	Controls ensure that (a) only resources received and paid in agency transactions are recognized as agency transactions, and (b) all such transactions are recognized.	Review the documentation underlying the receipt of assets from resource providers for propriety of classification and recognition as resources that are to be transferred to others.
	All agency transactions are recognized.		Review the documentation underlying the distribution of assets to others for propriety of classification and recognition.
			Review the historical patterns of the distribution of gifts in kind and other assets to determine the extent of the entity's discretion over those distributions.

(continued)

Audit Considerations—continued

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
Presentation and Disclosures			
<i>Contribution Revenues and Contributions Receivable</i>			
Classification and understandability	Restricted contributions are reported in the proper net asset class.	Contributions are reviewed for restrictions and other limitations.	Review the documentation underlying contributions and promises to give, including donor correspondence and governing board minutes, for propriety of classification, including classification within or outside the performance indicator.
	Disclosures related to contributions are clear and understandable.	Controls ensure that contributions are appropriately presented and disclosed.	Determine the appropriateness of disclosures for conditional and unconditional promises to give.
<i>Agency Transactions</i>			
Rights and obligations	Intermediary or agent transactions or transactions for which the health care entity acts as a recipient are not included in reported amounts of contributions.	Controls ensure that those transactions are identified and not included in contribution totals.	Determine whether agency transactions are excluded from the statement of operations and the statement of changes in net assets. If they are not, determine that the transactions are reported as described in the "Transfers of Assets to a Not-for-Profit Entity or Charitable Trust that Raises or Holds Contributions for Others" sections of FASB ASC 958-605.

11.66

Appendix—Q&A Section 6400, *Health Care Entities*

.35 Note to Sections 6400.36–.42—Implementation of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (in the Beneficiary's Financial Statements)

Some not-for-profit entities have separate fund-raising foundations (commonly referred to as "institutionally related foundations") that solicit contributions on their behalf. FASB ASC 958, *Not-for-Profit Entities*, provides guidance on (among other things) the accounting that should be followed by such institutionally related foundations and their related beneficiary entity(ies) with respect to contributions received by the foundation.

Some institutionally related foundations and their beneficiary entities meet the characteristics of financially interrelated entities provided in FASB ASC 958-20-15-2. If entities are financially interrelated, FASB ASC 958 provides that the balance sheet of the beneficiary entity(ies) should reflect that entity's interest in the net assets of the foundation, and that interest should be periodically adjusted to reflect the beneficiary's share of the changes in the net assets of the foundation. This accounting is similar to the equity method of accounting, which is described in FASB ASC 323.

FASB ASC 323-10-35-5 requires that the periodic adjustment of the investment be included in the determination of the investor's net income. The purpose of sections 6140.14–.18 (applicable to not-for-profit entities [NPEs] other than health care [HC] entities) and sections 6400.36–.42 (applicable to not-for-profit health care entities) is to clarify that in circumstances in which the recipient and the beneficiary are financially interrelated:

- Beneficiary entities should segregate the adjustment into changes in restricted and unrestricted net assets. (NPE sections 6140.14–.16; HC sections 6400.36–.37 and .39)
- In circumstances in which the beneficiary can influence the financial decisions of the recipient entity to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient to the beneficiary, the existence of the recipient entity should be transparent in determining the net asset classifications in the beneficiary's financial statements. In other words, the recipient cannot impose time or purpose restrictions beyond those imposed by the donor. (NPE section 6140.14 and .16; HC sections 6400.36 and .39)
- In circumstances in which the beneficiary cannot influence the financial decisions of the recipient entity to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient to the beneficiary, the existence of the recipient entity creates an implied time restriction on the beneficiary's net assets attributable to the beneficiary's interest in the net assets of the recipient (in addition to any other restrictions that may exist). Accordingly, in recognizing its interest in the net assets of the recipient entity and the changes in that interest, the beneficiary should classify the resulting net assets and changes in those net assets as temporarily restricted

(unless donors placed permanent restrictions on their contributions). (NPE section 6140.15; HC section 6400.37)

- In circumstances in which the beneficiary can influence the financial decisions of the recipient entity to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient to the beneficiary and some net assets held by the recipient for the benefit of the beneficiary are subject to purpose restrictions [for example, net assets of the recipient restricted to the beneficiary's purchase of property, plant, and equipment (PPE)], expenditures by the beneficiary that meet those purpose restrictions result in the beneficiary (and recipient) reporting reclassifications from temporarily restricted to unrestricted net assets (assuming that the beneficiary has no other net assets subject to similar purpose restrictions), unless those net assets are subject to time restrictions that have not expired, including time restrictions that are implied on contributed long-lived assets as a result of the beneficiary's accounting policy pursuant to FASB ASC 958-605-45-6. (If those net assets are subject to time restrictions that have not expired and the beneficiary has other net assets with similar purpose restrictions, the restrictions on those other net assets would expire in accordance with FASB ASC 958. These sections do not, however, establish a hierarchy pertaining to which restrictions are released first—restrictions on net assets held by the recipient or purpose restrictions on net assets held by the beneficiary.) (NPE section 6140.17; HC section 6400.40)
- In circumstances in which the beneficiary cannot influence the financial decisions of the recipient entity to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient to the beneficiary and some net assets held by the recipient for the benefit of the beneficiary are subject to purpose restrictions, though not subject to time restrictions other than the implied time restrictions that exist because the beneficiary cannot determine the timing and amount of distributions from the recipient to the beneficiary, expenditures by the beneficiary that are consistent with those purpose restrictions should not result in the beneficiary reporting a reclassification from temporarily restricted to unrestricted net assets, subject to the exceptions in the following sentence. Expenditures by the beneficiary that are consistent with those purpose restrictions should result in the beneficiary reporting a reclassification from temporarily restricted to unrestricted net assets if (a) the recipient has no discretion in deciding whether the purpose restriction is met¹ or (b) the recipient distributes or obligates itself to distribute to the beneficiary amounts attributable to net assets restricted for the particular purpose, or otherwise indicates that the recipient intends for those net assets to be

¹ In some circumstances, the purpose restrictions may be so broad that the recipient entity has discretion in deciding whether expenditures by the beneficiary that are consistent with those purpose restrictions actually meet those purpose restrictions. For example, the recipient's net assets may have arisen from a contribution that was restricted for the beneficiary's purchase of research equipment, with no particular research equipment specified. Purchasing an XYZ microscope, which is consistent with that purpose restriction, may or may not meet that purpose restriction, depending on the decision of the recipient. In contrast, the net assets may have arisen from a contribution that was restricted for an XYZ microscope. Purchasing an XYZ microscope, which also is consistent with that purpose restriction, would result in the recipient having no discretion in determining whether that purpose restriction is met.

used to support the particular purpose as an activity of the current period. In all other circumstances, (a) purpose restrictions and (b) implied time restrictions on the net assets attributable to the interest in the recipient entity exist and have not yet expired. (However, if the beneficiary has other net assets with similar purpose restrictions, those restrictions would expire in accordance with FASB ASC 958. These sections do not establish a hierarchy pertaining to which restrictions are released first—restrictions on net assets held by the recipient or restrictions on net assets held by the beneficiary.) (NPE section 6140.18; HC section 6400.41)

- *For HC NPEs Only.* In circumstances in which the beneficiary can influence the financial decisions of the recipient to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient to the beneficiary, changes in the beneficiary's interest in the net assets of a recipient entity attributable to unrealized gains and losses on investments should be included or excluded from the performance indicator in accordance with FASB ASC 954-10, FASB ASC 954-205-45, FASB ASC 954-320-45, FASB ASC 954-320-55, and FASB ASC 954-605, in the same manner that they would have been had the beneficiary had the transactions itself. Similarly, in applying this guidance, the determination of whether amounts are included or excluded from the performance measure should comprehend that if the beneficiary cannot influence the financial decisions of the recipient entity to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient to the beneficiary, an implied time restriction exists on the beneficiary's net assets attributable to the beneficiary's interest in the net assets of the recipient (in addition to any other restrictions that may exist). Accordingly, in circumstances in which the beneficiary cannot influence the financial decisions of the recipient entity to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient to the beneficiary, the beneficiary should classify the resulting net assets and changes in those net assets as temporarily restricted (unless donors placed permanent restrictions on their contributions) and therefore exclude those changes from the performance indicator. (HC section 6400.42)
- *For HC NPEs Only.* In circumstances in which the recipient entity and the beneficiary are both controlled by the same entity, entities should consider the specific facts and circumstances to determine whether the beneficiary can influence the financial decisions of the recipient entity to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient to the beneficiary. (HC section 6400.38)

**Technical Practice Aids for Not-for-Profit Entities
Implementation of FASB ASC 958—Classification of a Beneficiary's
Interest in the Net Assets of a Financially Interrelated Fund-Raising
Foundation (in the Beneficiary's Financial Statements)**

HC NPEs			
NPEs that are not HC NPEs			
<p>Can the beneficiary determine the timing and amount of distributions from the recipient to the beneficiary? (Not-for-profit health care entities [HC NPEs] under common control consider section 6400.38)</p>	<p>How does the existence of the recipient affect the beneficiary's reporting of its interest?</p>	<p>Are any net assets held by the recipient for the benefit of the beneficiary subject to donor-imposed purpose restrictions and has the beneficiary made expenditures that meet those purpose restrictions (in circumstances in which the beneficiary can determine the timing and amount of distributions from the recipient to the beneficiary) or that are consistent with those purpose restrictions (in circumstances in which the beneficiary cannot determine the timing and amount of distributions from the recipient to the beneficiary)?</p>	<p>Are any changes in the beneficiary's interest in the net assets of the recipient attributable to unrealized gains and losses on investments?</p>

Implementation of FASB ASC 958—continued

HC NPEs			
NPEs that are not HC NPEs			
Yes	Existence of recipient is transparent in determining net asset classifications. (NPE sections 6140.14 and .16; HC sections 6400.36 and .39)	Reclass the applicable net assets from temporarily restricted (TR) to unrestricted (UR) unless those net assets are subject to time restrictions that have not expired. (NPE section 6140.17; HC section 6400.40)	Changes in the beneficiary's interest in the net assets of a recipient entity attributable to unrealized gains and losses on investments should be included or excluded from the per-formance indicator in accordance with FASB ASC 954-10, FASB ASC 954-205-45, FASB ASC 954-320-45, FASB ASC 954-320-55, and FASB ASC 954-605, in the same manner that they would have been had the beneficiary had the transactions itself. (HC section 6400.42)
No	Existence of the recipient creates an implied time restriction on the beneficiary's net assets attributable to the beneficiary's interest in the net assets of the recipient. (NPE section 6140.15; HC section 6400.37)	Reclass the applicable net assets from TR to UR only if the purpose restriction and the implied time restriction are met. Whether the purpose restriction is met depends in part on (1) whether the recipient has discretion in determining whether the purpose restriction is met and (2) the recipient's decision in exercising that discretion, if any. (NPE section 6140.18; HC section 6400.41)	An implied time restriction exists on the beneficiary's net assets attributable to the beneficiary's interest in the net assets of the recipient. The beneficiary should classify the resulting net assets and changes in those net assets as temporarily restricted (unless donors placed permanent restrictions on their contributions) and therefore exclude those changes from the performance indicator. (HC section 6400.42)

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.36 Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary can influence the operating and financial decisions of the foundation to such an extent that the beneficiary can determine the timing and amount of distributions from the foundation.)

Inquiry—ABC Hospital, a not-for-profit health care entity subject to FASB ASC 954,² and ABC Foundation are financially interrelated entities as described in FASB ASC 958-20-15-2. ABC Foundation's bylaws state that it is organized for the purpose of stimulating voluntary financial support from donors for the sole benefit of ABC Hospital. Assume that ABC Hospital can influence the operating and financial decisions of ABC Foundation to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital.

During its most recent fiscal year, ABC Foundation's activities resulted in an increase in net assets (before distributions) of \$3,200, comprised of \$2,000 in unrestricted contributions, \$1,000 in temporarily restricted contributions (purpose restrictions), \$500 in unrestricted dividend and interest income, and \$300 in expenses. In addition, ABC Foundation distributed \$2,500 in cash representing unrestricted net assets to ABC Hospital. How should this activity be reported in ABC Hospital's financial statements?

Reply—Because ABC Foundation (the recipient entity) and ABC Hospital (the beneficiary) are financially interrelated, FASB ASC 958-20-25-2 requires ABC Hospital to recognize its interest in the net assets of ABC Foundation and periodically adjust that interest for its share of the change in net assets of ABC Foundation. This is similar to the equity method of accounting described in FASB ASC 323.

In recognizing its interest in the net assets of ABC Foundation and the changes in that interest, ABC Hospital should classify the resulting net assets as if contributions were received by ABC Hospital directly from the donor, because ABC Hospital can influence the operating and financial decisions of ABC Foundation to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital. In other words, the existence of ABC Foundation should be transparent in determining the net asset classifications in ABC Hospital's financial statements because ABC Foundation cannot impose time or purpose restrictions beyond those imposed by the donor. (Any instructions given by ABC Foundation are designations, rather than restrictions.)

In the circumstances described previously, ABC Hospital would initially increase its asset, "Interest in Net Assets of ABC Foundation" for the change in ABC Foundation's net assets (\$3,200). ABC Hospital's Statement of Operations would include "Change in Unrestricted Interest in ABC Foundation" of

² This section addresses not-for-profit health care entities subject to Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 954, *Health Care Entities*. Section 6140.14, "Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary can influence the operating and financial decisions of the foundation to such an extent that the beneficiary can determine the timing and amount of distributions from the foundation.)," addresses a similar issue for not-for-profit entities subject to FASB ASC 958, *Not-for-Profit Entities*.

\$2,200 (which would be included in the performance indicator in accordance with FASB ASC 954-10, FASB ASC 954-205, FASB ASC 954-310, 954-405, and FASB ASC 954-605) and "Change in Temporarily Restricted Interest in ABC Foundation" of \$1,000 which would be reported in the Statement of Changes in Net Assets.

The \$2,500 distribution from ABC Foundation to ABC Hospital would not be reported as an increase in net assets on ABC Hospital's Statement of Operations or its Statement of Changes in Net Assets. By analogy to equity method accounting, the \$2,500 would be reported in a manner similar to a distribution from a subsidiary to its parent (for example, a dividend). ABC Hospital should report the distribution by increasing cash and decreasing its interest in the net assets of ABC Foundation.

If the distribution represented restricted net assets, ABC Hospital would not reclassify the net assets from temporarily restricted to unrestricted at the time of the distribution. Instead, ABC Hospital would reclassify the net assets from temporarily restricted to unrestricted when those restrictions were met.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.37 Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary cannot influence the operating and financial decisions of the foundation to such an extent that the beneficiary can determine the timing and amount of distributions from the foundation.)

Inquiry—ABC Hospital, a not-for-profit health care entity subject to FASB ASC 954,³ and ABC Foundation are financially interrelated entities described in FASB ASC 958-20-15-2. ABC Foundation's bylaws state that it is organized for the purpose of stimulating voluntary financial support from donors for the sole benefit of ABC Hospital. Assume that ABC Hospital cannot, however, influence the operating and financial decisions of ABC Foundation to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital.

During its most recent fiscal year, ABC Foundation's activities resulted in an increase in net assets (before distributions) of \$3,200, comprised of \$2,000 in unrestricted contributions, \$1,000 in temporarily restricted contributions (purpose restrictions), \$500 in unrestricted dividend and interest income, and \$300 in expenses. In addition, ABC Foundation elected to distribute \$2,500 in cash representing unrestricted net assets to ABC Hospital. How should this activity be reported in ABC Hospital's financial statements?

Reply—Because ABC Foundation (the recipient entity) and ABC Hospital (the beneficiary) are financially interrelated, FASB ASC 958-20-25-2 requires

³ This section addresses not-for-profit health care entities subject to FASB ASC 954. Section 6140.15, "Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary cannot influence the operating and financial decisions of the foundation to such an extent that the beneficiary can determine the timing and amount of distributions from the foundation.)," addresses a similar issue for not-for-profit entities subject to FASB ASC 958.

ABC Hospital to recognize its interest in the net assets of ABC Foundation and periodically adjust that interest for its share of the change in net assets of ABC Foundation. This is similar to the equity method of accounting described in FASB ASC 323.

ABC Hospital cannot influence the operating and financial decisions of ABC Foundation to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation. Therefore, an implied time restriction exists on ABC Hospital's interest in the net assets of ABC Foundation (in addition to any other restrictions that may exist). Accordingly, in recognizing its interest in the net assets of ABC Foundation and the changes in that interest, ABC Hospital should classify the resulting net assets as changes in temporarily restricted net assets (unless donors placed permanent restrictions on their contributions).

In the circumstances previously described, ABC Hospital would initially increase its asset, "Interest in Net Assets of ABC Foundation" for the change in ABC Foundation's net assets (\$3,200). ABC Hospital's Statement of Changes in Net Assets would include "Change in Temporarily Restricted Interest in ABC Foundation" of \$3,200 as an increase in temporarily restricted net assets.

The \$2,500 distribution from ABC Foundation to ABC Hospital would not be reported as an increase in net assets on ABC Hospital's Statement of Operations or its Statement of Changes in Net Assets. By analogy to equity method accounting, the \$2,500 would be treated similar to a distribution from a subsidiary to its parent (for example, a dividend). ABC Hospital should report the distribution by increasing cash and decreasing its interest in the net assets of ABC Foundation.

ABC Hospital would reclassify the net assets from temporarily restricted to unrestricted at the time of the distribution, because the time restriction would expire at the time of the distribution. The reclassification would be reported as "net assets released from restrictions" and included in the performance indicator in the statement of operations. (If those net assets were subject to purpose or time restrictions that remained even after the net assets had been distributed to ABC Hospital, ABC Hospital would not reclassify the net assets from temporarily restricted to unrestricted at the time of the distribution. Instead, ABC Hospital would reclassify the net assets from temporarily restricted to unrestricted when those restrictions were met and the reclassification would be included in or excluded from the performance indicator in accordance with FASB ASC 954-10, FASB ASC 954-205, FASB ASC 954-310, FASB ASC 954-405, and FASB ASC 954-605.)

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.38 Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation—Does Common Control Lead to the Conclusion That the Beneficiary Can Determine the Timing and Amount of Distributions from the Recipient?

Inquiry — ABC Holding Company (a not-for-profit entity) has two not-for-profit subsidiaries (ABC Hospital and ABC Foundation) that it controls and

consolidates in accordance with the guidance in FASB ASC 954-10, FASB ASC 954-205, FASB ASC 954-605, and FASB ASC 954-810. ABC Hospital and ABC Foundation are brother-sister entities that are financially interrelated entities as described in FASB ASC 958-20-15-2. ABC Hospital issues separate financial statements in connection with a loan agreement. ABC Foundation's bylaws state that it is organized for the purpose of stimulating voluntary financial support from donors for the sole benefit of ABC Hospital.

Because ABC Hospital and ABC Foundation are under common control, does that lead to the conclusion that ABC Hospital can influence the financial decisions of ABC Foundation (either directly or indirectly) to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital?

Reply—In some circumstances ABC Hospital, though a subsidiary of ABC Holding Company, may be able to influence the financial decisions of ABC Foundation (either directly or indirectly) to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital. For example, if ABC Hospital formed ABC Holding Company as a nominally-capitalized shell with no real operating powers, a rebuttable presumption exists that ABC Hospital can influence the financial decisions of ABC Foundation (either directly or indirectly) to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital. On the other hand if, for example, ABC Hospital formed ABC Holding Company to be an operating entity with substance, other factors would need to be considered in determining whether ABC Hospital can influence the financial decisions of ABC Foundation (either directly or indirectly) to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital. Therefore, it is necessary to consider the facts and circumstances surrounding the relationships between ABC Holding Company and ABC Hospital, and ABC Hospital and ABC Foundation, to determine whether ABC Hospital exerts enough influence over ABC Foundation to determine the timing and amount of distributions from ABC Foundation to ABC Hospital. Indicators to consider may include, but are not limited to, the following:

- What is the extent of overlap among the boards of ABC Hospital, ABC Holding Company, and ABC Foundation (for example, do a majority of the individuals who govern ABC Hospital also govern ABC Foundation; do a majority of the individuals who govern ABC Hospital also govern ABC Holding Company; are the boards of ABC Hospital, ABC Foundation and ABC Holding Company substantially independent of one another)? The greater the overlap among the boards of ABC Hospital and either ABC Holding Company or ABC Foundation, the more likely that ABC Hospital can influence the financial decisions of ABC Foundation (either directly or indirectly) to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital.
- What is the extent of overlap among management teams of ABC Hospital, ABC Holding Company, and ABC Foundation (for example, do the individuals who manage ABC Hospital also manage ABC Foundation; do the individuals who manage ABC Hospital also manage ABC Holding Company; does ABC Holding Company have a separate management team that exercises significant authority over both ABC Hospital

and ABC Foundation)? The greater the overlap between ABC Hospital's management and management of either ABC Holding Company or ABC Foundation, the more likely that ABC Hospital can influence the financial decisions of ABC Foundation (either directly or indirectly) to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital.

- What are the origins of the parent/holding company structure? For example, were ABC Holding Company and ABC Foundation created by ABC Hospital through a corporate restructuring, which may indicate that ABC Hospital, as the original entity, can influence the financial decisions of ABC Foundation (either directly or indirectly) to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital. Alternatively, were ABC Hospital and ABC Foundation independent entities that merged and created ABC Holding Company to govern the combined entity, which may indicate that ABC Hospital cannot influence the financial decisions of ABC Foundation (either directly or indirectly) to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital.
- What is the number of entities under common control? The greater the number of entities under ABC Holding Company's control, the less likely it is that any one subsidiary, such as ABC Hospital, can influence the financial decisions of another brother-sister subsidiary, such as ABC Foundation, (either directly or indirectly) to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital

Other relevant facts and circumstances should also be considered.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.39 Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (More Than One Beneficiary—Some Contributions Are Designated)

Inquiry—DEF Health Entity is the parent company of three brother-sister not-for-profit entities: Health A, a not-for-profit health care entity subject to FASB ASC 954,⁴ Health B, and Foundation. Foundation is organized for the purpose of raising contributions for the benefit of both Health A and Health B. The four entities are legally separate not-for-profit entities that are financially interrelated pursuant to the guidance in FASB ASC 958-20-15-2. Assume that Health A can influence the financial decisions of Foundation to such an

⁴ This section addresses not-for-profit health care entities subject to FASB ASC 954. Section 6140.16, "Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (More Than One Beneficiary—Some Contributions Are Designated)," addresses a similar issue for not-for-profit entities subject to FASB ASC 958.

extent that Health A can determine the timing and amount of distributions from Foundation to Health A.

A donor contributes \$5,000 cash to Foundation and stipulates that the contribution is for the benefit of Health A. Foundation would record the contribution as temporarily restricted revenue because Foundation must use the contribution for the benefit of Health A. In its separately issued financial statements, Health A would recognize its interest in the net assets attributable to that contribution by debiting "Interest in Net Assets of Foundation" for \$5,000. Would the offsetting credit be reported as temporarily restricted revenue (because the net assets attributable to the contribution are restricted on Foundation's Balance Sheet) or unrestricted revenue (because there are no donor-imposed time restrictions or purpose restrictions on how Health A must use the contribution)?

Reply—Health A should report the offsetting credit as unrestricted revenue. Because Health A can influence the financial decisions of Foundation to such an extent that Health A can determine the timing and amount of distributions from Foundation to Health A, no implied time restriction exists on Health A's net assets attributable to its interest in the net assets of Foundation. Accordingly, in recognizing its interest in the net assets of Foundation and the changes in that interest, Health A should classify the resulting net assets as if contributions were received by Health A directly from the donor. In other words, the existence of Foundation should be transparent in determining the net asset classifications in Health A's separately issued financial statements because Foundation cannot impose time or purpose restrictions beyond those imposed by the donor. (Any instructions given by Foundation are designations, rather than restrictions.)

Because no donor-imposed restrictions exist on how Health A must use the contribution, Health A should report the change in its interest in the net assets attributable to the contribution as an increase in unrestricted net assets that is included in its performance indicator (in accordance with FASB ASC 954-10, FASB ASC 954-205, FASB ASC 954-310, FASB ASC 954-405, and FASB ASC 954-605) in its separately issued Statement of Operations. When Foundation actually distributes the funds, Health A should increase cash and decrease its interest in net assets of Foundation; the distributions would have no effect on Health A's Statement of Operations or its Statement of Changes in Net Assets.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.40 Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary makes an expenditure that meets a purpose restriction on net assets held for its benefit by the recipient entity—The beneficiary can influence the operating and financial decisions of the recipient to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient.)

Inquiry—ABC Hospital, a not-for-profit health care entity subject to FASB ASC 954,⁵ and ABC Foundation are financially interrelated entities as described in FASB ASC 958-20-15-2. ABC Foundation's bylaws state that it is organized for the purpose of stimulating voluntary financial support from donors for the sole benefit of ABC Hospital. Assume that ABC Hospital can influence the operating and financial decisions of ABC Foundation to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital.

ABC Foundation's net assets consist of \$3,000,000 resulting from cash contributions restricted for the purchase of PPE by ABC Hospital. ABC Hospital has recorded its interest in those net assets by debiting "Interest in net assets of ABC Foundation" and crediting "Change in interest in ABC Foundation," which is reported as an increase in temporarily restricted net assets. ABC Hospital's accounting policy is to not imply a time restriction that expires over the useful life of the donated long-lived assets pursuant to FASB ASC 958-605-45-6 and it has no other net assets restricted for the purchase of PPE.⁶ ABC Hospital subsequently purchased and placed into service \$3,000,000 of PPE that meets those donor restrictions prior to receiving a distribution from ABC Foundation. Should ABC Hospital reclassify \$3,000,000 from temporarily-restricted net assets as a result of building and placing into service the \$3,000,000 of PPE?

Reply—Because ABC Foundation (the recipient entity) and ABC Hospital (the beneficiary) are financially interrelated, FASB ASC 958-20-25-2 requires ABC Hospital to recognize its interest in the net assets of ABC Foundation and periodically adjust that interest for its share of the change in net assets of ABC Foundation. This is similar to the equity method of accounting described in FASB ASC 323.

In recognizing its interest in the net assets of ABC Foundation and the changes in that interest, ABC Hospital should classify the resulting net assets as if contributions were received by ABC Hospital directly from the donor, because ABC Hospital can influence the operating and financial decisions of

⁵ This section addresses not-for-profit health care entities subject to FASB ASC 954. Section 6140.17, "Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary makes an expenditure that meets a purpose restriction on net assets held for its benefit by the recipient entity—The beneficiary can influence the operating and financial decisions of the recipient to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient.)," addresses a similar issue for not-for-profit entities subject to FASB ASC 958.

⁶ The assumption that ABC Hospital has no other net assets restricted for the purchase of PPE is intended to avoid establishing a hierarchy pertaining to which restrictions are released first—restrictions on net assets held by the recipient or restrictions on net assets held by the beneficiary. That issue is not addressed in this section.

ABC Foundation to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital. Accordingly, the net assets representing contributions restricted for the purchase of PPE should be reported as temporarily restricted net assets (purpose restricted) in ABC Hospital's financial statements. Upon purchasing and placing into service the PPE, ABC Hospital (and ABC Foundation) should reclassify \$3,000,000 from temporarily restricted to unrestricted net assets,⁷ reported separately from the performance indicator in the statement of operations in accordance with the guidance in FASB ASC 954-10, FASB ASC 954-205, FASB ASC 954-310, FASB ASC 954-405, and FASB ASC 954-605. In other words, the existence of ABC Foundation should be transparent in determining the net asset classifications in ABC Hospital's financial statements because ABC Foundation cannot impose time or purpose restrictions beyond those imposed by the donor. (Any instructions given by ABC Foundation are designations, rather than restrictions.)

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.41 Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary makes an expenditure that is consistent with a purpose restriction on net assets held for its benefit by the recipient entity—The beneficiary cannot influence the operating and financial decisions of the recipient to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient.)

Inquiry—ABC Hospital, a not-for-profit health care entity subject to FASB ASC 954,⁸ and ABC Foundation are financially interrelated entities as described in FASB ASC 958-20-15-2. ABC Foundation's bylaws state that it is organized for the purpose of stimulating voluntary financial support from donors for the sole benefit of ABC Hospital. Assume that ABC Hospital cannot, however, influence the operating and financial decisions of ABC Foundation to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital.

⁷ In this fact pattern, ABC Research Institute's interest in the net assets of ABC Foundation is subject to only purpose restrictions because the net assets arose from cash contributions with no time restrictions. If instead the net assets arose from promises to give rather than from cash contributions, the net assets might be subject to time restrictions in addition to the purpose restrictions. In determining whether net assets that arose from promises to give are subject to time restrictions, NPEs should consider the guidance in section 6140.04, *Lapsing of Restrictions on Receivables if Purpose Restrictions Pertaining to Long-Lived Assets are Met Before the Receivables are Due*, which discusses whether restrictions on net assets arising from promises to give that are restricted by donors for investments in long-lived assets are met when the assets are placed in service or when the receivables are due.

⁸ This section addresses not-for-profit health care entities subject to FASB ASC 954. Section 6140.18, "Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary makes an expenditure that is consistent with a purpose restriction on net assets held for its benefit by the recipient entity—The beneficiary cannot influence the operating and financial decisions of the recipient to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient.)," addresses a similar issue for not-for-profit entities subject to FASB ASC 958.

ABC Foundation's net assets consist of \$3,000,000 resulting from cash contributions restricted for the purchase of PPE ABC Hospital. ABC Hospital has recorded its interest in those net assets by debiting "Interest in net assets of ABC Foundation" and crediting "Change in interest in ABC Foundation," which is reported as an increase in temporarily restricted net assets. ABC Hospital has no other net assets restricted for the purchase of PPE.⁹

ABC Hospital subsequently built and placed into service the New Modern Hospital Wing (at a cost of \$3,000,000) prior to receiving a distribution from ABC Foundation or any indication from ABC Foundation that it intends to support building and placing into service the New Modern Hospital Wing. Should ABC Hospital reclassify \$3,000,000 from temporarily-restricted net assets to unrestricted net assets as a result of building and placing into service the New Modern Hospital Wing?

Reply—From ABC Hospital's perspective, its interest in the net assets of ABC Foundation has two restrictions—a purpose restriction (the purchase of the PPE) and an implied time restriction. (ABC Hospital cannot influence the operating and financial decisions of ABC Foundation to such an extent that ABC Hospital can determine the timing and amount of distributions from ABC Foundation to ABC Hospital, including distributions pertaining to expenditures by ABC Hospital that meet the donor-imposed purpose restrictions. Therefore, an implied time restriction exists on ABC Hospital's interest in the net assets of ABC Foundation.) FASB ASC 958-205-45-9 provides, in part, as follows:

If two or more temporary restrictions are imposed on a contribution, the effect of the expiration of those restrictions is recognized in the period in which the last remaining restriction is expired.

FASB ASC 958-205-45-11 further provides, in part:

Temporarily restricted net assets with time restrictions are not available to support expenses until the time restrictions have expired.

In considering whether the purpose restriction on ABC Hospital's interest in the net assets of ABC Foundation is met, ABC Hospital should determine whether ABC Foundation has discretion in deciding whether an expenditure by ABC Hospital that is consistent with the purpose restriction satisfies that purpose restriction. For example, if the restricted net assets arose from a contribution that was restricted for "building projects of ABC Hospital," with no particular building project specified, purchasing and placing into service the New Modern Hospital Wing is consistent with the purpose restriction but may or may not meet it, because ABC Foundation has some discretion in deciding which building project releases the purpose restriction. In other words, ABC Foundation may, at its discretion, either release restricted net assets in support of building the New Modern Hospital Wing or not, because the purpose restriction imposed by the donor was broad enough to give ABC Foundation discretion in deciding which building projects meet the purpose restriction. If ABC Foundation has such discretion, a purpose restriction and an implied time restriction on ABC Hospital's interest in the net assets of ABC Foundation exist. Therefore, ABC Hospital should not reclassify \$3,000,000 from temporarily-restricted net

⁹ The assumption that ABC Hospital has no other net assets restricted for the purchase of PPE is intended to avoid establishing a hierarchy pertaining to which restrictions are released first—restrictions on net assets held by the recipient or restrictions on net assets held by the beneficiary. That issue is not addressed in this section.

assets to unrestricted net assets as a result of building and placing into service the New Modern Hospital Wing unless ABC Foundation distributes or obligates itself to distribute to ABC Hospital amounts attributable to net assets restricted for the purchase of PPE by ABC Hospital, or ABC Foundation otherwise indicates that it intends for those net assets to be used to support the building and placing into service the New Modern Hospital Wing as an activity of the current period (assuming that ABC Hospital had no other net assets that were restricted for the purchase of PPE).^{10,11}

In contrast to the example in the previous paragraph, if the restricted net assets arose from a contribution that was restricted for "building and placing into service the New Modern Hospital Wing," ABC Foundation has no discretion in deciding whether that purpose restriction is met by building and placing into service the New Modern Hospital Wing. Therefore, if ABC Hospital builds and places into service the New Modern Hospital Wing, the purpose restriction is met (assuming that ABC Hospital had no other net assets that were restricted for building and placing into service the New Modern Hospital Wing). In addition, the implied time restriction is met because ABC Foundation is required to distribute the funds to ABC Hospital in order to meet the donor's stipulation. Therefore, ABC Hospital (and ABC Foundation) should reclassify \$3,000,000 from temporarily-restricted net assets as a result of building and placing into service the New Modern Hospital Wing.

¹⁰ In this fact pattern, the expenditure is made prior to meeting the purpose restriction and the implied time restriction that exists because ABC Hospital cannot determine the timing and amount of distributions from ABC Foundation to ABC Hospital. FASB ASC 958-205-45-11 provides that in circumstances in which both purpose and time restrictions exist, expenditures meeting the purpose restriction must be made simultaneous with or after the time restriction has expired in order to satisfy both the purpose and time restriction and result in a reclassification of net assets from temporarily restricted to unrestricted. In other words, time restrictions, if any, must be met before expenditures can result in purpose restrictions being met. In this fact pattern, however, the time restriction is an implied time restriction that exists because the beneficiary cannot determine the timing and amount of distributions from the recipient to the beneficiary, rather than an implied time restriction that exists because a promise to give is due in a future period or because of an explicit donor stipulation. Accordingly, in this fact pattern, temporarily restricted net assets with implied time restrictions are available to support expenditures made before the expiration of the time restrictions and the net assets should be reclassified from temporarily restricted to unrestricted in the period in which the last remaining restriction has expired. In other words, in this fact pattern, if the expenditure that meets the purpose restriction is made before meeting the implied time restriction that exists because the beneficiary cannot determine the timing and amount of distributions from the recipient to the beneficiary, all the restrictions should be considered met once the implied time restriction is met.

¹¹ In this fact pattern, ABC Hospital's interest in the net assets of ABC Foundation is subject to an implied time restriction that exists because ABC Hospital cannot determine the timing and amount of distributions from ABC Foundation to ABC Hospital and a purpose restriction. Because the net assets arose from cash contributions with no other donor-imposed time restrictions, no time restrictions other than those imposed by ABC Foundation exist. If instead the net assets arose from promises to give rather than from cash contributions, the net assets might be subject to donor-imposed time restrictions in addition to the time restriction imposed by ABC Foundation and the purpose restriction. In determining whether net assets that arose from promises to give are subject to donor-imposed time restrictions in addition to the time restrictions imposed by ABC Foundation, NPEs should consider the guidance in section 6140.04, *Lapsing of Restrictions on Receivables if Purpose Restrictions Pertaining to Long-Lived Assets are Met Before the Receivables are Due*, which discusses whether restrictions on net assets arising from promises to give that are restricted by donors for investments in long-lived assets are met when the assets are placed in service or when the receivables are due. In circumstances in which the net assets are subject to (a) donor-imposed time restrictions in addition to the (b) implied time restrictions that exist because ABC Hospital cannot determine the timing and amount of distributions from ABC Foundation to ABC Hospital and (c) purpose restrictions, the last remaining time restriction should be considered in applying the guidance in FASB ASC 958-205-45-11 that provides that temporarily restricted net assets with time restrictions are not available to support expenses until the time restrictions have expired.

In summary, ABC Hospital should not reclassify \$3,000,000 from temporarily-restricted net assets to unrestricted net assets as a result of building and placing into service the New Modern Hospital Wing until both the purpose restriction and the implied time restriction are met. If both the purpose restriction and the implied time restriction are met, ABC Hospital should decrease its interest in the net assets of ABC Foundation and increase cash (or a receivable, if the Foundation has merely obligated itself to make the distribution) by the amount of the distribution, and simultaneously reclassify the same amount from temporarily restricted net assets to unrestricted net assets. The reclassification should be reported separately from the performance indicator in the statement of operations in accordance with the guidance in FASB ASC 954-10, FASB ASC 954-205, FASB ASC 954-310, FASB ASC 954-405, and FASB ASC 954-605.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.42 Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (Recipient Entity)—Accounting for Unrealized Gains and Losses on Investments Held by the Foundation

Inquiry—FASB ASC 958 provides that if entities are financially interrelated, the balance sheet of the beneficiary entity should reflect that entity's beneficial interest in the net assets of the recipient entity, and that that interest should be adjusted periodically to reflect the changes in the net assets of the recipient entity. This accounting is similar to the equity method of accounting. FASB ASC 954-10, FASB ASC 954-205-45, FASB ASC 954-320-45, FASB ASC 954-320-55, and FASB ASC 954-605 provide guidance pertaining to the classification of investment returns in the financial statements of health care entities.

ABC Hospital and ABC Foundation are financially interrelated entities. How should changes in ABC Hospital's interest in the net assets of ABC Foundation attributable to unrealized gains and losses on Foundation's investments be classified in ABC Hospital's financial statements?

Reply—In circumstances in which ABC Hospital can influence the financial decisions of ABC Foundation to such an extent that ABC Hospital can determine the timing and amount of distributions from Foundation to ABC Hospital, changes in ABC Hospital's interest in the net assets of ABC Foundation attributable to unrealized gains and losses on investments should be classified in the same manner that they would have been had ABC Hospital held the investments and had the transactions itself. In accordance with the guidance in FASB ASC 954-10, FASB ASC 954-205-45, FASB ASC 954-320-45, FASB ASC 954-320-55, and FASB ASC 954-605, ABC Hospital should include in the performance indicator the portion of the change attributable to unrealized gains and losses on trading securities that are not restricted by donors or by law, and should exclude from the performance indicator the portion of the change attributable to all other unrealized gains and losses.

In circumstances in which ABC Hospital cannot influence the financial decisions of Foundation to such an extent that ABC Hospital can determine the timing and amount of distributions ABC Hospital receives from Foundation, an implied time restriction exists on ABC Hospital's net assets attributable to

its interest in the net assets of Foundation (in addition to any other restrictions that many exist). Accordingly, ABC Hospital should classify all changes in that interest, including the portion of the change attributable to unrealized gains and losses on investments, as changes in temporarily restricted net assets (unless donors placed permanent restrictions on investment gains and losses pertaining to their contributions) and therefore should exclude those changes from the performance indicator.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

.43 Application of FASB ASC 958—Classification of Distributions From a Financially Interrelated Fund-Raising Foundation (Recipient Entity) to a Health Care Beneficiary

Inquiry—How should a fund-raising foundation (recipient), a not-for-profit entity subject to FASB ASC 958, report (in its separately issued financial statements) distributions to a financially interrelated beneficiary that is a health care entity? In other words, should such distributions be reported following (a) the guidance on reporting transfers among affiliated health care entities in FASB ASC 954-10, FASB ASC 954-205, FASB ASC 954-605, and FASB ASC 954-810 or (b) the guidance in FASB ASC 958.

Reply—FASB ASC 958 applies to all not-for-profit entities, except those that are providers of health care services (FASB ASC 958-10-15-3). Therefore, the guidance in FASB ASC 954 generally does not apply to financial statements of recipient entities that are financially interrelated fund-raising foundations. The foundation should follow the accounting and reporting requirements of FASB ASC 958 rather than FASB ASC 954 in the foundation's separately issued financial statements. The foundation should report distributions to beneficiary entities as expenses or distributions to related entities. The guidance in the previous sentence applies regardless of whether the recipient entity and the beneficiary are under common control or whether one controls the other in a parent-subsidiary relationship.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

Chapter 12

The Reporting Entity and Related Entities

Gray shaded text in this chapter reflects guidance issued but not yet effective as of the date of this guide, September 1, 2017, but becoming effective on or prior to June 30, 2018, exclusive of any option to early adopt ahead of the mandatory effective date. Unless otherwise indicated, all unshaded text reflects guidance that was already effective as of the date of this guide.

Overview

12.01 Health systems are complex operations made up of various business lines and subsidiaries. Not-for-profit (NFP) systems often operate through a combination of for-profit and NFPs. Various for-profit entities, such as health maintenance organizations (HMOs) or insurance entities, may be organized as stock corporations, partnerships, or limited liability entities. Fund-raising for NFPs typically is accomplished through a separate foundation. There may be financial transfers of cash or assets among related entities either to fund capital needs or start-up costs or to provide operating subsidies. Certain entities within an NFP system may be obligated for repayment of the system's municipal bonds, but others are not. The system may also be involved in joint ventures or joint operating agreements. This chapter addresses accounting and financial reporting considerations associated with these issues, including consolidation and combinations of entities (that is, mergers and acquisitions).

12.02 This chapter discusses the accounting and reporting for equity investments accounted for under the equity method if the investee is an integral part of the reporting entity's operations, such as a physician hospital organization or joint venture. Chapter 4, "Cash, Cash Equivalents, and Investments," of this guide discusses accounting and reporting if the investment's purpose is investment income or return (for example, collective trusts, funds of funds, hedge funds, or other alternative investments).

Reporting by NFP Health Care Entities

12.03 The guidance that follows in this section of the guide discusses an NFP health care entity's relationships with for-profit and NFPs that result in either consolidation of parent-subsidiary relationships, whether through stock ownership or other means of control, or equity method accounting. Other circumstances may exist in the health care industry in which 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 paragraphs 12.72–73.

12.04 Per FASB *Accounting Standards Codification* (ASC) 954-810-45-1, whether the financial statements of a reporting health care entity and those of one or more other for-profit entities or NFPs 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.

12.05 Health care organizations may be related to one or more other entities in numerous ways, including ownership, control, or economic interests. Exhibit 12-1, "Relationships of a Not-for-Profit Reporting Entity," describes some common relationships with other entities and identifies where those relationships are discussed in this chapter and FASB ASC. Exhibit 12-1 and this chapter summarize certain guidance in FASB ASC but are not intended as a substitute for reading the guidance itself.

Exhibit 12-1**Relationships of a Not-for-Profit Reporting Entity^a**

<i>Relationship</i>	<i>FASB ASC Reference</i>	<i>Discussion in This Chapter</i>
<i>Relationships With Not-for-Profit Entities</i>		
The reporting entity is the sole corporate member of an NFP entity.	Use the guidance in FASB ASC 958-810-25-2 and 954-810-45-3A.	Paragraph 12.10
The reporting entity has a controlling financial interest through a direct or indirect ownership of a majority voting interest in the other NFP.	Use the guidance in FASB ASC 958-810-25-2.	Paragraph 12.10
The reporting entity controls another NFP through a majority voting interest in its board and has an economic interest in that other entity.	Use the guidance in FASB ASC 958-810-25-3.	Paragraph 12.12
The reporting entity controls an NFP through a form other than majority ownership, sole corporate membership, or majority voting interest in the board of the other entity and has an economic interest in that other entity.	Use the guidance in FASB ASC 958-810-25-4.	Paragraphs 12.13–.15
The reporting entity has control over another NFP or an economic interest in the other but not both.	Use the guidance in FASB ASC 958-810-25-5.	Paragraph 12.16
The reporting entity receives distributions from a related fund-raising foundation, but it does not control that foundation.	Use the guidance in the "Transfers of Assets to a Not-for-Profit Entity or Charitable Trust that Raises or Holds Contributions for Others" subsections of FASB ASC 958-605.	Paragraphs 12.17–.25

(continued)

Relationships of a Not-for-Profit Reporting Entity—continued

<i>Relationship</i>	<i>FASB ASC Reference</i>	<i>Discussion in This Chapter</i>
<i>Relationships With For-Profit Entities</i>		
The reporting entity owns a majority of a for-profit entity's common voting stock.	Use the guidance in the "General" subsections of FASB ASC 810-10 to determine whether that interest constitutes a controlling financial interest.	Paragraphs 12.29–.32
The reporting entity owns 50 percent or less of the common voting stock of an investee and can exercise significant influence over the investee's operating and financial policies.	Except where the reporting entity elects to report such interests at fair value, in accordance with the "Fair Value Option" sections of FASB ASC 825-10, use the equity method of accounting, in accordance with FASB ASC 323-10.	Paragraphs 12.33–.38
The reporting entity owns 50 percent or less of the common voting stock of an investee and the reporting entity neither controls nor can exercise significant influence over the investee's operating and financial policies.	Use the guidance in FASB ASC 958-320-35-1 or FASB ASC 954-325-35.	Paragraph 12.38
The reporting entity is a partner in a general partnership.	May apply the guidance in FASB ASC 970-810 even though not required to do so.	Paragraphs 12.39–.40
The reporting entity is the general partner of a for-profit limited partnership or similar entity, such as a limited liability company that has governing provisions that are the functional equivalent of a limited partnership.	Use the guidance in FASB ASC 810-20 to determine whether the general partner within the group controls and, therefore, should consolidate the limited partnership or similar entity.	Paragraphs 12.41–.42
The reporting entity has an interest in a limited liability company that has governing provisions that are the functional equivalent of a regular corporation.	Use the guidance in FASB ASC 810-10 to determine whether the reporting entity has a majority voting interest that provides it with a controlling financial interest.	Paragraph 12.29

Relationships of a Not-for-Profit Reporting Entity—continued

<i>Relationship</i>	<i>FASB ASC Reference</i>	<i>Discussion in This Chapter</i>
The reporting entity has a noncontrolling interest that constitutes more than a minor interest in a for-profit partnership, limited liability entity, or similar entity engaged in real estate activities.	Except where the reporting entity elects to report such interests at fair value, in accordance with the "Fair Value Option" sections of FASB ASC 825-10, use the equity method, in accordance with the guidance in FASB ASC 970-323.	Paragraphs 12.44–.46
The reporting entity has a noncontrolling interest that constitutes more than a minor interest in a for-profit partnership, limited liability entity, or similar entity other than one engaged in real estate activities.	Except when the reporting entity elects to report such interests at fair value, in accordance with the "Fair Value Option" sections of FASB ASC 825-10, entities typically use by analogy the equity method, in accordance with the guidance in FASB ASC 970-323.	Paragraph 12.43
The reporting entity has a contractual management relationship with another entity and that contractual management relationship has a term that is either the entire remaining legal life of the other entity or a period of 10 years or more.	Use the guidance in the "Consolidation of Entities Controlled by Contract" subsections of FASB ASC 810-10 to determine whether the arrangement constitutes a controlling financial interest.	Paragraphs 12.30–.32
<i>Relationships With Special Entities</i>		
The reporting entity has a relationship with a variable interest entity (VIE), as described in the "Variable Interest Entities" subsections of FASB ASC 810-10.	Pursuant to FASB ASC 810-10-15-17, NFPs are not subject to the "Variable Interest Entities" subsections of FASB ASC 810-10, unless the NFP is used by a business entity in a manner similar to a VIE in an effort to circumvent the provisions of those standards.	Paragraph 12.27

(continued)

Relationships of a Not-for-Profit Reporting Entity—continued

<i>Relationship</i>	<i>FASB ASC Reference</i>	<i>Discussion in This Chapter</i>
The reporting entity is engaged in a leasing transaction with a special-purpose entity lessor.	Use the guidance in paragraphs 8–10 of FASB ASC 958-810-25 and paragraphs 7–16 of FASB ASC 958-810-55 to determine whether to consolidate the lessor.	Paragraphs 12.50–.54
The reporting entity has entered into a joint operating agreement with another entity. They agree to jointly conduct an activity while sharing the operating results and a residual interest upon dissolution.	If housed in a separate legal entity, use the method of accounting for that entity type; otherwise, use the guidance in FASB ASC 808, <i>Collaborative Arrangements</i> .	Paragraphs 12.55–.57
The reporting entity is a sponsor in a research and development arrangement.	Use the guidance in FASB ASC 810-30.	Uncommon; not discussed in this chapter.
The reporting entity has another type of relationship with a special-purpose entity.	The Financial Reporting Executive Committee observes that entities typically analogize to the guidance in paragraphs 8–10 of FASB ASC 958-810-25 and paragraphs 7–16 of FASB ASC 958-810-55.	Paragraph 12.58
^a The guidance in this table applies to relationships with entities that provide goods or services that accomplish the purpose or mission for which the NFP exists or that serve the NFP's administrative purposes.		

Relationships of a Not-for-Profit Reporting Entity^{a 1}

<i>Relationship</i>	<i>FASB ASC Reference</i>	<i>Discussion in This Chapter</i>
<i>Relationships With Not-for-Profit Entities</i>		
The reporting entity is the sole corporate member of a NFP entity.	Use the guidance in FASB ASC 958-810-25-2 and 954-810-45-3A.	Paragraph 12.10
The reporting entity has a controlling financial interest through a direct or indirect ownership of a majority voting interest in the other NFP.	Use the guidance in FASB ASC 958-810-25-2.	Paragraph 12.10
The reporting entity controls another NFP through a majority voting interest in its board and has an economic interest in that other entity.	Use the guidance in FASB ASC 958-810-25-3.	Paragraph 12.12
The reporting entity controls an NFP through a form other than majority ownership, sole corporate membership, or majority voting interest in the board of the other entity and has an economic interest in that other entity.	Use the guidance in FASB ASC 958-810-25-4.	Paragraphs 12.13–.15
The reporting entity has control over another NFP or an economic interest in the other but not both.	Use the guidance in FASB ASC 958-810-25-5.	Paragraph 12.16
The reporting entity receives distributions from a related fund-raising foundation, but it does not control that foundation.	Use the guidance in the "Transfers of Assets to a Not-for-Profit Entity or Charitable Trust that Raises or Holds Contributions for Others" subsections of FASB ASC 958-605.	Paragraphs 12.17–.25

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¹ FASB Accounting Standards Update (ASU) No. 2017-02, *Not-for-Profit Entities—Consolidation (Subtopic 958-810): Clarifying When a Not-for-Profit Entity That Is a General Partner or a Limited Partner Should Consolidate a For-Profit Limited Partnership or Similar Entity*, issued in January 2017, is effective for not-for-profit (NFP) health care entities for fiscal years beginning after December 15, 2016, and for interim periods within fiscal years beginning after December 15, 2017. Early adoption is permitted, provided that both FASB ASU No. 2017-02 and FASB ASU 2015-02, *Consolidation (Topic 810): Amendments to the Consolidation Analysis*, are adopted at the same time and using the same transition method. Special transition guidance is provided if the NFP already adopted FASB ASU No. 2015-02.

Relationships of a Not-for-Profit Reporting Entity—continued

<i>Relationship</i>	<i>FASB ASC Reference</i>	<i>Discussion in This Chapter</i>
<i>Relationships With For-Profit Entities</i>		
The reporting entity owns a majority of a for-profit entity's common voting stock.	Use the guidance in the "General" subsections of FASB ASC 810-10 to determine whether that interest constitutes a controlling financial interest.	Paragraphs 12.29–.32
The reporting entity owns 50 percent or less of the common voting stock of an investee and can exercise significant influence over the investee's operating and financial policies.	Except where the reporting entity elects to report such interests at fair value, in accordance with the "Fair Value Option" sections of FASB ASC 825-10, use the equity method of accounting, in accordance with FASB ASC 323-10.	Paragraphs 12.33–.38
The reporting entity owns 50 percent or less of the common voting stock of an investee and the reporting entity neither controls nor can exercise significant influence over the investee's operating and financial policies.	Use the guidance in FASB ASC 958-320-35-1 or FASB ASC 954-325-35.	Paragraph 12.38
The reporting entity is a partner in a general partnership.	May apply the guidance in FASB ASC 970-810 even though not required to do so.	Paragraphs 12.39–.40
The reporting entity is the general partner of a for-profit limited partnership or similar entity, such as a limited liability company that has governing provisions that are the functional equivalent of a limited partnership.	Use the guidance in FASB ASC 810-20 to determine whether the general partner within the group controls and, therefore, should consolidate the limited partnership or similar entity.	Paragraphs 12.41–.42
The reporting entity is a limited partner for-profit limited partnership or similar entity, such as a limited liability company that has governing provisions that are the functional equivalent of a limited partnership.	Use the guidance in FASB ASC 958-810-25 to determine if a limited partner has a controlling financial interest.	Paragraphs 12.29, .41–.42

Relationships of a Not-for-Profit Reporting Entity—*continued*

<i>Relationship</i>	<i>FASB ASC Reference</i>	<i>Discussion in This Chapter</i>
The reporting entity has an interest in a limited liability company that has governing provisions that are the functional equivalent of a regular corporation.	Use the guidance in FASB ASC 810-10 to determine whether the reporting entity has a majority voting interest that provides it with a controlling financial interest.	Paragraph 12.29
The reporting entity has a noncontrolling interest that constitutes more than a minor interest in a for-profit partnership, limited liability entity, or similar entity engaged in real estate activities.	Except where the reporting entity elects to report such interests at fair value, in accordance with the "Fair Value Option" sections of FASB ASC 825-10, use the equity method, in accordance with the guidance in FASB ASC 970-323.	Paragraphs 12.44–.46
The reporting entity has a noncontrolling interest that constitutes more than a minor interest in a for-profit partnership, limited liability entity, or similar entity other than one engaged in real estate activities.	Except when the reporting entity elects to report such interests at fair value, in accordance with the "Fair Value Option" sections of FASB ASC 825-10, entities typically use by analogy the equity method, in accordance with the guidance in FASB ASC 970-323.	Paragraph 12.43
The reporting entity has a contractual management relationship with another entity and that contractual management relationship has a term that is either the entire remaining legal life of the other entity or a period of 10 years or more.	Use the guidance in the "Consolidation of Entities Controlled by Contract" subsections of FASB ASC 810-10 to determine whether the arrangement constitutes a controlling financial interest.	Paragraphs 12.30–.32

(continued)

Relationships of a Not-for-Profit Reporting Entity—continued

<i>Relationship</i>	<i>FASB ASC Reference</i>	<i>Discussion in This Chapter</i>
<i>Relationships With Special Entities</i>		
The reporting entity has a relationship with a VIE, as described in the "Variable Interest Entities" subsections of FASB ASC 810-10.	Pursuant to FASB ASC 810-10-15-17, NFPs are not subject to the "Variable Interest Entities" subsections of FASB ASC 810-10, unless the NFP is used by a business entity in a manner similar to a VIE in an effort to circumvent the provisions of those standards.	Paragraph 12.27
The reporting entity is engaged in a leasing transaction with a special-purpose entity lessor.	Use the guidance in paragraphs 8–10 of FASB ASC 958-810-25 and paragraphs 7–16 of FASB ASC 958-810-55 to determine whether to consolidate the lessor.	Paragraphs 12.50–.54
The reporting entity has entered into a joint operating agreement with another entity. They agree to jointly conduct an activity while sharing the operating results and a residual interest upon dissolution.	If housed in a separate legal entity, use the method of accounting for that entity type; otherwise, use the guidance in FASB ASC 808.	Paragraphs 12.55–.57
The reporting entity is a sponsor in a research and development arrangement.	Use the guidance in FASB ASC 810-30.	Uncommon; not discussed in this chapter.
The reporting entity has another type of relationship with a special-purpose entity.	The Financial Reporting Executive Committee observes that entities typically analogize to the guidance in paragraphs 8–10 of FASB ASC 958-810-25 and paragraphs 7–16 of FASB ASC 958-810-55.	Paragraph 12.58
^a The guidance in this table applies to relationships with entities that provide goods or services that accomplish the purpose or mission for which the NFP exists or that serve the NFP's administrative purposes.		

Relationships With Another NFP

12.06 FASB ASC 958-810-05-3 explains that ownership of NFPs may be evidenced in various ways because NFPs may exist in various legal forms, such as corporations issuing stock, corporations issuing ownership certificates, membership corporations issuing membership certificates, joint ventures, and partnerships, among other forms. FASB ASC 958-810-25-1 states that a relationship with another NFP can take any one of the following forms, which determines the appropriate reporting:

- a. A controlling financial interest through direct or indirect ownership of a majority voting interest or sole corporate membership in the other NFP (see FASB ASC 958-810-25-2)
- b. Control of a related but separate NFP through a majority voting interest in the board of that NFP by means other than ownership or sole corporate membership and an economic interest in that other NFP (see FASB ASC 958-810-25-3)
- c. An economic interest in the other NFP combined with control through means other than those listed in items *a–b* (see FASB ASC 958-810-25-4)
- d. Either an economic interest in the other NFP or control of the other NFP, but not both (see FASB ASC 958-810-25-5)

12.07 As discussed in FASB ASC 954-810-05-3, the rights and powers of the controlling entity may vary depending on the legal structure of the controlled entity and the nature of control. As a result, whether the financial statements of a controlled NFP should be consolidated with those of the reporting entity depends on the nature of control and whether an economic interest exists, as follows:

- Certain kinds of control, such as controlling financial interests, require consolidation (see paragraphs 12.10–.11).
- Other kinds of control (for example, a majority voting interest in the board of the other NFP) result in consolidation only if coupled with an economic interest (see paragraph 12.13).
- Still other kinds of control, if coupled with an economic interest, result in consolidation being permitted but not required (see paragraphs 12.12–.15).
- The existence of either control or an economic interest, but not both, precludes consolidation but may trigger disclosure requirements (see paragraph 12.16).

12.08 For purposes of applying the guidance for relationships with other NFPs, the FASB ASC glossary defines *control* as "the direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise." The FASB ASC glossary defines an *economic interest* as an NFP's interest in another entity that exists if any of the following criteria are met:

- a. The other entity holds or utilizes significant resources that must be used for the unrestricted or restricted purposes of the NFP, either directly or indirectly by producing income or providing services.
- b. The NFP is responsible for the liabilities of the other entity.

12.09 FASB ASC 958-810-55-6 provides the following examples of economic interests:

- a. Other entities solicit funds in the name of and with the expressed or implied approval of the NFP, and substantially all of the funds solicited are intended by the contributor or are otherwise required to be transferred to the NFP or used at its discretion or direction.
- b. An NFP transfers significant resources to another entity whose resources are held for the benefit of the NFP.
- c. An NFP assigns certain significant functions to another entity.
- d. An NFP provides or is committed to provide funds for another entity, or the NFP guarantees significant debt of another entity.
- e. An NFP has a right to or a 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.

Controlling Financial Interests

12.10 FASB ASC 958-810-25-2 states that an NFP with a controlling financial interest in another NFP through direct or indirect ownership of a majority voting interest or sole corporate membership in that other NFP should consolidate that other NFP, unless control does not rest with the majority owner or sole corporate member (for instance, if the other NFP is in legal reorganization or in bankruptcy or if other legal or contractual limitations are so severe that control does not rest with the sole corporate member), in which case consolidation is prohibited, as discussed in FASB ASC 810-10-15-8. See FASB ASC 958-810-25-2A for an example in which control may not rest with the holder of the majority voting interest. (This example is provided in paragraph 12.11.) FASB ASC 954-810-45-3A states that a parent corporation typically owns stock in a for-profit entity, whereas a sole corporate member holds membership rights in an NFP. Sole corporate membership in an NFP, like ownership of a majority voting interest in a for-profit entity, should be considered a controlling financial interest, unless control does not rest with the sole corporate member (for instance, if the other [membership] entity is in bankruptcy or if other legal or contractual limitations are so severe that control does not rest with the sole corporate member).

12.11 FASB ASC 958-810-25-2A provides the following example of a situation in which control might not rest with the holder of the majority voting interest. In some situations, certain actions require approval by a supermajority vote of the board. Such voting requirements might overcome the presumption of control by the owner or holder of a majority voting interest. FASB ASC 958-810-55-4A provides the following implementation guidance for that paragraph. An NFP should exercise judgment in evaluating such situations. If supermajority voting requirements exist—for example, a specified supermajority of the board is needed to approve fundamental actions such as amending the articles of incorporation or dissolving the entity—an NFP should consider whether those voting requirements have little or no effect on the ability to control the other entity's operations or assets or, alternatively, whether those voting requirements are so restrictive that they call into question whether control rests with the holder of the majority voting interest. Paragraphs 2–14 of FASB ASC 810-10-25 may be helpful in considering whether the inability of the majority voting interest to unilaterally approve certain actions due to supermajority voting requirements is substantial enough to overcome the presumption of control.

Control Combined With an Economic Interest

12.12 FASB ASC 958-810-25-3 states that in the case of control of a related but separate NFP through (a) a majority voting interest in the board of the other NFP by means other than ownership or sole corporate membership² and (b) an economic interest in that other NFP, consolidation is required, unless control does not rest with the holder of the majority voting interest, in which case consolidation is prohibited. An NFP has a majority voting interest in the board of another NFP if it has the direct or indirect ability to appoint individuals that together constitute a majority of the votes of the fully constituted board (that is, including any vacant board positions).

12.13 FASB ASC 958-810-25-4 states that control of a related but separate NFP in which the reporting entity has an economic interest may take forms other than majority ownership interest, sole corporate membership, or majority voting interest in the board of the other entity; for example, control may be through contract or affiliation agreement. In circumstances such as these, consolidation is permitted but not required.³ Consolidation is encouraged for these entities if it would be meaningful.

12.14 Evidence of control, as discussed in the preceding paragraph, 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; authority to select, terminate, and set the compensation of management responsible for implementing the policies and procedures; and mergers or dissolutions.

12.15 According to FASB ASC 958-810-50-2, if an NFP (the reporting entity) controls a related but separate NFP through a form other than majority ownership, sole corporate membership, or majority voting interest in the board of the other entity and has an economic interest in that other NFP, the reporting entity should disclose all of the following information if it does not present consolidated financial statements:

- a. Identification of the other NFP and the nature of its relationship with the reporting entity that results in control
- b. Summarized financial data of the other NFP, which should include the following information:
 - i. Total assets, liabilities, net assets, revenue, and expenses
 - ii. Resources that are held for the benefit of the reporting entity or that are under its control
- c. The disclosures required by paragraphs 1–6 of FASB ASC 850-10-50

² 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 from FASB *Accounting Standards Codification* (ASC) 958-810-55-5. 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 Entity A has the ability to appoint three or more of Entity B's board members. If three of Entity A's board members, employees, or officers 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.

³ Additional information about the consolidation of entities controlled by contract can be found in paragraphs 12.29–.32.

Control or Economic Interest (But Not Both)

12.16 FASB ASC 958-810-25-5 states that the existence of control or an economic interest, but not both, precludes consolidation. Pursuant to FASB ASC 958-810-50-3, the reporting entity should disclose the information about related parties required by paragraphs 1–6 of FASB ASC 850-10-50 for these relationships.

Related Fund-Raising Organizations

12.17 A common situation in which a health care entity may have an economic interest in another entity but may not control it is the fund-raising entity described in paragraph 12.08a. In such situations, the related NFP acts as a recipient entity (an agent, a trustee, or an intermediary) for contributions made to the health care entity.

12.18 The "Transfers of Assets to a Not-for-Profit Entity or Charitable Trust that Raises or Holds Contributions for Others" sections of FASB ASC 958-605 apply if contributions intended to benefit a specific NFP (the beneficiary) are made through another NFP acting as an agent, a trustee, or an intermediary. In such transactions, a donor makes a contribution by transferring assets to an NFP or charitable trust (the recipient entity) that accepts the assets from the donor and agrees to use those assets on behalf of an unaffiliated entity (beneficiary) or transfer those assets, the return on investment of those assets, or both to an unaffiliated entity (the beneficiary) that is specified by the donor.⁴ FASB ASC 958-605-55-78 states that a donor may specify the beneficiary by (a) name; (b) stating that all entities that meet a set of donor-defined criteria are beneficiaries; or (c) actions surrounding the transfer that make clear the identity of the beneficiary, such as by responding to a request from a recipient entity to raise assets for the beneficiary. Paragraphs 80–115 of FASB ASC 958-605-55 provide examples of donor stipulations and discuss whether those stipulations specify a beneficiary.

12.19 According to FASB ASC 958-20-25-1, if a recipient entity and specified health care entity (beneficiary) are *financially-interrelated entities*, as defined in FASB ASC 958-20-15-2 and described in paragraph 12.82, and the recipient entity is not a trustee, the recipient entity should recognize a received contribution when it receives financial or nonfinancial assets from the donor that are specified for the beneficiary. For example, a foundation that exists to raise, hold, and invest assets for the specified health care entity (beneficiary) or a group of affiliates of which the specified health care entity is a member generally is financially interrelated with the NFP(s) it supports and recognizes contribution revenue when it receives assets from the donor.⁵ According to FASB ASC 958-20-25-2 and 958-20-35-1, the specified health care entity (beneficiary) should recognize its interest in the net assets of the foundation (the recipient

⁴ The "Transfers of Assets to a Not-for-Profit Entity or Charitable Trust that Raises or Holds Contributions for Others" sections of FASB ASC 958-605 also establish standards for transactions that take place in a similar manner but are not contributions because the transfers are revocable, repayable, or reciprocal. For example, FASB ASC 958-605-55-110 states that if a resource provider transfers assets to a recipient entity and specifies itself or its affiliate as the beneficiary, a presumption that the transfer is reciprocal and, therefore, not a contribution is necessary, even if the resource provider explicitly grants the recipient entity variance power. Those standards and transactions are discussed in paragraphs 4.61–.63 and 12.81–.84 of this guide. FASB ASC 958-605 and this guide do not use the word *donor* in discussing those transactions because they are not contributions.

⁵ Foundations that are not providers of health care services are not covered by this guide and should follow the Audit and Accounting Guide *Not-for-Profit Entities*.

entity) and adjust that interest for its share of the change in net assets of the recipient entity. Recognizing an interest in the net assets of the recipient entity and adjusting that interest for a share of the change in net assets of the recipient entity is similar to the equity method, which is described in FASB ASC 323-10.⁶

12.20 According to FASB ASC 958-20-55-11, when measuring its interest in the foundation (recipient entity), the health care entity (specified beneficiary) would include only the net assets of the recipient entity that are restricted to that health care entity's use. According to FASB ASC 958-20-55-12, if the recipient entity supports more than one beneficiary, and an agreement with the recipient entity specifies how unrestricted gifts to the recipient entity should be divided between the supported entities, the specified health care entity would also include its share of the recipient entity's unrestricted assets, computed in accordance with that agreement, when it measures its interest in the recipient entity. Similarly, if a parent entity controls both the recipient entity and specified health care entity, and the parent directed that unrestricted gifts would be distributed to affiliates in accordance with a specified formula, each affiliate would include its share of unrestricted net assets, computed in accordance with that formula, when it measures its interest in the recipient entity.

12.21 According to FASB ASC 954-605-25-12, distributions from a financially-interrelated recipient entity to a nongovernmental health care entity that it supports should generally be reported by the health care entity as a reduction of its interest in the recipient entity. However, if the distribution is made from net assets that are not includable in that interest because the health care entity does not have rights to them (that is, the recipient entity can determine to whom the assets will be distributed), the health care entity should report a contribution from the related recipient entity.

12.22 For example, assume a foundation's mission is to raise contributions for 2 financially interrelated health care entities: Hospital A and Hospital B. The foundation receives \$10,000 in contributions from donors who do not specify which of the 2 hospitals should benefit from their gifts. No agreement exists 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.

12.23 As discussed in FASB ASC 958-605-25-24, if the recipient entity and specified health care entity are not *financially-interrelated entities*, as defined in FASB ASC 958-20-15-2 (see paragraph 12.82), a recipient entity that accepts assets from a donor and agrees to use those assets on behalf of the specified health care entity (beneficiary) or transfer those assets, the return on investment of those assets, or both to the specified health care entity (beneficiary) should recognize its liability to the specified health care entity (beneficiary) concurrent with its recognition of cash or other financial assets received from the donor, unless the recipient entity is explicitly granted variance power (see the

⁶ FASB ASC 958-20-45-3 states if the beneficiary and recipient entity are included in consolidated financial statements, the beneficiary's interest in the net assets of the recipient entity should be eliminated, in accordance with FASB ASC 810-10-45-1.

discussion of variance power in paragraph 11.42 of this guide). Except in cases when the donor grants variance power, or the entities are financially interrelated, as described in paragraphs 25–26 of FASB ASC 958-605-25 and FASB ASC 958-605-25-27, respectively, a recipient entity that receives nonfinancial assets is permitted, but not required, to recognize its liability and those assets, provided that the recipient entity consistently reports from period to period and discloses its accounting policy. The FASB ASC glossary defines *nonfinancial asset* as "[a]n asset that is not a financial asset. Nonfinancial assets include land, buildings, use of facilities or utilities, materials and supplies, intangible assets, or services." According to FASB ASC 958-605-25-28, a specified health care entity (beneficiary) should recognize its rights to the financial or nonfinancial assets held by a recipient entity as an asset, unless the recipient entity is explicitly granted variance power (see further discussion in paragraph 11.42 of this guide).

12.24 In contrast, if the donor does not specify a beneficiary (see further discussion in paragraph 12.18, and the foundation and a hospital are under common control, but they are not financially interrelated, the recipient entity should recognize contribution revenue when it receives the gift. At a later date, when the foundation transfers assets to the hospital, the gift should be accounted for as contributions received by the hospital, consistent with the "Contributions Received" sections of FASB ASC 958-605, provided that the foundation is acting other than as an owner.

12.25 Additional guidance regarding accounting for contributions received by agents, trustees, and intermediaries can be found in Technical Questions and Answers (Q&A) sections 6400.35–.43 of section 6400, *Health Care Entities* (AICPA, *Technical Questions and Answers*) (the appendix, "Q&A Section 6400, *Health Care Entities*," of chapter 11, "Contributions Received and Made," of this guide), and chapter 5, "Contributions Received and Agency Transactions," of the Audit and Accounting Guide *Not-for-Profit Entities*.

Relationships With a For-Profit Entity

12.26 An NFP health care system may own stock, partnership interests, or other ownership interests in for-profit entities, such as HMOs or insurance entities, that may or may not provide patient care. Whether the financial statements of a for-profit entity should be consolidated with the reporting entity depends on the nature of control. Certain types of control require consolidation; other relationships require the equity method of accounting to be used. Chapter 4 of this guide discusses the reporting of an interest in a for-profit entity if it is neither consolidated nor reported using the equity method.

12.27 When applying the guidance in FASB ASC 810-10, NFP health care entities do not apply tests to determine whether the other entity is a variable interest entity (VIE). According to FASB ASC 810-10-15-17, NFPs are not subject to the "Variable Interest Entities" sections of FASB ASC 810-10, except that they may be related parties for purposes of applying paragraphs 42–44 of FASB ASC 810-10-25 (see paragraph 12.54 for discussion of certain exceptions relating to VIE treatment for private companies).

12.28 Guidance in this section is organized as follows:

- Consolidation required by a controlling financial interest
- Equity method of accounting for noncontrolling interests in corporations

- Interests in general partnerships
- Interests in limited partnerships and similar entities

Controlling Financial Interests

12.29 FASB ASC 958-810-15-4(a) states that an NFP with a controlling financial interest in a for-profit entity through direct or indirect ownership of a majority voting interest in that entity should apply the guidance in the "General" subsections of FASB ASC 810-10. Per FASB ASC 810-10-15-8, the usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one reporting entity, directly or indirectly, of more than 50 percent of the outstanding voting shares of another entity is a condition pointing toward consolidation. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree. However, when applying the guidance in FASB ASC 810-10, NFPs are not subject to the guidance for variable interest entities.

The "Pending Content" in FASB ASC 958-810-15-4(a) states that an NFP with a controlling financial interest in a for-profit entity through direct or indirect ownership of a majority voting interest in that entity should apply the guidance in the "General" subsections of FASB ASC 810-10. Per "Pending Content" in FASB ASC 810-10-15-8, for legal entities other than limited partnerships, the usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one reporting entity, directly or indirectly, of more than 50 percent of the outstanding voting shares of another entity is a condition pointing toward consolidation. For limited partnerships, the usual condition for a controlling financial interest, as a general rule, is ownership by one limited partner, directly or indirectly, of more than 50 percent of the limited partnership's kick-out rights⁷ through voting interests. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree. However, when applying the guidance in FASB ASC 810-10, NFPs are generally not subject to the guidance for variable interest entities.⁸

12.30 FASB ASC 810-10-15-10(a)(1) provides an exception if control does not rest with the majority owner. For instance, a majority-owned subsidiary should not be consolidated if any of the following are present: (a) the subsidiary is in legal reorganization; (b) the subsidiary is in bankruptcy; (c) the subsidiary operates under foreign exchange restrictions, controls, or other governmentally-imposed uncertainties that are so severe that they cast significant doubt on the parent's ability to control the subsidiary; and (d) the rights of noncontrolling shareholder(s) are so restrictive that it is questioned whether control rests with the majority owner. The guidance in paragraphs 2–14 of

⁷ The rights underlying the limited partner's or partners' ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause. Kick-out rights through voting interests are analogous to voting rights held by shareholders of a corporation.

⁸ FASB ASU No. 2015-02, *Consolidation (Topic 810): Amendments to the Consolidation Analysis*, was issued in February 2015. For all NFP health care entities, the amendments are effective for fiscal years beginning after December 15, 2016, and for interim periods within fiscal years beginning after December 15, 2017. Early adoption is permitted. Readers are encouraged to read the full text of the ASU, available at www.fasb.org. Readers should apply the appropriate guidance based on their facts and circumstances.

FASB ASC 810-10-25 should be applied in assessing the impact of consolidation on noncontrolling shareholder approval or veto rights.

12.31 Legal or business reasons often preclude a physician practice management entity from acquiring the outstanding equity instruments of the physician practice. Per FASB ASC 810-10-15-21, a physician practice management entity can establish a controlling financial interest in a physician practice through contractual management arrangements. Specifically, a controlling financial interest exists if, for a requisite period of time, the physician practice management entity has control over the physician practice and a financial interest in the physician practice that meets all six of the requirements listed in FASB ASC 810-10-15-22. That paragraph contains guidance that describes how those six requirements are to be applied. FASB ASC 810-10-55-206 contains a decision tree illustrating the basic analysis called for by both the six requirements and presumptive, but not other, interpretive guidance.

12.32 Additional guidance for determining whether a controlling financial interest exists is located as follows:

- a. Per FASB ASC 810-30-15, if the reporting entity has a research and development arrangement in which all of the funds for the research and development activities are provided by the sponsor, the reporting entity should follow the guidance in FASB ASC 810-30 to determine whether and how the sponsor should consolidate that arrangement. Per FASB ASC 810-10-15-17, NFPs do not apply tests to determine whether the research and development entity is determined to be a VIE.
- b. The "Consolidation of Entities Controlled by Contract" subsections of FASB ASC 810-10 provide additional guidance about consolidation by physician practice management entities and other situations in which one entity manages another under similar circumstances and arrangements.

Noncontrolling Interests in Voting Stock

© Update 12-1 *Accounting and Reporting: Recognition and Measurement of Financial Assets and Financial Liabilities*

FASB Accounting Standards Update (ASU) No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, was issued January 2016. The amendments are effective for public business entities for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is not permitted by public business entities; however, this FASB ASU provides for early application of certain specified amendments as of the beginning of the fiscal year of adoption.

For all other entities including not-for-profit entities and employee benefit plans within the scope of Topics 960 through 965 on plan accounting, the amendments in this ASU are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted by entities other than public business entities as of the fiscal years beginning after December 15, 2017, and interim periods within those fiscal years.

The amendments in this ASU address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments.

This edition of the guide has not been updated to reflect changes as a result of this ASU, however, the sections that follow will be updated in a future edition. Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

For more information on FASB ASU 2016-01, see appendix D, "Accounting for Financial Instruments," of this guide.

12.33 FASB ASC 958-810-15-4(c) states that an NFP that owns 50 percent or less of the voting stock in a for-profit entity should apply the guidance in FASB ASC 323-10 unless that investment is reported at fair value in conformity with the guidance in FASB ASC 958-810-15-4(e).

12.34 FASB ASC 323-10 requires that the equity method of accounting be used if investments in common stock or in-substance common stock (or both common stock and in-substance common stock), including investments in common stock of joint ventures, give the investor the ability to exercise significant influence over operating and financial policies of an investee, even though the investor holds 50 percent or less of the common stock or in-substance common stock (or both common stock and in-substance common stock).

FASB ASC 323-10 requires that the equity method of accounting be used if investments in common stock or in-substance common stock (or both common stock and in-substance common stock), including investments in common stock of joint ventures, give the investor the ability to exercise significant influence over operating and financial policies of an investee, even though the investor holds 50 percent or less of the common stock or in-substance common stock (or both common stock and in-substance common stock). The "Pending Content" in FASB ASC 323-10-35-33 provides guidance for an increase in level of ownership or degree of influence that requires transition to the equity method of accounting as of the date the investment becomes qualified for equity method accounting.⁹

12.35 *Significant influence* is defined by paragraphs 6–11 of FASB ASC 323-10-15. 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. An investment of less than 20 percent of the voting stock of an investee should lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated. Conversely, an investment (direct or indirect) of 20 percent or more of the voting stock of an investee should lead to a presumption that, in the absence of predominant evidence to the contrary, an investor has the ability to exercise significant influence over an investee. However, this presumption can be overcome in certain instances. FASB ASC 323-10-15-6 provides indications of significant influence that could exist even if the investor owns less than 20 percent of the voting stock. Paragraphs 10–11 of FASB ASC 323-10-15 provide examples of indications that an investor may be unable to exercise significant

⁹ The amendments in FASB ASU No. 2016-07, *Investments—Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting*, are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. The amendments should be applied prospectively upon their effective date to increases in the level of ownership interest or degree of influence that result in the adoption of the equity method. Earlier application is permitted.

influence. Additionally, according to FASB ASC 323-10-25-2, the limitations under which a majority-owned subsidiary should not be consolidated, as discussed in paragraph 12.29, should also be applied as limitations to the use of the equity method.

12.36 Paragraphs 37–39 of FASB ASC 323-10-35 provide guidance on how an investor should account for its proportionate share of an investee's equity adjustments for other comprehensive income (below the performance indicator) in all of the following circumstances: (a) a loss of significant influence, (b) a loss of control that results in the retention of a cost method investment, and (c) discontinuation of the equity method for an investment in a limited partnership because the conditions in FASB ASC 970-323-25-6 are met for applying the cost method. Those paragraphs do not provide guidance for entities that have not historically recorded their proportionate share of an investee's equity adjustments for other comprehensive income. In accordance with FASB ASC 954-225-45-7(e), an NFP health care entity should report items that are required to be reported in, or reclassified from, other comprehensive income separately from (below) the performance indicator.

12.37 An NFP that would otherwise be required to use the equity method may be permitted to report at fair value by making an election pursuant to FASB ASC 825-10-25-1 (the fair value option).

12.38 If the NFP's ownership of voting stock in a for-profit business entity is not sufficient to result in a controlling financial interest or significant influence, the NFP may be required to report its interest in the for-profit business entity at fair value in conformity with FASB ASC 958-320-35-1. That guidance applies to equity securities with a readily determinable fair value, other than consolidated subsidiaries and investments reported under the equity method. If the voting stock does not have a readily determinable fair value and the ownership is not sufficient to result in a controlling financial interest or significant influence, the investment is within the scope of FASB ASC 958-325. Alternatively, the NFP can report the individual investment at fair value if it makes an election pursuant to FASB ASC 825-10-25-1 (the fair value option).

Interests in General Partnerships

12.39 An NFP that is a partner in a general partnership might apply the guidance in FASB ASC 970-810 even though it is not required to do so. FASB ASC 970-810 provides consolidation guidance for partners of general partnerships engaged in real estate activities. FASB ASC 970-810-25-1 states that a general partnership that is directly or indirectly controlled by an investor is, in substance, a subsidiary of the investor. FASB ASC 970-810-25-2 states that a noncontrolling investor in a general partnership should account for its investment by the equity method and be guided by the provisions of FASB ASC 323, *Investments—Equity Methods and Joint Ventures*. Alternatively, the reporting entity may elect to report that noncontrolling interest at fair value, in accordance with the "Fair Value Option" sections of FASB ASC 825-10.

12.40 For example, NFP G and NFP H hold their annual meetings at the same time and in the same city. In order to save costs, they create a general partnership to conduct their meetings, negotiating better rates with the hotel and realizing other synergies. Though they share equally in the decision-making, NFP G has a 70 percent ownership account and NFP H has a 30 percent ownership account. Neither NFP G nor NFP H has control because they share equally in decision-making and therefore neither entity should consolidate the general

partnership. If they analogize to the guidance in FASB ASC 970-810-25-2, the NFPs would apply the equity method to their general partnership interests. Alternatively, the NFPs might elect to report their interests at fair value in accordance with the "Fair Value Option" sections of FASB ASC 825-10. (See paragraph 3.137 of the AICPA Audit and Accounting Guide *Not-for-Profit Entities* for a similar example involving an unincorporated joint venture.)

Interests in Limited Partnerships and Similar Entities

12.41 FASB ASC 810-20 discusses the potential consolidation of partnerships and similar entities. It provides a framework for the determination of which, if any, general partner within the group controls and, therefore, should consolidate a limited partnership or limited liability company that has governing provisions that are the functional equivalent of a limited partnership. See paragraph 12.30 for a limited liability company that is the functional equivalent of a regular corporation.

The "Pending Content" in FASB ASC 958-810 discusses the potential consolidation of partnerships and similar entities by NFPs. It provides a framework for the determination of which, if any, general partner or limited partner within the group controls and, therefore, should consolidate a limited partnership or limited liability company that has governing provisions that are the functional equivalent of a limited partnership. See paragraph 12.30 for a limited liability company that is the functional equivalent of a regular corporation.¹⁰

12.42 FASB ASC 810-20-25-3 states that the general partners in a limited partnership are presumed to control a limited partnership, regardless of the extent of the general partners' ownership interest in the limited partnership. Paragraphs 4–20 of FASB ASC 810-20-25 provide guidance for purposes of assessing whether the limited partners' rights might preclude a general partner from controlling a limited partnership. Paragraphs 10–11 of FASB ASC 810-20-25 state that if the presumption of control by the general partners is overcome, each of the general partners would account for its investment in the limited partnership using the equity method of accounting.

The "Pending Content" in FASB ASC 958-810-25-12 states that the general partners in a limited partnership are presumed to control that limited partnership, regardless of the extent of the general partners' ownership interest in the limited partnership. The "Pending Content" in paragraphs 14–19 of FASB ASC 958-810-25 provides guidance for purposes of assessing whether the limited partners' rights might preclude a general partner from controlling a limited partnership. The "Pending Content" in FASB ASC 958-810-25-15 states that if the limited partners have substantive kick-out rights or substantive participating rights, the presumption of control by the general partners is

¹⁰ FASB ASU No. 2017-02, *Not-for-Profit Entities—Consolidation (Subtopic 958-810): Clarifying When a Not-for-Profit Entity That Is a General Partner or a Limited Partner Should Consolidate a For-Profit Limited Partnership or Similar Entity*, issued in January 2017, is effective for NFP health care entities for fiscal years beginning after December 15, 2016, and for interim periods within fiscal years beginning after December 15, 2017. Early adoption is permitted, provided that both FASB ASU No. 2017-02 and FASB ASU 2015-02, *Consolidation (Topic 810): Amendments to the Consolidation Analysis*, are adopted at the same time and using the same transition method. Special transition guidance is provided if the NFP already adopted FASB ASU No. 2015-02.

overcome and each of the general partners should account for its investment in the limited partnership using the equity method of accounting.

The "Pending Content" in paragraphs 19–29 of FASB ASC 958-810-25 should be considered in evaluating whether rights held by the limited partners overcome the presumption of control by the general partners. If the presumption of control by a general partner is overcome, then one of the limited partners may have a controlling financial interest, and if so, that limited partner should consolidate the limited partnership. A limited partner is deemed to have a controlling financial interest if the limited partner directly or indirectly owns more than 50 percent of the limited partnership's kick-out rights through voting interests. However, if noncontrolling limited partners have substantive participating rights, then the limited partner with a majority of kick-out rights through voting interests does not have a controlling financial interest.¹¹

12.43 FASB ASC 970-323 provides guidance for the real estate industry and limited partners in limited partnerships, noncontrolling interests in corporate joint ventures, and undivided interests in real property. Although health care entities are not required to apply that guidance, except as indicated in the following paragraph, in current practice, NFP health care entities often apply it for their noncontrolling interests in all limited partnerships, limited liability companies, corporate joint ventures, and similar entities. Alternatively, the reporting entity may elect to report that investment at fair value, in accordance with the "Fair Value Option" sections of FASB ASC 825-10.

12.44 FASB ASC 954-810-15-3(i) states that noncontrolling interests in for-profit real estate partnerships, limited liability entities, and similar entities over which the reporting entity has more than a minor interest should be reported under the equity method, in accordance with the guidance in the "General" sections of FASB ASC 970-323, unless the reporting entity elects to report that investment at fair value, in accordance with the "Fair Value Option" sections of FASB ASC 825-10. Those sections state that the equity method of accounting is generally appropriate for accounting by limited partners for their investments in limited partnerships. Alternatively, an NFP health care entity can irrevocably elect fair value as the initial and subsequent measure for noncontrolling interests in partnerships under the "Fair Value Option" sections of FASB ASC 825-10. Paragraph 12.48 provides additional information about distinguishing a minor interest from a more than a minor interest.

12.45 FASB ASC 954-810-15-3(i) also states that an NFP health care entity should apply the guidance in FASB ASC 970-323-25-2 to determine whether its interest in a for-profit real estate partnership, limited liability entity, or similar entity is a controlling or noncontrolling interest. FASB ASC 970-323-25-2 refers to FASB ASC 970-810-25-2, which states that a majority interest holder may not control the entity if one or more of the other partners have substantive participating rights that permit those other partners to effectively participate in significant decisions that would be expected to be made in the ordinary course of business. The determination of whether the rights of the other partners are substantive participating rights should be evaluated in accordance with the guidance for substantive participating rights in FASB ASC 810-20. If the other partners have substantive participating rights, the presumption of control by the majority interest holder is overcome.

¹¹ See footnote 10.

12.46 An NFP health care entity should apply the guidance in FASB ASC 323-30-35-3 to determine whether a limited liability company should be viewed as similar to a partnership, as opposed to a corporation, for purposes of determining whether a noncontrolling interest in a limited liability entity or similar entity should be accounted for in accordance with FASB ASC 970-323 or 323-10. FASB ASC 323-30-35-3 states that an investment in a limited liability company should be viewed as similar to an investment in a limited partnership if the limited liability company maintains a specific ownership account for each investor—similar to a partnership capital account structure.

12.47 A limited partner's interest may be so minor that the limited partner may have virtually no influence over partnership operating and financial policies. FASB ASC 970-323-25-6 states that such a limited partner is, in substance, in the same position (with respect to the investment) as an investor that owns a minor common stock interest in a corporation; accordingly, accounting for the investment using the cost method may be appropriate.

12.48 Although not registrants, many NFP health care entities analogize to the guidance in FASB ASC 323-30-S99-1 to determine what is more than a minor interest. FASB ASC 323-30-S99-1 states that the SEC staff understands that practice generally has viewed investments of more than 3 percent to 5 percent to be more than minor.

Special Entities

12.49 This section discusses relationships with three types of special entities, as follows:

- Special-purpose leasing entities
- Joint operating agreements
- Other special-purpose entities

Consolidation of a Special-Purpose Leasing Entity

12.50 FASB ASC 954-810-15-3(g) states that if an NFP business-oriented health care entity is engaged in leasing transactions with a special-purpose-entity (SPE) lessor, it should consider whether it should consolidate the lessor, in accordance with the guidance in paragraphs 8–10 of FASB ASC 958-810-25.

12.51 FASB ASC 958-810-25-8 states that an NFP lessee should consolidate a special-purpose entity lessor (SPE) if all of the following conditions are met:

- a. Substantially all of the activities of the SPE involve assets that are to be leased to a single lessee.
- b. The expected substantive residual risks and substantially all the residual rewards of the leased asset(s) and the obligation imposed by the underlying debt of the SPE reside directly or indirectly with the lessee through means such as any of the following:
 - i. The lease agreement
 - ii. A residual value guarantee through, for example, the assumption of first-dollar-of-loss provisions
 - iii. A guarantee of the SPE's debt
 - iv. An option granting the lessee a right to either

- (1) purchase the leased asset at a fixed price or at a defined price other than fair value determined at the date of exercise or
 - (2) receive any of the lessor's sales proceeds in excess of a stipulated amount
- c. The owner(s) of record of the SPE has not made an initial, substantive, residual equity capital investment that is at risk during the entire lease term. This criterion should be considered met if the majority owner(s) of the lessor is not an independent third party, regardless of the level of capital investment.

12.52 According to FASB ASC 958-810-25-9, to satisfy the at-risk requirement in FASB ASC 958-810-25-8(c) (see paragraph 12.51), an initial, substantive, residual equity capital investment should meet all of the following conditions:

- a. It represents an equity interest in legal form.
- b. It is subordinate to all debt interests.
- c. It represents the residual equity interest during the entire lease term.

12.53 FASB ASC 958-810-25-10 states that if all the conditions in FASB ASC 958-810-25-8 (see paragraph 12.51) exist, the assets, liabilities, results of operations, and cash flows of the SPE should be consolidated in the lessee's financial statements. This conclusion should be applied to SPEs that are established for both the construction and subsequent lease of an asset for which the lease would meet all the conditions in FASB ASC 958-810-25-8 (see paragraph 12.51). In those cases, the consolidation by the lessee should begin at the lease inception, rather than the beginning of the lease term. Implementation guidance may be found in paragraphs 7–15 of FASB ASC 958-810-55 and 958-840-55-1.

12.54 FinREC believes that 3 percent is the minimum acceptable investment to qualify as an initial, substantive, residual equity capital investment. A greater investment may be necessary depending on the facts and circumstances, including the credit risk associated with the lessee and market risk factors associated with the leased property. For example, the cost of borrowed funds for the transaction might be indicative of the risk associated with the transaction and whether an equity investment greater than 3 percent is needed. Additional information about the application of the preceding criteria and guidance for consolidation of the SPE is located in FASB ASC 958-840.

Agreements to Jointly Operate a Facility or Other Activity

12.55 Health care systems may enter into an agreement in which two or more entities agree to jointly operate and control a certain endeavor, such as a hospital or treatment center, while sharing in the operating results and residual interest upon dissolution, based upon an agreed-upon ratio. Those agreements are similar to joint ventures and, typically, are characterized by factors such as the following:

- *Common purpose.* For example, to share risks and rewards; develop a new market, health service, or program; or pool resources.
- *Joint funding.* All parties contribute resources toward the accomplishment.

- *Defined relationship.* Typically governed by an agreement.
- *Joint control.* No one entity controls the joint operating activity.

12.56 If the endeavor is housed in a separate legal entity, such as a corporation or partnership, it would be accounted for similar to a corporate joint venture using the equity method of accounting described in FASB ASC 323-10. Alternatively, the reporting entity may elect to report such interests at fair value, in accordance with the "Fair Value Option" sections of FASB ASC 825-10.

12.57 If the endeavor is not conducted within a separate legal entity, it would be accounted for based on the guidance in FASB ASC 808, *Collaborative Arrangements*. FASB ASC 808-10-45-1 states that participants in a collaborative arrangement should report costs incurred and revenue generated from transactions with third parties (that is, parties that do not participate in the arrangement) in each entity's respective income statement, pursuant to the guidance in FASB ASC 605-45 for principal agents. An entity should not apply the equity method of accounting to the activities of a collaborative arrangement.

Other Special-Purpose Entities

12.58 An NFP business-oriented health care entity may be engaged in transactions with an SPE that are other than leasing transactions or transactions of a collaborative arrangement. In practice, entities analogize to the guidance in paragraphs 8–10 of FASB ASC 958-810-25 and paragraphs 7–16 of FASB ASC 958-810-55 to determine whether to consolidate the SPE.

Reporting by Investor-Owned Health Care Entities

12.59 FASB ASC 954-810-15-2 provides a summary of the locations of standards that an investor-owned health care entity uses for reporting relationships with other entities, as follows:

- a. Pursuant to FASB ASC 810-10-15-3(a), an investor-owned health care entity should first apply the guidance in the "Variable Interest Entities" sections of FASB ASC 810-10 if it is within the scope of those sections.
- b. Pursuant to FASB ASC 810-10-15-3(b), if the investor-owned health care entity has an investment in another entity that is not determined to be a VIE, it should use the guidance in the "General" sections of FASB ASC 810-10 to determine whether that interest constitutes a controlling financial interest. That guidance also is used to determine if an NFP health care entity has a controlling financial interest in a for-profit entity, and it is discussed in paragraphs 12.29–.32.
- c. Pursuant to FASB ASC 810-10-15-3(c), if the investor-owned health care entity has a contractual management relationship with another entity (for example, a physician practice), and that other entity is not determined to be a VIE, it shall use the guidance in the "Consolidation of Entities Controlled by Contract" sections of FASB ASC 810-10 to determine whether the arrangement constitutes a controlling financial interest. That guidance also is used to determine if an NFP health care entity has a controlling financial interest in a for-profit entity, and it is discussed in paragraphs 12.30–.32.
- d. Pursuant to FASB ASC 810-20-15, if the investor-owned health care entity is the general partner of a limited partnership or similar

entity, such as a limited liability entity that has governing provisions that are the functional equivalent of a limited partnership, it should apply the guidance in FASB ASC 810-20. That guidance also is used by an NFP health care entity that has an interest in a for-profit partnership, and it is discussed in paragraph 12.42.

- e. Pursuant to FASB ASC 810-30-15, if the investor-owned health care entity is a sponsor in a research and development arrangement, it shall apply the guidance in FASB ASC 810-30.

The "Pending Content" in FASB ASC 954-810-15-2 provides a summary of the locations of standards that an investor-owned health care entity uses for reporting relationships with other entities, as follows:

- a. Pursuant to FASB ASC 810-10-15-3(a), if an investor-owned health care entity has an interest in an entity, it must determine whether that entity is within the scope of the "Variable Interest Entities" subsections of FASB ASC 810-10, pursuant to FASB ASC 810-10-15-14. If that entity is within the scope of the "Variable Interest Entities" subsections, the investor-owned health care entity should first apply the guidance in those subsections. Paragraph 810-10-15-17 provides specific exceptions to applying the "Variable Interest Entities" subsections.
- b. Pursuant to FASB ASC 810-10-15-3(b), if the investor-owned health care entity has an interest in an entity that is determined not to be a VIE and is not within the scope of the subsections mentioned in FASB ASC 810-10-15-3(c), it should use the guidance in the "General" sections of FASB ASC 810-10 to determine whether that interest constitutes a controlling financial interest. That guidance also is used to determine if an NFP health care entity has a controlling financial interest in a for-profit entity, and it is discussed in paragraphs 12.29–.32.
- c. Pursuant to FASB ASC 810-10-15-3(c), if the investor-owned health care entity has a contractual management relationship with another entity (for example, a physician practice), and that other entity is determined not to be a VIE, it should use the guidance in the "Consolidation of Entities Controlled by Contract" sections of FASB ASC 810-10 to determine whether the arrangement constitutes a controlling financial interest. That guidance also is used to determine if an NFP health care entity has a controlling financial interest in a for-profit entity, and it is discussed in paragraphs 12.30–.32.
- d. Pursuant to FASB ASC 810-30-15, if the investor-owned health care entity is a sponsor in a research and development arrangement, it should apply the guidance in FASB ASC 810-30.¹²

12.60 In addition, the SEC staff's position is that health care entities that are registrants should follow applicable SEC guidance and the guidance

¹² FASB ASU No. 2015-02, *Consolidation (Topic 810): Amendments to the Consolidation Analysis*, was issued in February 2015. The amendments are effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2016, and for interim periods within fiscal years beginning after December 15, 2017. Early adoption is permitted. Readers are encouraged to read the full text of the ASU, available at www.fasb.org.

in paragraphs 6–7 of FASB ASC 970-323-25 for their noncontrolling interests in non-real estate limited partnerships. Although investor-owned health care entities that are not registrants are not required to apply that guidance, in current practice, they often apply it for their noncontrolling interests in general partnerships, limited partnerships, limited liability companies, corporate joint ventures, and similar entities.

12.61 The "Variable Interest Entities" sections of FASB ASC 810-10 address consolidation by business entities of VIEs. An investor-owned health care entity should follow the guidance in the "Variable Interest Entities" sections if, by design, any of the conditions in FASB ASC 810-10-15-14 exist. The phrase *by design* refers to entities that meet the conditions in that paragraph because of the way they are structured. For example, a legal entity under the control of its equity investors that originally was not a VIE does not become one because of operating losses. The design of the legal entity is important in the application of these provisions.

12.62 *Considerations for Private Companies That Elect to Use Standards Issued by FASB as a Consensus of the Private Company Council*

A private company lessee (the reporting entity) may elect to not apply VIE guidance to a lessor entity under common control when certain conditions are met. For entities that make this election, there are certain disclosure requirements per "Pending Content" in FASB ASC 810-10-50-2AD. Per FASB ASC 810-10-15-17AB, a legal entity need not be evaluated by a private company under the guidance in the "Variable Interest Entities" subsections if items *a–c* are met and, in applicable circumstances, item *d* is met:

- a.* The private company lessee (the reporting entity) and the lessor legal entity are under common control.
- b.* The private company lessee has a lease arrangement with the lessor legal entity.
- c.* Substantially all activities between the private company lessee and the lessor legal entity are related to leasing activities (including supporting leasing activities) between those two entities.
- d.* If the private company lessee explicitly guarantees or provides collateral for any obligation of the lessor legal entity related to the asset leased by the private company, then the principal amount of the obligation at inception of such guarantee or collateral arrangement does not exceed the value of the asset leased by the private company from the lessor legal entity.

Presentation of Consolidated and Combined Financial Statements

12.63 Some accounting standards, including some for reporting relationships with other entities, specify the display of certain financial statement elements or items without considering the reporting model used by NFP health care entities. Therefore, FASB ASC 958-10-45-1 states that preparers of financial statements of NFP entities should follow the guidance in an analogous manner that is appropriate for their method of reporting financial performance and financial position and should consider the reporting objectives of the guidance when exercising judgment about how best to display elements, such as in

which net asset class. Paragraph 12.62 of this guide provides additional information about the alternative for private companies.

12.64 FASB ASC 810-10-10-1 states that the purpose of consolidated financial statements is to present, primarily for the benefit of the shareholders and creditors of the parent entity, the results of operations and financial position of a parent entity and its subsidiaries essentially as if the group was a single entity with one or more branches or divisions. A presumption exists that consolidated financial statements are more meaningful than separate financial statements and that they are usually necessary for a fair presentation when one of the entities in the group has a direct or indirect controlling financial interest in the other entities.

12.65 FASB ASC 810-10-25-15 states that application of guidance of an industry-specific topic to a subsidiary within the scope of that industry-specific topic should be retained in consolidation of that subsidiary.

12.66 For example, if an NFP health care entity has a controlling financial interest in an investor-owned entity, and that entity in turn has a controlling financial interest in a VIE, the consolidation of the VIE is retained in the consolidated financial statements. Similarly, if an NFP health care entity has a controlling financial interest in an investor-owned entity, the debt and equity securities owned by the investor-owned entity are measured and reported using the standards in FASB ASC 320, *Investments—Debt and Equity Securities*, rather than being remeasured using the standards in FASB ASC 958-320.

12.67 FASB ASC 958-810-45-1 states that noncontrolling interests in the equity (net assets) of consolidated subsidiaries should be reported as a separate component of the appropriate class of net assets in the consolidated statement of financial position of an NFP health care entity. That amount shall be clearly identified and described (for example, as noncontrolling ownership interest in subsidiaries) to distinguish it from the components of net assets of the parent, which includes the parent's controlling financial interest in its subsidiaries. The effects of donor-imposed restrictions, if any, on a partially-owned subsidiary's net assets should be reported in accordance with FASB ASC 958-205 and 958-320. Paragraphs 4–6 of FASB ASC 958-810-50 require certain disclosures about noncontrolling interests. Paragraph 9.18 of this guide provides additional information about noncontrolling interests.

12.68 According to FASB ASC 954-810-45-3B, when consolidated financial statements are required or permitted by FASB ASC 958-810-25, a noncontrolling interest in the other NFP should be provided if such interest is represented by an economic interest whereby the noncontrolling interest would share in the operating results or residual interest upon dissolution.

12.69 According to FASB ASC 958-810-50-1, if consolidated financial statements are presented by an NFP (parent), the parent should disclose any restrictions made by entities outside the reporting entity on distributions from the controlled NFP (subsidiary) to the parent and any resulting unavailability of the net assets of the subsidiary for use by the parent.

12.70 FASB ASC 810-10-45-11 states that in some cases, parent-entity financial statements may be needed, in addition to consolidated financial statements, to adequately indicate the position of bondholders and other creditors or preferred shareholders of the parent. Consolidating financial statements, in which one column is used for the parent and other columns for particular

subsidiaries or groups of subsidiaries, often are an effective means of presenting the pertinent information. However, consolidated financial statements are the general-purpose financial statements of a parent having one or more subsidiaries; thus, parent-entity financial statements are not a valid substitute for consolidated financial statements.

12.71 However, neither GAAP nor this guide discuss the use of the parent entity's financial statements as other than the general-purpose financial statements for the primary reporting entity.¹³ 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 ASC 850, *Related Party Disclosures*, and other relevant pronouncements.

12.72 FASB ASC 810-10-55-1B states that in some circumstances, combined financial statements, as distinguished from consolidated financial statements, of commonly controlled entities are likely to be more meaningful than their separate statements. Combined statements would be useful if one individual owns a controlling financial interest in several entities that are related in their operations. Combined financial statements might also be useful to present the financial position and results of operations of entities under common management. Pursuant to FASB ASC 810-10-45-10, both consolidation and combination require elimination of intra-entity transactions and profits and losses.

12.73 In some situations, debt agreements may require the combined financial statements of affiliated entities, the assets or revenues of which serve as collateral for the related debt (sometimes called an obligated group). However, if debt or other agreements prescribe a financial presentation that varies from GAAP (for example, exclusion of entities otherwise required to be consolidated), AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* (AICPA, *Professional Standards*), establishes requirements and provides guidance regarding auditor's reports.

Accounting for Transfers Between Related Entities

12.74 Transfers from a foundation that acts as an agent, a trustee, or an intermediary (that is, a recipient entity) for contributions to a related non-governmental health care entity are discussed in paragraphs 12.17–.25. This section discusses equity transfers, equity transactions, and other transfers between related entities.

Equity Transfers

12.75 The FASB ASC glossary defines an *equity transfer* as follows:

An equity transfer is nonreciprocal. An equity transfer is a transaction directly between a transferor and a transferee. Equity transfers are similar to ownership transactions between a for-profit parent and its owned subsidiary (for example, additional paid-in capital or dividends). However, equity transfers can occur only between related not-for-profit entities (NFPs) if one controls the other or both are under

¹³ Contractual agreements or regulatory provisions may require parent company-only financial statements. AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* (AICPA, *Professional Standards*), provides guidance for reporting on financial presentations to comply with contractual agreements or regulatory provisions.

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).

Per FASB ASC 954-225-45-2, 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 the basis of the transferred underlying assets.

12.76 The "Transactions Between Entities Under Common Control" sections of FASB ASC 805-50 provide guidance when accounting for a transfer of assets or exchange of shares between entities under common control. The entity that receives the net assets or equity interests should recognize the transferred assets and liabilities at the date of transfer, initially measuring them at their carrying amounts in the accounts of the transferring entity. If the carrying amounts of the transferred assets and liabilities differ from the historical cost of the parent of the entities under common control (for example, because push-down accounting had not been applied), then the financial statements of the receiving entity should reflect the transferred assets and liabilities at the historical cost of the parent of the entities under common control. FASB ASC 805-50-45 provides guidance on the presentation of financial statements for the period of transfer and comparative financial statements for prior years, and disclosures are required by FASB ASC 805-50-50.

12.77 FASB ASC 805-50-30-6 notes that in some instances, the entity that receives the net assets or equity interests (the receiving entity) and the entity that transferred the net assets or equity interests (the transferring entity) may account for similar assets and liabilities using different accounting methods. In such circumstances, the carrying amounts of the transferred assets and liabilities may be adjusted to the basis of accounting used by the receiving entity if the change would be preferable. Any such change in accounting method should be applied retrospectively, and financial statements presented for prior periods should be adjusted, unless it is impracticable to do so. FASB ASC 250-10-45 provides guidance if retrospective application is impracticable.

12.78 In most situations, transfers are recorded at the time they are formally obligated to occur (formal board resolutions, legal notes, passage of title to real estate, and so on), as would be the case when each of the entities have independent governance, and the timing of the transfer is controlled by the governing board of the transferor. Yet, in situations of clear, common control of the related entities, it would be appropriate to record transfers at the time when both the transfer amount is known, and the receiving entity is given control over the timing of the transfer.

Equity Transactions

12.79 According to FASB ASC 958-20-25-4, a transfer from a nongovernmental health care entity to an NFP or charitable trust (referred to as a recipient entity) is an equity transaction if all of the following conditions are present:

- A nongovernmental health care entity transfers assets to an NFP or charitable trust (called a recipient entity) that accepts those assets and agrees to use them on behalf of the nongovernmental health care entity or transfer them, their investment return, or both back to the nongovernmental health care entity or its affiliate (that is, the nongovernmental health care entity specifies itself or its affiliate as the beneficiary of the transfer).

- The nongovernmental health care entity and recipient entity are financially-interrelated entities.
- Neither the nongovernmental health care entity nor its affiliate expects payment of the transferred assets, although payment of investment return on the transferred assets may be expected.

12.80 FASB ASC 958-20-15-2 provides that a recipient entity and specified beneficiary are financially-interrelated entities if the relationship between them has both of the following characteristics: one entity has the ability to influence the operating and financial decisions of the other, and one entity has an ongoing economic interest in the net assets of the other. The ability to exercise that influence can be demonstrated in several ways, including the following:

- a. The entities are *affiliates*, as defined in the FASB ASC glossary.
- b. One entity has considerable representation on the governing board of the other entity.
- c. The charter or bylaws of one entity limits its activities to those that are beneficial to the other entity.
- d. An agreement between the entities allows one entity to actively participate in the policy-making processes of the other, such as setting organizational priorities, budgets, and management compensation.

The FASB ASC glossary defines an *ongoing economic interest in the net assets of another* as "[a] residual right to another not-for-profit entity's (NFP'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 entity."

12.81 Per FASB ASC 954-225-55-1, an equity transaction differs from an equity transfer in that an equity transaction, as described in FASB ASC 958-20-25-4, involves a financially-interrelated party either as a third party in a transfer from an entity to one of its affiliates or 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 transferee. In addition, an equity transaction is reciprocal; the health care entity or its affiliate named as the beneficiary receives an ongoing economic interest in the assets held by the recipient entity. As noted in the FASB ASC glossary definition of *equity transfer*, an equity transfer is nonreciprocal; no expectation of repayment exists, and the transferor does not receive a financial interest or ownership (see paragraphs 12.77–.79).

12.82 The reporting of an equity transaction depends upon whether the resource provider or its affiliate is the specified beneficiary. As discussed in FASB ASC 958-20-25-5, if the resource provider specifies itself as beneficiary, it should report an equity transaction as an asset—an interest in the net assets of the recipient entity or an increase in a previously-recognized interest.¹⁴ According to FASB ASC 958-20-25-6, if a resource provider specifies an affiliate as beneficiary of an equity transaction, the resource provider should report an equity transaction as a separate line in its statement of activities, and the affiliate named as beneficiary should report an interest in the net assets of the

¹⁴ According to FASB ASC 958-20-45-3, if the beneficiary (resource provider) and recipient entity are included in consolidated financial statements, the beneficiary's interest in the net assets of the recipient entity should be eliminated, in accordance with FASB ASC 810-10-45-1.

recipient entity.¹⁵ In accordance with FASB ASC 958-20-45-1, the recipient entity should report an equity transaction as a separate line in its statement of activities. The resource provider should disclose the information described in FASB ASC 958-605-50-6 (see paragraph 4.63 of this guide) for each period for which a statement of financial position is presented.

Other Transfers

12.83 Other transfers may occur among related entities. If the entities are consolidated or combined, such transfers are eliminated in consolidation or combination, or both. If the entities are not consolidated or combined (for example, in separate subsidiaries or obligated group financial statements),¹⁶ 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 NFP health care entity are reported as contributions, as discussed in paragraphs 12.17–.25. In other situations, payments may be made for services provided between NFPs under common control, which should be accounted for as revenues and expenses depending on the types of provided services. Transfers that result in changes in ownership interest are accounted for as investments, in accordance with FASB ASC 323 and 810.

12.84 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 in the "Transactions Between Entities Under Common Control" sections of FASB ASC 805-50. For additional information, see paragraphs 12.78–.80.

12.85 According to FASB ASC 954-310-25-3, a health care entity may loan or advance resources to a related entity. If repayment is reasonably assured, a receivable or payable should be recorded by the entities.

12.86 Subsequent to the time that a receivable is recorded, the ability of the receiving entity to repay the receivable should be considered.

12.87 According to FASB ASC 954-310-40-1, if the receivable from a related entity is not to be repaid, or the related entity is perceived as unable to repay, the write-off of the receivable is recognized as an equity transfer, as discussed in FASB ASC 954-225-45-2, with the transferor reducing net assets and the transferee increasing net assets at the date such determination is made. See paragraphs 12.76–.80 for additional discussion.

Disclosure

12.88 Significant relationships and transactions not in the ordinary course of business with directors; management; medical staff; or other related parties, including unconsolidated related entities, should be disclosed in accordance with FASB ASC 850. AU-C section 550, *Related Parties* (AICPA, *Professional Standards*), establishes requirements and provides guidance for the auditor when determining the existence of transactions with related parties and identifying them.

¹⁵ According to FASB ASC 958-20-45-3, if the beneficiary (affiliate) and recipient entity are included in consolidated financial statements, the beneficiary's interest in the net assets of the recipient entity should be eliminated, in accordance with FASB ASC 810-10-45-1.

¹⁶ See paragraphs 7.75–.76 of this guide for additional discussion regarding obligated group financial statements.

12.89 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. The auditor should evaluate the impact of these arrangements on the hospital's internal controls and disclose related-party transactions, as required by FASB ASC 850.

Considerations for Audits Performed in Accordance With PCAOB Standards

PCAOB AS 2410, *Related Parties* (AICPA, *PCAOB Standards and Related Rules*), assists the auditor in identifying, assessing, and responding to risks of material misstatement associated with related parties. It addresses auditing of relationships and transactions with related parties, significant unusual transactions, and financial relationships and transactions with executive officers. It requires the auditor to communicate with the audit committee significant matters arising from its audit of the related party transactions.

Mergers and Acquisitions

12.90 The reporting entity is changed by mergers and acquisitions (referred to jointly as combinations) entered into by the health care entity. Standards for financial accounting and reporting for combinations differ depending upon whether the combining entities are investor-owned entities, NFPs, or one of each. Paragraphs 12.93–.116 summarize some of the guidance in FASB ASC 958-805 and FASB ASC 805, *Business Combinations*, but are not intended as a substitute for reading those standards.

12.91 FASB ASC 805 provides guidance on accounting and reporting for transactions or other events in which an acquirer obtains control of one or more businesses in a combination to be accounted for under the acquisition method. FASB ASC 958-805 provides guidance on a transaction or other event in which an NFP that is the reporting entity combines with one or more other NFPs, businesses, or nonprofit activities.

12.92 If the reporting entity is an investor-owned health care entity, all combinations are accounted for using the acquisition method, including transactions or events referred to as true mergers or mergers of equals.

12.93 FASB ASC 958-805-25-1 requires that an NFP determine whether that transaction or other event is a merger of NFPs or an acquisition by an NFP by applying the definitions. FASB ASC 958-805-55-1 states that ceding control to a new NFP is the sole definitive criterion for identifying a merger, and one entity obtaining control over the other is the sole definitive criterion for an acquisition. Paragraphs 1–31 of FASB ASC 958-805-55 provide guidance on distinguishing between a merger and an acquisition.

12.94 FASB ASC 958-805-55-6 discusses some of the more common characteristics that distinguish a merger from an acquisition by an NFP:

For example, one entity appointing significantly more of the governing board of the newly formed entity, retaining significantly more of its key senior officers, or retaining its bylaws, operating policies, and practices substantially unchanged is more likely to be a feature of an acquisition than of a merger. Similarly, the relative financial strength and

relative size of the participants in the combination may help to determine whether one participant is able to dominate the process leading to the combination. For example, if one entity is financially strong and the other is experiencing financial difficulty, the stronger entity may be able to dominate the transaction, which would indicate that the transaction is an acquisition rather than a merger. Similarly, a participant that is substantially larger than each of the others in terms of revenues, assets, and net assets may be able to dominate the transaction. However, relative size, like relative financial strength and the other indicators discussed, is only one characteristic that may help to distinguish between a merger and an acquisition in particular situations—none of the indicators, by itself, is determinative. As discussed in FASB ASC 958-805-55-1, ceding of control is the sole definitive criterion for a merger.

12.95 The guidance for combinations of entities in this section is organized as follows:

- Mergers of NFPs
- Acquisitions by an NFP
- Acquisitions by an investor-owned entity, including a for-profit subsidiary of an NFP health care entity
- Disclosures about combinations
- Acquired entities

Merger of NFPs

12.96 The FASB ASC glossary defines *merger of not-for-profit entities* as "[a] transaction or other event in which the governing bodies of two or more NFPs cede control of those entities to create a new NFP." FASB ASC 958-805-25-3 requires that the NFP resulting from a merger (the new entity) account for the merger by applying the carryover method described in the "Merger of Not-for-Profit Entities" subsections of FASB ASC 958-805.

12.97 Applying the carryover method requires combining the assets and liabilities recognized in the separate financial statements of the merging entities as of the merger date (or that would be recognized if the entities issued financial statements as of that date), with certain adjustments. The new NFP does not recognize additional assets or liabilities, such as internally-developed intangible assets, that GAAP did not require or permit the merging entities to recognize. However, if a merging entity's separate financial statements are not prepared in accordance with GAAP, those statements should be adjusted to GAAP before the new entity recognizes the assets and liabilities. The new NFP should carry forward at the merger date the merging entities' classifications and designations of their assets and liabilities, unless one of the exceptions in FASB ASC 958-805-25-9 applies. Those exceptions are for certain modifications in contracts as a result of the merger and for conforming accounting policies to reflect a consistent method of accounting.

Acquisition by an NFP

12.98 The FASB ASC glossary defines *acquisition by a not-for-profit entity* as "[a] transaction or other event in which an NFP acquirer obtains control of one or more nonprofit activities or businesses and initially recognizes their assets and liabilities in the acquirer's financial statements." An NFP should

account for each acquisition of a business or nonprofit activity by applying the acquisition method described in the "Acquisition by a Not-for-Profit Entity" subsections of FASB ASC 958-805. That acquisition method is the same as the acquisition method described in FASB ASC 805; however, FASB ASC 958-805 includes guidance on aspects of the items that are unique or especially significant to an NFP.

12.99 Pursuant to FASB ASC 805-10-05-4, as modified by FASB ASC 958-805-25, the following are steps for applying the acquisition method:

- a. Identifying the acquirer
- b. Determining the acquisition date
- c. Recognizing the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree
- d. Recognizing goodwill acquired or a contribution received, including consideration transferred

12.100 FASB ASC 805-10-25-4 requires that one of the combining entities be identified as the acquirer. The guidance on control and consolidation of NFPs should be used to identify the acquirer. For an NFP acquirer other than a health care entity, the guidance to be used is the guidance in FASB ASC 958-810, including the guidance referenced in FASB ASC 958-810-15-4. Consolidation of NFPs is discussed beginning at paragraph 12.03. If that guidance does not clearly indicate which of the combining entities is the acquirer, the factors in paragraphs 42–46 of FASB ASC 958-805-55 should be considered in making that determination.

12.101 Paragraphs 6–7 of FASB ASC 805-10-25 require that the acquirer identify the *acquisition date*, which is the date on which it obtains control of the acquiree. The date on which the acquirer obtains control of the acquiree generally is the date on which the acquirer legally transfers the consideration (if any), acquires the assets, and assumes the liabilities of the acquiree (the closing date). In addition, FASB ASC 958-805-25-17 states that the date on which an NFP acquirer obtains control of an NFP with sole corporate membership generally also is the date on which the acquirer becomes the sole corporate member of that entity.

12.102 FASB ASC 805-20 requires that as of the acquisition date, the acquirer recognize separately from goodwill the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree.¹⁷

12.103 In conformity with FASB ASC 958-805-30-6(b), an NFP acquirer determines the net of the acquisition date amounts of the identifiable assets acquired and the liabilities assumed, measured in accordance with FASB ASC 805-20 and 958-805. Most assets and liabilities are measured at fair value. However, FASB ASC 805-20-25-16 notes that there are limited exceptions to the recognition and measurement principles applicable to business combinations, including acquisitions by an NFP. The limited exceptions are specified in paragraphs 16–28 of FASB ASC 805-20-25, paragraphs 12–23 of FASB ASC 805-20-30, and paragraphs 11–26 of FASB ASC 958-805-25. Examples of items that are either not recognized or are measured at an amount other than their

¹⁷ Reporting noncontrolling interests in financial statements is discussed in chapter 11, "Net Assets and Reclassification of Net Assets" of the AICPA Audit and Accounting Guide *Not-for-Profit Entities*.

acquisition date fair values include income taxes, employee benefits, assets held for sale, collections, conditional promises to give, donor relationships, and certain assets and liabilities arising from contingencies.

12.104 Next, in conformity with FASB ASC 958-805-30-6(a), an NFP acquirer determines the aggregate of the following:

- a. The consideration transferred, measured at its acquisition date fair value (See paragraphs 10–13 of FASB ASC 958-805-30.)
- b. The fair value of any noncontrolling interest in the acquiree
- c. In an acquisition by an NFP achieved in stages, the acquisition date fair value of the acquirer's previously-held equity interest in the acquiree

12.105 If the amount determined in accordance with FASB ASC 958-805-30-6(a) is greater than the amount determined in accordance with FASB 958-805-30-6(b), an NFP acquirer should determine whether the operations of the acquiree as part of the combined entity are expected to be predominantly supported by contributions and returns on investments. If not in conformity with FASB ASC 958-805-25-28, an NFP acquirer should recognize goodwill as of the acquisition date, measured as of the acquisition date as the excess of FASB ASC 958-805-30-6(a) over FASB ASC 958-805-30-6(b).

12.106 If instead, the operations of the acquiree as part of the combined entity are expected to be predominantly supported by contributions and returns on investments, FASB ASC 958-805-25-29 states that an NFP acquirer should recognize a separate charge in its statement of activities as of the acquisition date, measured as the excess of FASB ASC 958-805-30-6(a) over FASB 958-805-30-6(b), rather than goodwill. *Predominantly supported* by means that contributions and returns on investments are expected to be significantly more than the total of all other sources of revenues.

12.107 If the amount determined in accordance with FASB ASC 958-805-30-6(b) is greater than the amount determined in accordance with FASB 958-805-30-6(a), FASB ASC 958-805-25-31 requires an NFP acquirer to recognize the inherent contribution received. The inherent contribution is measured as the excess of the amount in FASB ASC 958-805-30-6(b) over the amount in FASB ASC 958-805-30-6(a). The inherent contribution is reported as a separate credit in the statement of activities as of the acquisition date and, in accordance with FASB ASC 958-805-45-6, is classified on the basis of the type of restrictions imposed on the related net assets. FASB ASC 958-805-45-6 states that those restrictions include restrictions imposed on the net assets of the acquiree by a donor before the acquisition and those imposed by the donor of the business or nonprofit activity acquired, if any. Donor-restricted contributions are reported as restricted support, even if the restrictions are met in the same reporting period in which the acquisition occurs. That is, the acquirer should not apply the reporting exception in FASB ASC 958-605-45-4, as discussed in paragraph 11.13 of this guide, to restricted net assets acquired in an acquisition.

Performance Indicator

12.108 FASB ASC 954-805 provides standards for reporting amounts related to an acquisition by an NFP health care entity within or outside of the performance indicator. The following amounts are reported within the performance indicator:

- The changes in the fair value of a contingent consideration recognized in accordance with FASB ASC 958-805-35-3, unless the arrangement is a hedging instrument for which FASB ASC 954-815 requires the entity to recognize the changes outside the performance indicator
- The separate charge that is recognized in accordance with FASB ASC 958-805-25-29 (that is, the immediate write-off of the goodwill amount)
- The gain or loss resulting from remeasuring a previously-held equity interest in the acquiree in an acquisition achieved in stages, as discussed in paragraphs 9–10 of FASB ASC 805-10-25 and FASB ASC 954-805-45-3

12.109 Per FASB ASC 954-805-45-2, whether the inherent contribution received, recognized in accordance with FASB ASC 958-805-25-31, is presented within or outside the performance indicator depends on whether the contribution is unrestricted or restricted. An unrestricted contribution should be presented within the performance indicator. A contribution that is either temporarily restricted or permanently restricted should be presented outside the performance indicator.

12.110 FASB ASC 954-805-50 requires disclosures about the performance indicator in periods in which mergers or acquisitions occur.

Acquisition by an Investor-Owned Entity, Including a For-Profit Subsidiary of an NFP Health Care Entity

12.111 FASB ASC 805-10-25-1 requires that an investor-owned health care entity determine whether a transaction or other event is a business combination by applying the definition of a *business combination*, which requires that the acquired assets and assumed liabilities constitute a *business*, as defined. If the acquired assets are not a business, the reporting entity should account for the transaction or other event as an asset acquisition. An entity should account for each business combination by applying the acquisition method.

12.112 FASB ASC 805-10-05-4 states that the acquisition method requires all of the following steps:

- a. Identifying the acquirer, which is discussed in FASB ASC 805-10
- b. Determining the acquisition date, which is discussed in FASB ASC 805-10
- c. Recognizing and measuring the identifiable acquired assets, the assumed liabilities, and any noncontrolling interest in the acquiree, as discussed in FASB ASC 805-20
- d. Recognizing and measuring goodwill or a gain from a bargain purchase, as discussed in FASB ASC 805-30

12.113 FASB ASC 958-805-25-14 identifies the differences in the application of the acquisition method by an NFP acquirer from the application of the acquisition method by a business entity. Those differences include all of the following:

- a. An investor-owned health care entity identifies the acquirer in accordance with FASB ASC 805-10-25-5 instead of the guidance in paragraphs 15–16 of FASB ASC 958-805-25.

- b. An investor-owned health care entity recognizes and measures goodwill in accordance with FASB ASC 805-30-25-1 and paragraphs 1–3 of FASB ASC 805-30-30-3 instead of the guidance in paragraphs 27–30 of FASB ASC 958-805-25. Only an NFP acquirer may recognize the immediate charge to the statement of activities.
- c. An investor-owned health care entity recognizes and measures a gain from a bargain purchase in accordance with paragraphs 2–4 of FASB ASC 805-30-25 and paragraphs 4–6 of FASB ASC 805-30-30 instead of the guidance for an inherent contribution received in FASB ASC 958-805-25-31 and paragraphs 8–9 of FASB ASC 958-805-30.

12.114 *Considerations for Private Companies That Elect to Use Standards Issued by FASB as a Consensus of the Private Company Council*

If the accounting alternative in FASB ASC 805-20 is applied, a private company should no longer recognize separately from goodwill (a) customer-related intangible assets unless they are capable of being sold or licensed independently from the other assets of the business and (b) noncompetition agreements.

Disclosures

12.115 FASB ASC 958-805-50 requires an NFP health care entity to disclose information that enables users of its financial statements to evaluate the nature and financial effect of a merger of NFPs or an acquisition by an NFP. If acquisitions are individually immaterial but are material collectively, the NFP should disclose the required information in the aggregate. Disclosures are also required if an acquisition date is after the reporting date but before the financial statements are issued or available for issue (unless the initial accounting for an acquisition by an NFP is incomplete at the time financial statements are issued or available for issue, in which case the acquirer describes which disclosures could not be made and the reason why they could not be made). If amounts that relate to acquisitions that occurred in the current or previous reporting periods are adjusted, the NFP should disclose information that enables users of its financial statements to evaluate the financial effects of those adjustments in the current reporting period.

Acquired Entities

12.116 All acquired entities may elect to apply pushdown accounting in its separate financial statements upon a change-in-control event in which an acquirer obtains control of the acquired entity. FASB ASC 805-50 addresses the specific guidance on pushdown accounting for all entities.

Auditing

12.117 The independent auditor may consider the examples of specific audit objectives, specific control objectives, and substantive audit procedures for related parties, balances, and transactions that are presented in exhibit 12-2.

Exhibit 12-2

The following table illustrates the use of assertions in developing audit objectives and designing substantive tests. The examples are not intended to be all-inclusive nor is it expected that all the procedures are necessarily applied in an audit. Irrespective of the assessed risks of material misstatement, paragraph .18 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), states the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. The use of assertions in assessing risks and designing appropriate audit procedures to obtain audit evidence is described in paragraphs .26–.32 of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*). Various audit procedures and the purposes for which they may be performed are described in paragraphs .A10–.A26 of AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*).

Considerations for Audits Performed in Accordance With PCAOB Standards

For public companies, PCAOB AS 2110, *Identifying and Assessing Risks of Material Misstatements*, PCAOB AS 2810, *Evaluating Audit Results*, and PCAOB AS 1105, *Audit Evidence* (AICPA, *PCAOB Standards and Related Rules*), contain related guidance.

Audit Considerations

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i> ¹⁸	<i>Substantive Audit Procedures</i> ¹⁹
Reporting Entity and Related Entities			
Transactions/Account Balances/Presentation and Disclosure			
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.

(continued)

¹⁸ The auditor should consider a combination of preventative and detective controls responsive to the control objectives.

¹⁹ The auditor should determine the nature, timing, and extent of substantive procedures to perform, considering, for example, the results of tests of controls and risk areas.

Audit Considerations—continued

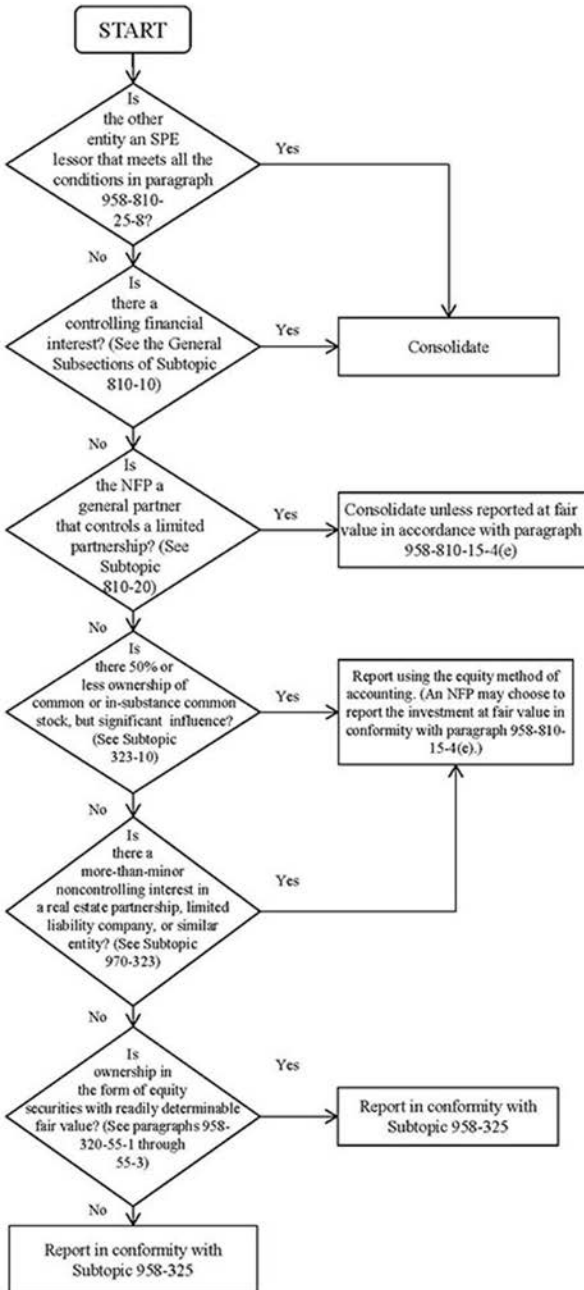
<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
			Obtain representations from management about whether all investees, affiliates, and related entities have been accounted for properly or disclosed.
			Review transactions with investees, affiliates, and other related entities to determine that they are properly reported and clearly expressed.
	Relationships and transactions with related entities are identified and disclosed, if appropriate, because of economic dependence of the entity.	Procedures ensure that conflict-of-interest policies, procedures, and disclosure requirements are met.	Test significant related-party transactions as follows: <ul style="list-style-type: none"> • Determine substance. • Examine documents (invoices, contracts, and agreements). • Determine the basis of pricing. • Determine the collectibility of receivables and advances.
			Review related-party transactions for completeness by <ul style="list-style-type: none"> • considering previously identified transactions or relationships. • reviewing the minutes of directors' and other meetings.

Audit Considerations—continued

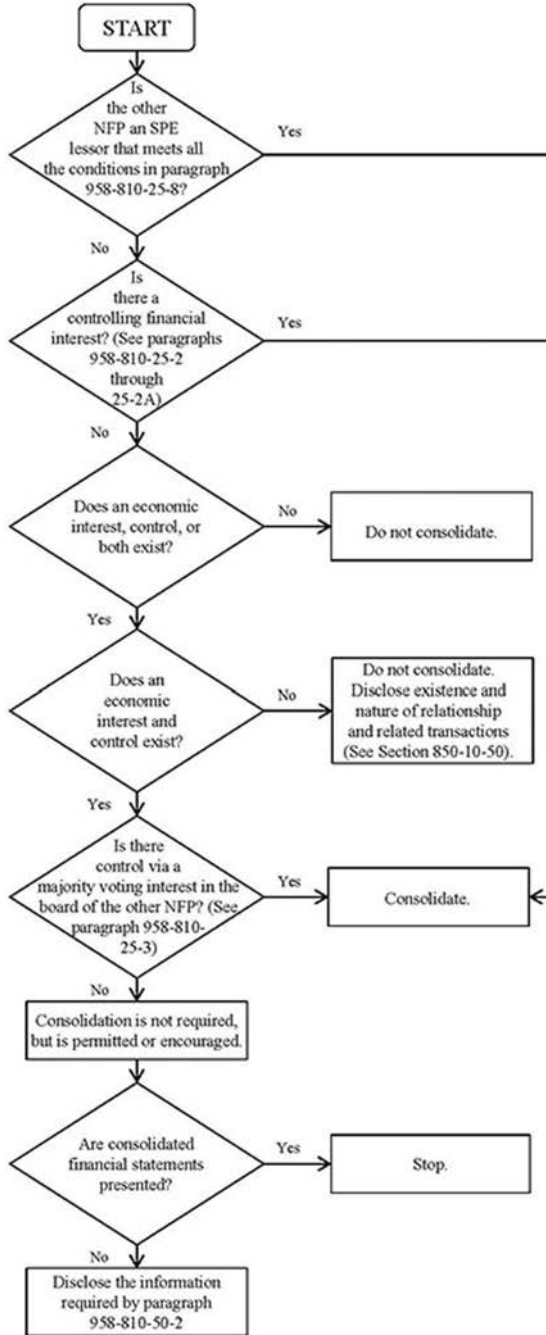
<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
			<ul style="list-style-type: none"> • discussing related-party transactions with entity personnel. • reviewing unusual transactions. • reviewing the responses to related-party (conflict-of-interest) questionnaires.
<i>Presentation and Disclosure</i>			
Classification and understandability	Related-party transactions and entities are properly reported.		Review the presentation and disclosure of related-party information for completeness and understandability.

Appendix—Flowcharts

Ownership of a For-Profit Entity



Relationship With Another Not-for-Profit Entity



Chapter 13

Financial Accounting and Reporting for Managed Care Services

© Update 13-1 *Accounting and Reporting: FASB Accounting Standards Codification 606, Revenue from Contracts with Customers*

FASB ASU No. 2014-09, *Revenue from Contracts with Customers*, as amended, provides a framework for revenue recognition and supersedes or amends several of the revenue recognition requirements in FASB *Accounting Standards Codification* (ASC) 605, *Revenue Recognition*, as well as guidance within the industry-specific topics, including FASB ASC 954, *Health Care Entities*, and FASB ASC 958, *Not-for-Profit Entities*. The standards apply to any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance or lease contracts).

The effective date of the new revenue standards for health care entities is dependent on the type of reporting entity, as follows:

- Health care entities that are either public business entities or NFPs that have issued, or are conduit bond obligors for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market are required to apply the standards for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Earlier application by those entities is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.
- All other health care entities are required to apply the guidance in FASB ASU No. 2014-09 to annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. Earlier application by those health care entities is permitted only as of an annual reporting period beginning after December 15, 2016, including interim reporting periods within that reporting period, or an annual reporting period beginning after December 15, 2016, and interim reporting periods within annual reporting periods beginning one year after the annual reporting period in which an entity first applies the guidance in FASB ASU No. 2014-09.

Readers are encouraged to consult the full text of FASB ASU No. 2014-09 on FASB's website at www.fasb.org.

The AICPA has formed 16 industry task forces to assist in developing a new accounting guide on revenue recognition that will provide helpful hints and illustrative examples for how to apply the new standard. Revenue recognition implementation issues identified by the Health Care Entities Revenue Recognition Task Force will be available for informal comment, after review by the AICPA Financial Reporting Executive Committee, at www.aicpa

.org/InterestAreas/FRC/AccountingFinancialReporting/RevenueRecognition/Pages/RRTF-HealthCare.aspx.

Readers are encouraged to submit comments to revrecomments@aicpa.org.

For more information, see appendix C, "The New Revenue Recognition Standard: FASB ASC 606," of this guide.

This edition of the guide has not been updated to reflect changes as a result of FASB ASC 606, however, the section that follows will be updated in a future edition.

Overview

13.01 Managed care entities, health maintenance organizations (HMOs), affordable care organizations (ACOs), physicians, hospitals, and other health care providers and managers have organized into integrated delivery systems and networks that combine inpatient, outpatient, pharmacy, and physician services into single contracting entities. These systems and networks may be formed by merger, joint venture, affiliation, or contractual risk sharing. Services may be provided under predetermined, fixed-fee capitation arrangements, such as per member per month, or other risk-based arrangements, rather than charging fees for provided services (fee for service). As health care providers and managed care entities adopt new structures and commence new operations in response to the demands of the market, many activities that were traditionally performed by insurance entities, such as assuming medical insurance risk, are being performed by health care entities. Conversely, many activities that were performed by health care entities, such as arranging for the provision of medical services, are being performed by managed care entities.

13.02 This chapter provides guidance for transactions in which an entity assumes or transfers the medical insurance risk or administers the costs of health care services for a predetermined amount. Examples of entities that enter into such transactions include HMOs, ACOs, hospitals, nursing homes, specialty care managers, managed care entities, physician entities, independent practice associations (IPAs), preferred provider organizations (PPOs), public entity risk pools, and third-party administrators. This chapter covers various kinds of managed care arrangements, including group health managed care, capitation arrangements, and administrative services only (ASO) arrangements. Paragraphs 2.67–.77 of this guide provide additional guidance on statutory reporting and other regulatory considerations. Paragraph 4.64 of this guide discusses regulations pertaining to investment activities.

Recognition and Classification of Revenue

13.03 Revenue from managed care arrangements is classified based on the assumed risk and type of service provided, as follows:

- Revenue received in exchange for assuming full medical risk is recognized as premium revenue.
- Revenue received in exchange for performing administrative services is recognized as administrative fees. See paragraphs 13.25–.29.

It is appropriate to carefully review each arrangement entered to determine whether revenue should be recognized for gross cash inflows or whether the cash inflows and outflows should be recorded net or not recorded at all in the financial statements. To record the gross cash inflows as revenue, the entity is generally considered the primary obligor under the arrangement. The guidance in FASB ASC 605-45 should be considered when determining whether an entity is the primary obligor. An arrangement may have various components with some components putting the entity in the primary obligor position and other components putting the entity in an agency type relationship. Under arrangements in which administrative services are typically an integral part of providing or arranging medical care, revenue from those administrative services is included in premium revenue.

13.04 Premium revenue is recognized in income in the period that members are entitled to receive services, as specified by the provisions of the arrangement. Premiums billed or received in advance are reported as deferred revenue (unearned premiums).

13.05 Administrative fees are recognized in income in the period that the related services are performed. Administrative fees billed or received in advance are reported as deferred revenue.

13.06 Under arrangements that include performing administrative services, such as third-party administrator, cost-plus, and minimum premium contracts, entities (a) act as administrators or network managers between employers or other obligated entities and providers of health care services and (b) handle cash inflows and outflows in connection with amounts due from obligated entities to providers of health care services. The inflows and outflows associated with the health care payments from obligated entities to providers of health care services are not revenue and expenses of the entity providing the administrative services.

Capitation Arrangements

13.07 Costs of capitation arrangements are reported as health care expenses. FinREC recommends that amounts received under capitation arrangements be reported as premium revenue. The recognition of premium revenue from capitation arrangements is discussed in paragraphs 10.37–.40 of this guide.

Accounting for Health Care Costs

13.08 According to FASB ASC 954-405-25-2, 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 currently accrued. Costs that will be incurred after a contract is terminated, such as guaranteed salaries, rent, and depreciation, net of any anticipated revenue, should be accrued when it is determined that a contract with a sponsoring employer or other group will be terminated.

13.09 FASB ASC 954-405-25-2 also requires that amounts payable to hospitals, physicians, or other health care providers under risk-retention, bonus,

or similar programs be accrued during the contract period based on relevant factors, such as experience to date.

13.10 According to FASB ASC 954-405-50-2, providers of prepaid health care services should disclose the basis for accruing health care costs and the nature of significant business and contractual arrangements (for example, capitation arrangements) with hospitals, physicians, or other associated entities in the notes to the financial statements.

13.11 The following health care costs are accrued:

- Estimated costs of services rendered but not reported. Typically, health care entities utilize actuaries to assist in determining estimated costs of services rendered but not reported. Auditors often also use actuaries to assist in auditing the recorded liability. See paragraphs 8.118–121 of this guide for additional discussion on the use of actuaries and actuarial methods. Paragraph 2.33 of this guide discusses the risks associated with costs of services rendered but not reported.
- Estimated costs of future health care services to be rendered that the entity is presently obligated to provide, with or without receiving future premiums, according to the terms of the arrangement, regulatory requirements, or other requirements.

13.12 The effects of reinsurance and stop-loss insurance recoveries are considered in calculating and recording those estimated costs. See paragraphs 13.18–19 for additional information.

Accounting for Loss Contracts

13.13 FASB ASC 954-450-25-4 states that 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 demonstrate. Associated entities, such as hospitals, medical groups, and 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.

13.14 In accordance with FASB ASC 954-450-30-4, losses under prepaid health care services contracts 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. 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. FASB ASC 954-450-30-3 states that 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.

13.15 For example, for purposes of determining whether a loss (premium deficiency) will occur over the remaining terms of existing contracts for which premiums will be received, managed care arrangements, including noncancelable, executed contracts that are not yet in force, would be grouped on a basis consistent with the entity's manner of acquiring, servicing, and measuring the profitability of those arrangements. Groupings would be done on a consistent basis from year to year. A loss would be recognized if the sum of expected future fixed and variable, direct, and allocable indirect costs, including health care costs, claim adjustment expenses, maintenance costs, and other costs that are related to a group of contracts, exceeds the sum of related anticipated future premiums, other direct contract revenue, unearned premiums, reinsurance recoveries on those contracts, and investment income considered. See paragraph 13.17 for additional discussion.

13.16 The calculation of loss contracts would be made at the end of each reporting period. Changes in loss contract accruals represent changes in estimate that are reported in the current period's operations.

Consideration of Anticipated Investment Income

13.17 For purposes of determining whether a premium deficiency will occur and measuring that deficiency, FinREC recommends that entities consider investment income that is expected to be earned on premiums received in advance of health care costs incurred during the contract period for the group of contracts. Entities would disclose their accounting policy concerning whether they consider investment income in determining whether a premium deficiency exists on managed care arrangements.

Accounting for Stop-Loss Insurance

13.18 By using stop-loss insurance, prepaid health care providers or associated entities contract to recover health care costs in excess of stated amounts during the contract periods.

13.19 FASB ASC 954-720-45-1 requires that stop-loss insurance premiums be included in reported health care costs. Stop-loss insurance recoveries should be reported as reductions of related health care costs. FASB ASC 954-310-25-2 states that amounts recoverable from stop-loss insurers, reduced by appropriate valuation allowances, should be included in receivables. In addition, FASB ASC 954-720-50-4 requires that the nature, amounts, and effects of significant stop-loss insurance contracts be disclosed.

General and Administrative Expenses

13.20 General and administrative expenses are reported as gross amounts, rather than net of other items, such as fees for administering payments under Medicare and Medicaid arrangements.

Acquisition Costs

13.21 As described in FASB ASC 954-720-05-2, many prepaid providers of managed care services 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 related directly 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 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.

13.22 FASB ASC 954-720-25-6 explains that although theoretical support exists for deferring certain contract or member acquisition costs, acquisition costs of providers of prepaid health care services, other than costs of advertising, should be expensed as incurred. Advertising costs should be accounted for in accordance with the guidance in FASB ASC 720-35.

Financial Statement Display Considerations

Balance Sheet

13.23 Pursuant to FASB ASC 954-210-45-1, entities whose primary business is engaging in managed care arrangements should classify assets and liabilities as current and noncurrent, as discussed in FASB ASC 210-10-45.

13.24 Receivables and payables related to ASO contracts usually are reported at gross values. An ASO arrangement involves three parties (the employer, the hospital or other provider of health care to employees, and the ASO organization); therefore, these arrangements do not meet the conditions of FASB ASC 210-20-45-1 for right of offset. Those conditions are not met in situations involving more than two parties.

Income and Cash Flow Statement

13.25 When entities act as administrators or network managers between employers or other obligated entities and providers of health care services, cash inflows and outflows associated with amounts due from obligated entities to providers of health care services are not accounted for as revenues and expenses in the income statement. Cash flow related to both ASO revenue and cash inflows and outflows through the company would be reflected in the operating cash flows in the cash flow statement.

13.26 FASB ASC 605-45 provides guidance about whether an entity should report revenue gross or net of certain amounts paid to others. The reporting depends on whether the entity functions as principal or agent. FASB ASC 605-45-45 states that it is a matter of judgment whether an entity should report revenue based on either of the following: (a) the gross amount billed to a customer because it has earned revenue as a principal from the sale of the goods or services or (b) the retained net amount (that is, the amount billed to the customer less the amount paid to a supplier) because it has earned a commission or fee as an agent. The factors or indicators set forth in FASB ASC 605-45-45 should be considered in that evaluation. Those factors are listed in paragraphs 13.28–.29 but are not intended as a substitute for reading the cited paragraphs.

13.27 Although FASB ASC 605-45-15-4(b)(3) lists insurance and reinsurance premiums as transactions to which the guidance does not apply, that

exclusion pertains to transactions for which guidance is provided in other subtopics of FASB ASC, rather than the managed care arrangements addressed in this guide. Gross versus net revenue reporting is a matter of judgment that depends on each entity's relevant facts and circumstances after evaluating those facts and circumstances using the indicators.

Indicators of Gross Revenue Reporting

13.28 FASB ASC 605-45-45 describes the following eight indicators that may support reporting gross revenue:

- The entity is the primary obligor in the arrangement, as discussed in FASB ASC 605-45-45-4.
- The entity has general inventory risk before a customer order is placed or upon customer return, as discussed in paragraphs 5–7 of FASB ASC 605-45-45.
- The entity has latitude in establishing price, as discussed in FASB ASC 605-45-45-8.
- The entity changes the product or performs part of the service, as discussed in FASB ASC 605-45-45-9.
- The entity has discretion in supplier selection, as discussed in FASB ASC 605-45-45-10.
- The entity is involved in the determination of product or service specifications, as discussed in FASB ASC 605-45-45-11.
- The entity has physical loss inventory risk after a customer order or during shipping, as discussed in FASB ASC 605-45-45-12.
- The entity has credit risk, as discussed in paragraphs 13–14 of FASB ASC 605-45-45.

Indicators of Net Revenue Reporting

13.29 FASB ASC 605-45-45 describes the following three indicators that may support reporting net revenue:

- The entity's supplier is the primary obligor in the arrangement, as discussed in FASB ASC 605-45-45-16.
- The amount that the entity earns is fixed, as discussed in FASB ASC 605-45-45-17.
- The supplier has credit risk, as discussed in FASB ASC 605-45-45-18.

Disclosures

13.30 Consistent with the requirements of FASB ASC 275, *Risks and Uncertainties*, managed care entities may consider disclosing the following in the notes to the financial statements:

- a. Nature of operations, such as the following:
 - i. Types of rendered managed care services (for example, health maintenance, third-party administrator, and risk sharing)

- ii. Types of entity structures from which the services are rendered (for example, HMO, PPO, point of service, and indemnity)
 - iii. Types of customers
 - b. Risk assumption and risk management profile.
 - c. The amount of ceded premiums and recognized reinsurance recoveries, if not reported in the income statement as separate line items or parenthetically.
 - d. Entities that incur health care costs pertaining only to premium revenue disclose total health care costs either in the income statement as separate line items or parenthetically or in the notes to the financial statements.
 - e. Entities that incur health care costs pertaining to both other revenue and premiums disclose health care costs related to premiums, if practicable.
 - f. Nature of, and amounts paid under, capitation arrangements included in health care costs.
-

Chapter 14

Financial Accounting and Reporting by Continuing Care Retirement Communities

© Update 14-1 *Accounting and Reporting: FASB Accounting Standards Codification 606, Revenue from Contracts with Customers*

FASB ASU No. 2014-09, *Revenue from Contracts with Customers*, as amended, provides a framework for revenue recognition and supersedes or amends several of the revenue recognition requirements in FASB *Accounting Standards Codification* (ASC) 605, *Revenue Recognition*, as well as guidance within the industry-specific topics, including FASB ASC 954, *Health Care Entities*, and FASB ASC 958, *Not-for-Profit Entities*. The standards apply to any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance or lease contracts).

The effective date of the new revenue standards for health care entities is dependent on the type of reporting entity, as follows:

- Health care entities that are either public business entities or NFPs that have issued, or are conduit bond obligors for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market are required to apply the standards for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Earlier application by those entities is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.
- All other health care entities are required to apply the guidance in FASB ASU No. 2014-09 to annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. Earlier application by those health care entities is permitted only as of an annual reporting period beginning after December 15, 2016, including interim reporting periods within that reporting period, or an annual reporting period beginning after December 15, 2016, and interim reporting periods within annual reporting periods beginning one year after the annual reporting period in which an entity first applies the guidance in FASB ASU No. 2014-09.

Readers are encouraged to consult the full text of FASB ASU No. 2014-09 on FASB's website at www.fasb.org.

The AICPA has formed 16 industry task forces to assist in developing a new accounting guide on revenue recognition that will provide helpful hints and illustrative examples for how to apply the new standard. Revenue recognition implementation issues identified by the Health Care Entities Revenue Recognition Task Force will be available for informal comment, after review

by the AICPA Financial Reporting Executive Committee, at www.aicpa.org/interestareas/frc/accountingfinancialreporting/revenuerecognition/pages/rtrf-healthcare.aspx.

Readers are encouraged to submit comments to revrecomments@aicpa.org.

For more information, see appendix C, "The New Revenue Recognition Standard: FASB ASC 606," of this guide.

This edition of the guide has not been updated to reflect changes as a result of FASB ASC 606, however, the section that follows will be updated in a future edition.

Overview

14.01 Continuing care retirement communities (CCRCs) or Life Plan Communities provide residents with a diversity of residential, social, and health care services, in accordance with a resident service agreement (resident agreement or contract) or other agreement specifying the obligations of the CCRC to the resident. This chapter provides guidance on applying generally accepted accounting principles (GAAP) to transactions found in CCRCs for refundable and nonrefundable advance fees, obligations to provide future services and the use of facilities to current residents, and the costs of acquiring initial care contracts.

14.02 The United States has over 1,800 CCRCs. Many CCRCs are operated by NFP organizations, and many are affiliated with religious organizations. Recently, there has been an increase in the number of investor-owned entities operating CCRCs.

14.03 FASB ASC 954-605-05-7 explains that CCRC facilities may be independent, or they may be affiliated with other health care facilities. They usually provide less intensive care than hospitals.

14.04 CCRCs may provide a variety of health care services, including nursing care, home health care, physician services, and other services either directly or by agreement with other health care providers. These health care services are provided in addition to the residential services and amenities, including social, recreational, dining, and laundry services. In addition to providing services to CCRC residents, certain services, predominantly nursing services, may be provided to nonresidents. CCRCs have increased the diversity of residential, social, and health care services rendered in response to consumer demands.

14.05 Many states regulate CCRCs; however, state oversight of CCRCs and the CCRC's disclosures to residents may take various forms.

Types of Contracts

14.06 CCRCs use a variety of contracts, which are constantly undergoing change based on financial and consumer-driven considerations. These continuing-care contracts contain a number of different approaches to providing delivery of services and the fees associated with those services. The fees charged to residents generally consist of three basic components: advance fees, periodic fees, and use fees (or a combination of these fees).

14.07 The contract provisions generally stipulate the amount of the advance fee; whether periodic fees and use fees, or both, are required; whether

those fees can be adjusted; and the underlying circumstances and computations for such adjustments. In addition, contracts generally detail the future services that will be provided to residents; explain how residents will be charged for services; and describe the CCRC's refund policies, if applicable, and calculation of the amount of the refunds, if any. Furthermore, the contract generally describes the obligation of the CCRC and the resident if a contract is terminated, and the resident's unit is or is not reoccupied.

Advance Fees

14.08 *Advance fees* (one-time fee typically at the time of occupancy) are those paid by the resident as a condition of admission to the CCRC for future services and use of the facilities, as specified in the resident agreement. The advance fee generally entitles the resident to the use of the residential facilities; access to amenities and social services; and the provision of, or access to, certain health care services. In addition to advance fees for admission to the CCRC, residents may also pay advance fees relating to upgraded furnishings and amenities, renovation or additions to the resident's living unit, or other upgrades. The advance fees may be nonrefundable or refundable to the resident or resident's estate, depending on the terms of the contract with the resident. The extent to which amenities, social services, and health care services are included is based on the respective resident agreement. In certain instances, the advance fee may be payment for an all-inclusive continuing-care contract that includes residential facilities, meals, and amenities. It may also provide nursing care for little or no increase in periodic fees, except to cover normal operating costs and inflation.

Periodic Fees

14.09 *Periodic fees*, sometimes referred to as service or maintenance fees, are those paid periodically (generally monthly) for services typically provided by CCRCs that are not covered by the advance fees. These periodic fees are generally fixed with periodic modification based on increases in operating costs or other factors defined in the resident agreement.

Use Fees

14.10 *Use fees* are those that may be charged to the resident based on personal preferences or usage by the resident. These fees are paid periodically (generally monthly) for services not covered by the advance or periodic fees. Items typically provided for a separate use fee could include provision of a special parking arrangement, beauty and salon services, health care services, excess meal or other amenity services beyond those provided through the payment of advance or periodic fees.

Types of Living Accommodations

14.11 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, housekeeping, and laundry services.

14.12 CCRCs generally provide nursing, personal care, and assisted living services at the same location. As the health of a resident declines, he or she may be transferred, as needed to a personal care or assisted living unit; nursing

center unit; or specialized long-term care facility or unit, such as a memory-care facility.

Fees and Payment Methods

14.13 A CCRC may require several different payment methods for services and the use of facilities. The following are two of the most prevalent methods:

- a. Advance fee with periodic fees.* Under this method, a resident pays an advance fee and periodic fees for services and the use of facilities. Such periodic fees are generally subject to adjustment for increases in operating costs or inflation or other economic reasons.
- b. Periodic fees only.* 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.

14.14 According to FASB ASC 954-605-05-11, an advance fee may be met by transferring a resident's personal assets, which may include rights to future income or paying a lump sum of cash to the CCRC. Some contracts allow the advance fee to be paid by installment payments. 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 and timing of the refund generally is based on contractual provisions or statutory requirements.

14.15 As explained in FASB ASC 954-605-05-9, many continuing-care contracts are similar to annuity contracts. Under those contracts, the CCRC assumes the risks associated with both of the following: (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. The CCRC has an obligation to provide future services for the length of the contract or life of the resident. In certain circumstances, this obligation continues regardless of whether advance or periodic fees are sufficient to meet the costs of providing services to a resident.

Accounting for Refundable Advance Fees

14.16 As explained in FASB ASC 954-605-05-12, payment of an advance fee generally is required before a resident acquires a right to reside in an apartment or a residential unit for life. A portion of advance fees may be refundable by rescission within a legally or contractually 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.

14.17 FASB ASC 954-605-05-13 states that 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. Refunded amounts may be based on a fixed amount or percentage, an amount that declines to a fixed amount over time (see paragraph 14.19), an amount that declines to zero (see paragraph 14.19), 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.

14.18 For some contracts, the refundable amount is determinable because the contract is fully refundable, the refund amount is fixed, or the refund amount is a percentage. Contracts that provide for fully-refundable advance fees are accounted for and reported as liabilities. If contracts provide for amounts to be refunded based on a fixed amount or percentage, the portion of the advance fee attributable to the fixed amount or percentage is accounted for and reported as a liability, with the balance accounted for as deferred revenue within the "Liability" section of the balance sheet and amortized as discussed in paragraph 14.20. In situations in which the refundable amount declines over time to a fixed amount or zero, the guidance in paragraph 14.19 is applied.

14.19 For other contracts, the refundable amount must be estimated. FASB ASC 954-430-25-1 states that 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 remaining amount of refundable advance fees should be accounted for as deferred revenue within the "Liability" section of the balance sheet. According to FASB ASC 954-430-30-1, the estimated amount of advance fees that are expected to be refunded to current residents under the terms of contracts should be based on the individual facility's own experience or, if records are not available, the experience of comparable facilities. FASB ASC 954-430-35-3 states that adjustments to the estimated liability should be accounted for as deferred revenue and amortized together with nonrefundable advance fees, as discussed in FASB ASC 954-430-35-1 (see paragraph 14.20).

14.20 In accordance with FASB ASC 954-430-35-1, deferred revenue from advance fees from a resident should be amortized to income over future periods based on the estimated life of the resident or 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 the joint and last survivor life expectancy of each pair of residents occupying the same unit. The straight-line method is 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 expected revenues. The amortized amount should not exceed the amount available to the CCRC under state regulations, contract provisions, or management policy. According to FASB ASC 954-430-40-1, unamortized deferred revenue from nonrefundable advance fees should be recorded as revenue upon a resident's death or termination of the contract.

Accounting for Fees Refundable to Residents Only From Reoccupancy Proceeds of a Contract Holder's Unit

14.21 As explained in FASB ASC 954-605-05-14, some contracts between a CCRC and 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.

14.22 According to FASB ASC 954-430-25-1A, in situations in which a contract between a CCRC and a resident stipulates that all or a portion of the refundable advance fees will be paid to current residents or their designees, only to the extent of the proceeds of reoccupancy of a contract holder's unit, that portion 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 subsequent residents in excess of the amount to be paid to previous residents or their designees also should be deferred. According to FASB ASC 954-430-35-4, when a contract between a CCRC and a resident stipulates that all or a portion of the advance fee may be refundable if the contract holder's unit is reoccupied by another person and that the refund amount is limited to the extent of the proceeds of reoccupancy of a contract holder's unit, and if legal and management policy and practice support the withholding of refunds under this condition, the resulting 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.

14.23 Refundable advance fees that are contingent upon reoccupancy by a subsequent resident but are not limited to the proceeds of reoccupancy should be accounted for and reported as a liability.

Accounting for Nonrefundable Advance Fees

14.24 FASB ASC 954-430-25-1 states that under provisions of continuing-care contracts entered into by a CCRC and residents, nonrefundable advance fees represent payment for future services and are accounted for as deferred revenue. According to FASB ASC 954-430-35-2, 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 are amortized in the manner discussed in FASB ASC 954-430-35-1 (see paragraph 14.20).

14.25 The application of the conclusions in paragraphs 14.22–.24 is presented in exhibit 14-1.

Classification of Refundable Advance Fees

14.26 Diversity in practice exists regarding classification of the refundable portion of the advance fee between CCRCs that are SEC registrants and those that are not.

14.27 CCRCs that are SEC registrants are required to consider paragraphs 9–10 of FASB ASC 470-10-45 in determining the classification of the refundable portion of advance fees. Frequently, resident agreements will require that refundable advance fees be refunded if the residents elect to terminate the agreement. CCRC residents do not frequently exercise the option to terminate the resident agreement early; however, the resident does have the contractual right to do so. Upon the resident's election to terminate, the CCRC is then obligated to repay the refundable portion of the advance fee to the resident within a short period of time, generally less than one year. In many cases,

this refund on-demand provision will require that the refundable advance fees be shown as a current liability.

14.28 In practice, CCRCs that are not SEC registrants classify refundable advance fees based upon the expected timing of refunds to be made. The classification as current or noncurrent depends upon the CCRC's own history of refunds and the terms of its resident agreements. Alternatively, CCRCs may elect not to present a classified balance sheet (see paragraph 14.37).

14.29 Other contract provisions or regulations also may affect the CCRC's ability to control the timing of refund payments. For example, provisions that make refunds to a former resident dependent upon resale to, and reoccupancy by, a new resident might allow the CCRC to classify some or all of the refundable advance fees as a noncurrent liability. In addition, if contract provisions or regulations state that a portion of a nonrefundable advance fee (for example, the deferred revenue component) is repayable to the resident only if the CCRC contract is terminated in its early years, and after that period, the advance fee is nonrefundable, the specific terms of each agreement or regulation may indicate that some or all of the advance fees would be reported as a liability (see paragraph 14.19) and that some portion of that liability might be classified as current.

14.30 FinREC recommends CCRCs provide disclosure of the classification of these refundable advance fees; the key terms of the underlying agreements; and, if classified as noncurrent, the amount of the advance fees that are subject to repayment based on the residents' ability to terminate the agreement and require the CCRC to pay the refund.

Accounting for the Obligation to Provide Future Services and the Use of Facilities to Current Residents

14.31 FASB ASC 954-440 discusses the commitments of CCRCs to provide services. This paragraph and paragraphs 14.32–.34 summarize that guidance. 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 use of facilities. Although many CCRCs are contractually allowed to increase periodic fees, some contracts may restrict increases in periodic fees and require continuing services without additional compensation. If the advance and periodic fees that are charged are insufficient to meet the costs of providing future services and the use of facilities, the CCRC should record a liability 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. The liability is equal to the amount that is 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.

14.32 In accordance with paragraphs 1 and 3 of FASB ASC 954-440-35, the obligation of a CCRC 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 should be 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 on.

14.33 In measuring the liability, FASB ASC 954-440-35-3 states that the cash inflows should include revenue contractually committed to support the residents and inflows resulting from monthly fees, including anticipated increases in accordance with contract terms. This measurement should include 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 should comprise operating expenses, including interest expense and excluding selling expense, 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, is 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 that are used should be the same as those used to amortize deferred revenue (see paragraph 14.20). 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.

14.34 FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, provides a useful discussion of general principles governing the use of present value and of the objective of present value in accounting measurements. FASB Concepts Statements are not sources of established accounting principles and, thus, do not amend, modify, or justify a change from GAAP currently in effect.

14.35 The application of the conclusions in paragraph 14.33 is presented in exhibit 14-2.

Accounting for the Costs of Acquiring Initial Continuing-Care Contracts

14.36 Advertising costs incurred in connection with acquiring initial continuing-care contracts should be accounted for in conformity with the guidance in FASB ASC 720-35. Start-up costs are expensed as incurred, in accordance with FASB ASC 720-15. However, according to FASB ASC 954-340-25-1 and 954-720-25-7, costs of acquiring initial continuing-care contracts that are within the scope of FASB ASC 970, *Real Estate—General*, should be expensed or capitalized in accordance with that guidance. FASB ASC 954-340-35-1 states that 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. According to FASB ASC 954-720-25-7, the costs of acquiring continuing-care contracts after a CCRC is substantially occupied or one year following completion should be expensed when incurred.

Financial Statements

14.37 FASB ASC 954-210-45-1 indicates that rather than presenting a classified balance sheet, a CCRC may instead 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.

14.38 The following information about advance fees is required to be disclosed, per FASB ASC 954-430-50:

- The method of accounting for advance fees, the method of calculating the obligation to provide future services and the use of facilities, and the refund policy for refundable fees
- The gross amount of contractual refund obligations under existing contracts and the CCRC's refund policy
- The method(s) of amortization for refundable advance fees and deferred revenue for advance fees

14.39 Because the liability amount in the balance sheet is based upon the CCRC's expected refunds, the amount disclosed in the preceding paragraph will exceed the amount of the liability for entities that have sliding scale contracts.

14.40 FASB ASC 954-440-50 requires that a CCRC disclose the following in the notes to the financial statements for each year presented:

- a. A description of the CCRC and the nature of the related continuing-care contracts entered into by the CCRC
- b. 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
- c. The interest rate used to discount that liability to provide future services
- d. The statutory escrow or similar requirements
- e. The refund policy of the CCRC and the general amount of refund obligation under the existing contracts

14.41 In addition to the required disclosures, FinREC recommends that CCRCs disclose all of the following:

- Amounts classified as current and noncurrent for deferred revenues and liabilities under provisions of resident contracts
- Any applicable state regulatory requirements regarding refunds under existing contracts
- The disclosures recommended in paragraph 14.30 for the classification of refundable advance fees

14.42 FASB ASC 954-430-45-1 requires that advance fees refunded be presented in the statement of cash flows as a financing transaction. Proceeds from refundable fees that are expected to be refunded, and proceeds from nonrefundable entrance fees that are used to finance the construction of new buildings, also impact financing activities in the statement of cash flows.

14.43 Paragraphs 3.42–.43 discuss locating example financial statements.

Auditing

14.44 When auditing a CCRC, the independent auditor may need to consider the examples of specific audit objectives, specific control objectives, and substantive audit procedures that are presented in exhibit 14-3.

14.45 A CCRC ordinarily documents the terms of its arrangements with its residents using standardized sales or residency contracts. It is common for a CCRC to use several different types of residency contracts, each with different terms. As discussed in paragraphs 14.13–.25, the terms of those contracts may significantly affect the accounting treatment for the transactions. Reading the standardized contract(s) and analyzing the terms allows auditors to determine whether the revenue associated with the transactions is recognized in accordance with GAAP.

14.46 In determining which standardized agreements to read and analyze, audit procedures may include the following:

- Requesting copies of all standardized contract(s) currently in use
- Evaluating the standardized contracts for terms that may affect revenue recognition
- Reviewing a sample of transactions for compliance with the standardized agreement

14.47 In determining which transactions to review, the auditor should select a sufficient number and type of contracts to reduce audit risk to an acceptable level. In determining which transactions to select, the auditor may consider the following:

- *The materiality of the transaction.* An auditor may be able to reduce audit risk to an acceptable level by analyzing all material contracts entered into during the audit period, together with a selection of other contracts that, individually, were not considered material.
- *The date the contract was entered into.* To reduce the risk of revenues being recorded in the wrong period, the auditor may consider focusing audit attention on transactions near the end of the reporting period.
- *Whether the transaction utilizes a new form of standardized contract.* To reduce the risk of misstatement of revenues due to transactions on new forms of standardized contracts, the auditor may focus attention on whether revenues and obligations were recognized in the correct amount and period.
- *Contracts relating to transactions with a relatively higher inherent risk.* For example, auditors may consider focusing audit attention on transactions that include notes receivable or that restrict or limit future revenues. If the resident has negotiated a note receivable, a risk exists that payments will not be collected in accordance with terms. Contract terms that require continuing services or provide for other services without additional compensation or with limitations of fee increases may require recognition of a liability, as discussed in paragraphs 14.31–.35.

14.48 When reviewing a transaction, the auditor may consider the following:

- Whether the contract was fully executed by both parties during the fiscal period
- The fees provided for under the contract
- The payment provisions
- The obligations of both parties under the contract
- Any other terms that affect the revenue recognition

14.49 In order to address the completeness assertion, the auditor also should determine whether any revenue recognized is subject to forfeiture, refund, or other concessions. To make this determination, the auditor may consider such factors as the terms specified in the contract(s) and management's intent to provide refunds or the historical pattern of providing refunds or other concessions that are not required under the provisions of the contract.

Exhibit 14-1

The following example is reproduced from paragraphs 1–3 of FASB *Accounting Standards Codification* (ASC) 954-430-55.

Continuing Care Retirement Community**Accounting for Refundable and Nonrefundable Advance Fees**

This Example illustrates the guidance in Sections 954-430-25, 954-430-35, and 954-430-40. This Example has the following assumptions for a continuing care retirement community and a resident of that community:

- a. The unit is occupied for 20 years.
- b. The facility has an estimated 30-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.

Advance fees are accounted for as follows.

Year Admitted	Dies	Resident	Entry Age	Advance Fees			Refunded to the Previous Occupant ^(a)
				Total	Non- refundable 25%	Refundable 75%	
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

^(a) Per contract, 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

Because the refund paid to resident C was limited to the proceeds of reoccupancy received from resident D of \$97,500, the amortization amount continues to be \$4,100 per year for Years 14 through next change in occupancy

The following tables illustrate the amortization of nonrefundable advance fees.

Resident A	Unamortized Deferred Revenue	Estimated Remaining Life (in Years)	Income
Year 1	\$25,000	12.1 =	\$2,066
Year 2	22,934	11.5 =	1,994
Year 3	20,940	11.1 =	1,886
Year 4	19,054	10.6 =	1,798
Unamortized deferred revenue recognized upon the death of the resident			17,256
Total			<u>\$25,000</u>

<i>Resident B</i>	<i>Unamortized Deferred Revenue</i>	<i>Estimated Remaining Life (in Years)</i>	<i>Income</i>
Year 5	\$30,000	6.1 =	\$4,918
Year 6	25,082	5.8 =	4,324
Year 7	20,758	5.5 =	3,774
Year 8	16,984	5.3 =	3,205
Unamortized deferred revenue recognized upon the death of the resident			13,779
Total			<u>\$30,000</u>

<i>Resident C</i>	<i>Unamortized Deferred Revenue</i>	<i>Estimated Remaining Life (in Years)</i>	<i>Income</i>
Year 9	\$37,500	7.0 =	\$5,357
Year 10	32,143	6.7 =	4,797
Year 11	27,346	6.4 =	4,273
Year 12	23,073	6.1 =	3,783
Year 13	19,290	5.8 =	3,324
Unamortized deferred revenue recognized upon the death of the resident			15,966
Total			<u>\$37,500</u>

<i>Resident D</i>	<i>Unamortized Deferred Revenue</i>	<i>Estimated Remaining Life (in Years)</i>	<i>Income</i>
Year 14	\$32,500	6.7 =	\$4,851
Year 15	27,649	6.4 =	4,321
Year 16	23,328	6.1 =	3,824
Year 17	19,504	5.8 =	3,363
Year 18	16,141	5.5 =	2,935
Year 19	13,206	5.3 =	2,492
Year 20	10,714	5.1 =	2,100

Amortization continues until the death of the resident.

Exhibit 14-2

The following example is reproduced from paragraphs 1–4 of FASB *Accounting Standards Codification* (ASC) 954-440-55.

Continuing Care Retirement Community**Accounting for the Obligation to Provide [Future] Services and the Use of Facilities to Current Residents**

This Example illustrates the guidance in Sections 954-440-25 and 954-440-35. This example has the following assumptions:

- 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 continuing care retirement community opened on 1/1/X4. (See exhibit 14-1 for an illustration of how to compute refundable and deferred revenue.)
- An additional periodic fee of \$1,000 is payable monthly with a 5 percent increase annually.
- The unamortized (deferred) costs of acquiring related initial contracts on 12/31/X6 are assumed to be \$17,000.
- The unamortized deferred revenue on 12/31/X6 is assumed to be \$27,027.

The following tables illustrate the present value of net cash flow on 12/31/X6.

<i>Resident</i>	<i>Estimated Remaining Life (in Months) on 12/31/X6</i>	<i>Estimated Cash Inflows</i>			
		<i>[20]X7</i>	<i>[20]X8</i>	<i>[20]X9</i>	<i>[20]X0</i>
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		<u>\$48,000</u>	<u>\$48,300</u>	<u>\$29,768</u>	<u>\$2,315</u>

<i>Resident</i>	<i>Estimated Remaining Life (in Months) on 12/31/X6</i>	<i>Estimated Cash Outflows</i>			
		<i>20]X7</i>	<i>[20]X8</i>	<i>[20]X9</i>	<i>[20]X0</i>
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		<u>\$47,000</u>	<u>\$52,000</u>	<u>\$34,000</u>	<u>\$4,000</u>

<i>Recapitulation</i>	<i>[20]X7</i>	<i>[20]X8</i>	<i>[20]X9</i>	<i>[20]X0</i>
Cash inflows	\$ 48,000	\$ 48,300	\$29,768	\$ 2,315
Cash outflows	(47,000)	(52,000)	(34,000)	(4,000)
	<u>\$1,000</u>	<u>\$(3,700)</u>	<u>\$(4,232)</u>	<u>\$(1,685)</u>
Present value of net cash flows discounted at 10 percent				<u>\$(7,137)</u>

The following tables illustrate the 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

<i>Resident</i>	<i>Estimated Remaining Life (in Months) on 12/31/X6</i>	<i>[20]X7</i>	<i>[20]X8</i>	<i>[20]X9</i>	<i>[20]X0</i>
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		<u>\$7,500</u>	<u>\$7,185</u>	<u>\$4,218</u>	<u>\$312</u>
Total estimated depreciation of the use of facilities to be charged to the current residents					<u>\$19,215</u>

The following table illustrates the 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 paragraph 954-440-55-1(c)	17,000 ^(a)
Liability for providing future services and the use of facilities to current residents on 12/31/X6	<u>\$16,325</u>

^(a) These numbers are for illustrative purposes only and no inference has been made as to the recoverability of the \$17,000.

Exhibit 14-3

The following table illustrates the use of assertions in developing audit objectives and designing substantive tests. The examples are not intended to be all-inclusive nor is it expected that all the procedures are necessarily applied in an audit. Irrespective of the assessed risks of material misstatement, paragraph .18 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), states the auditor should design and perform audit substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. The use of assertions in assessing risks and designing appropriate procedures to obtain audit evidence is described in paragraphs .26–.32 of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*). Various audit procedures and the purposes for which they may be performed are described in paragraphs .A10–.A26 of AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*).

Audit Considerations

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives¹</i>	<i>Substantive Audit Procedures²</i>
<i>Classes of Transactions, Account Balances, and Disclosures</i>			
Existence, completeness, and presentation	Liabilities relating to refundable fee arrangements are accounted for and properly reported.	Written documentation is prepared for refundable fee arrangements.	Review the refundable fee arrangements regarding stipulations for repayments, and determine that such arrangements are properly classified and disclosed in the financial statements.
	Liabilities are accounted for and properly reported.	All liabilities are classified, described, and properly disclosed in the financial statements.	Compare the account balances with the prior periods' balance and amortization schedules.
		Management monitors compliance with restrictive covenants.	Confirm any significant new obligations.

¹ The auditor should consider a combination of preventative and detective controls responsive to the control objectives.

² The auditor should determine the nature, timing, and extent of substantive procedures to perform, considering, for example, the results of tests of controls and risk areas.

Audit Considerations—continued

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
Deferred Revenue			
<i>Classes of Transactions, Account Balances, and Disclosures</i>			
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 continuing care retirement communities are recognized and properly reported.	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.
	Deferred revenues are appropriately classified on the balance sheet.	Appropriate consideration is given to those factors influencing classification of deferred revenues relating to refunds based on reoccupancy proceeds.	Review and document any applicable state requirements relating to the timing and other factors relating to making refunds to residents.
Long-Term Obligations			
<i>Classes of Transactions, Account Balances, and Disclosures</i>			
Existence, completeness, and presentation	Liabilities relating to refundable fee arrangements are accounted for and properly reported.	Written documentation is prepared for refundable fee arrangements.	Review the refundable fee arrangements regarding stipulations for repayments, and determine that such arrangements are properly classified and disclosed in the financial statements.
Obligations to Provide Future Services			
<i>Classes of Transactions, Account Balances, and Disclosures</i>			
Existence, completeness, and presentation	Liabilities relating to any obligations to provide future services appropriately consider contractual rate constraints.	Written documentation is maintained and used in future cash flow considerations based on existing resident agreements.	Review the resident agreements for appropriate consideration in the determination of future cash flows.

(continued)

Audit Considerations—continued

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
Revenues From Periodic Service Fees			
<i>Classes of Transactions, Account Balances, and Disclosures</i>			
Existence and completeness	Propriety of revenue from periodic service fees	Written documentation and monitoring of service fees established and charged to residents.	Review resident agreements and charges, including changes in charges to residents, for consistency.

Chapter 15

Unique Considerations of State and Local¹ Government Health Care Entities

Gray shaded text in this chapter reflects guidance issued but not yet effective as of the date of this guide, September 1, 2017, but becoming effective on or prior to June 30, 2018, exclusive of any option to early adopt ahead of the mandatory effective date. Unless otherwise indicated, all unshaded text reflects guidance that was already effective as of the date of this guide.

Introduction

15.01 This chapter discusses the accounting, financial reporting, and auditing requirements of this guide as they apply to governmental health care entities. The topics covered in this chapter are organized in a manner similar to the organization of topics by chapter in this guide. This chapter is intended to be the primary source of guidance for governmental health care entities; content in the other chapters of this guide is referenced, if applicable. This chapter addresses transactions that are unique to, or prevalent in, the health care industry. However, the AICPA Audit and Accounting Guide *State and Local Governments* contains information about governmental accounting and financial reporting standards and other matters that are unique to, or prevalent in, governmental entities that are not comprehensively addressed in this guide.

15.02 GASB is the primary accounting and financial reporting standard setter for governmental entities. This chapter references provisions of certain GASB statements, as well as the AICPA Audit and Accounting Guide *State and Local Governments*. However, not all guidance included in the GASB statements and that guide is incorporated, repeated, or summarized in this chapter. Accordingly, GASB statements, that guide, and all other relevant authoritative guidance should be read in conjunction with this chapter.

Applicability of This Chapter

15.03 The definition of a *governmental health care entity* (see paragraph 1.08c of this guide) should be applied to determine whether a health care entity is subject to the governmental generally accepted accounting principles (GAAP) hierarchy or private-sector GAAP (for example, FASB *Accounting Standards Codification* [ASC]). Entities are governmental or nongovernmental for accounting and financial reporting purposes based solely on the application of that definition.

15.04 The provisions of this chapter apply to governmental health care entities that report as special-purpose governments engaged only in business-type activities (that is, whose financial statements are prepared using

¹ Paragraph 1.08c of this guide defines a *governmental health care organization (entity)*. This guide is not applicable to federal government health care entities.

enterprise fund accounting and reporting).² Accounting, financial reporting, and auditing matters associated with other types of governmental health care entities (that is, those that use governmental fund accounting and financial reporting) are not within the scope of this chapter or guide.³ A governmental health care entity that uses enterprise fund accounting and reporting may be part of a larger entity, such as a general-purpose government, medical school, or university. In those situations, the recommendations in this chapter apply to the health care entity's separately-issued financial statements.

GAAP Hierarchy for Governmental Health Care Entities

15.05 GASB Statement No. 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, defines the sources of accounting principles used in the preparation of financial statements of state and local governmental entities that are presented in conformity with GAAP, and the framework for selecting those principles. GASB Statement No. 76 categorizes the sources of authoritative GAAP, in descending order of authority, as follows:

- a. Category A: Officially established accounting principles—GASB statements⁴
- b. Category B: GASB Technical Bulletins, GASB Implementation Guides, and literature of the AICPA specifically cleared by GASB⁵

15.06 Under GASB Statement No. 76, if the accounting treatment for a transaction or other event is not specified by a pronouncement in category A, a governmental health care entity should consider whether the accounting treatment is specified by an accounting principle from a source in category B. In such cases, if category B contains an accounting principle that specifies the accounting treatment for a transaction or other event, the governmental entity should follow the accounting treatment specified by that accounting principle.

15.07 If the accounting treatment for a transaction or other event is not specified within a source of authoritative GAAP sources, a governmental entity should first consider accounting principles for similar transactions or other events within a source of authoritative GAAP and then may consider nonauthoritative accounting literature from other sources that does not conflict with

² Paragraph 15 of GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, as amended, describes *business-type activities* as those financed in whole or part by fees charged to external parties for goods or services. Paragraphs 91–105 and 138 of GASB Statement No. 34 describe the financial statements of enterprise funds.

³ Often, governments will use governmental funds, rather than enterprise funds, to report activities relating to long-term institutional care, which includes health care, of the elderly; children; and mentally impaired when user fees (for example, fees for services) are not a principal revenue source for the activity. Although activities that are reported in governmental funds are not within the scope of this guide, chapter 12, "Special-Purpose and State Governments," of the AICPA Audit and Accounting Guide *State and Local Governments* indicates that auditors of such entities should consider referring to this guide for specific auditing considerations unique to health care entities, such as audit procedures relating to amounts due from discharged patients and third-party payors, to the extent they are relevant.

⁴ All GASB Interpretations previously issued and currently in effect also are included in category A of generally accepted accounting principles (GAAP) until altered, amended, supplemented, revoked, or superseded by subsequent GASB pronouncements.

⁵ The provisions of this guide that are category B accounting and financial reporting guidance for state and local governmental entities appear in orange font within the text of the guide and are noted in appendix F, "Category B Guidance."

or contradict authoritative GAAP. Sources of nonauthoritative accounting literature include the following:

- GASB Concepts Statements
- Pronouncements and other literature of FASB
- Pronouncements and other literature of the Federal Accounting Standards Advisory Board
- Pronouncements and other literature of the International Public Sector Accounting Standards Board
- Pronouncements and other literature of the International Accounting Standards Board
- AICPA literature not cleared by GASB
- Practices that are widely recognized and prevalent in state and local government
- Literature of other professional associations or regulatory agencies
- Accounting textbooks, handbooks, and articles

In accordance with paragraph 8 of GASB Statement No. 76, in evaluating the appropriateness of nonauthoritative accounting literature, a governmental entity should consider the consistency of the literature with the GASB Concepts Statements, the relevance of the literature to particular circumstances, the specificity of the literature, 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. 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 nonauthoritative accounting literature. In accordance with paragraph 6 of GASB Statement No. 76, a governmental health care entity should not follow the accounting treatment specified in accounting principles for similar transactions or other events in cases in which those accounting principles either prohibit the application of the accounting treatment to the particular transaction or other event or indicate that the accounting treatment should not be applied by analogy.

15.08 This chapter makes various references to implementation guidance published in the GASB Implementation Guides. GASB Implementation Guides are category B guidance as defined in GASB Statement No. 76.

Applicability of FASB and AICPA Pronouncements

15.09 GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, directly incorporated into GASB's authoritative literature certain pronouncements issued by FASB and its predecessors on or before November 30, 1989. GASB Statement No. 62 eliminated the need for financial statement preparers and auditors to determine which FASB and AICPA pronouncement provisions apply to state and local governments. When the guidance from the pre-November 30, 1989, pronouncements was included as part of GASB Statement No. 62, it was modified as necessary to appropriately recognize the governmental environment and needs of governmental financial statement users.

15.10 GASB Statement No. 62 also eliminated the election provided in paragraph 7, as amended, of GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*. That election permitted governmental entities engaged in business-type activities to elect to apply all FASB statements and interpretations issued after November 30, 1989, that are applicable to private-sector business enterprises and do not conflict with or contradict GASB pronouncements. However, those governmental entities can continue to apply as nonauthoritative accounting literature post-November 30, 1989, FASB pronouncements that do not conflict with or contradict GASB pronouncements, as discussed in paragraph 15.07.

15.11 As governmental health care entities and their auditors consider the applicability of private-sector standards discussed in the other chapters of this guide, it is important to remember that Question 7.8.8 of GASB Implementation Guide No. 2016-1, *Implementation Guidance Update—2016* (IG 2016-1), as amended, states that "business-type activities are not considered not-for-profit activities and should not apply guidance for not-for-profit organizations." Thus, governmental health care entities are prohibited from applying FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*; No. 117, *Financial Statements of Not-for-Profit Organizations*; No. 124, *Accounting for Certain Investments Held by 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*; and No. 164, *Not-for-Profit Entities: Mergers and Acquisitions—Including an amendment of FASB Statement No. 142*. (Those FASB statements are included in FASB ASC 958, *Not-for-Profit Entities*.)

Basic Financial Statements

15.12 Governmental health care entities covered by this chapter use a financial reporting model established by GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, as amended, for special-purpose governments engaged only in business-type activities. GASB Statement No. 34 requires the following statements and information to be provided in separately-issued, general-purpose external financial statements of special-purpose governments engaged only in business-type activities:^{6,7}

⁶ Paragraph 138 of GASB Statement No. 34.

⁷ Although this discussion of the guidance in GASB Statement No. 34 is written from the perspective of legally separate 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 within an enterprise fund of that government. In developing an opinion on financial statements for one or more individual funds, the auditor considers GAAP to the extent those principles apply to the fund financial statements. Although GASB standards do not address the accounting and financial reporting for separately-issued, GAAP-based financial statements for one or more individual funds, and accordingly, GASB did not clear the provisions set forth in this footnote, paragraph 16.87 of the AICPA Audit and Accounting Guide *State and Local Governments* states that in auditing financial statements of such activities, auditors should consider long-established practice dictating that those presentations should apply all relevant GAAP. Thus, in developing an opinion on the separately-issued, GAAP-based financial statements for one or more individual funds, the auditor considers whether the financial statements include all relevant GAAP financial statements, note disclosures, management's discussion and analysis topics, and other required supplementary information (RSI). Paragraphs 15.199.204 discuss the auditor's responsibility with respect to RSI.

- a. Statement of net position
- b. Statement of revenues, expenses, and changes in net position
- c. Statement of cash flows
- d. Notes to financial statements
- e. Management's discussion and analysis (MD&A) as RSI
- f. If applicable, other RSI established by GAAP

The statements should be prepared using the accrual basis of accounting and economic resources measurement focus.⁸

Statement of Net Position

15.13 Governmental health care entities may report their financial position using either a balance sheet format (assets plus deferred outflows of resources equals liabilities plus deferred inflows of resources plus net position) or a net position format (assets plus deferred outflows of resources less liabilities less deferred inflows of resources equals net position). Deferred outflows of resources and deferred inflows of resources are separate financial statement elements, as discussed in paragraphs 32–35 and paragraph 38 of GASB Concepts Statement No. 4, *Elements of Financial Statements*. That Concepts Statement defines *deferred outflows of resources* as a consumption of net assets by the government that is applicable to a future reporting period, and defines *deferred inflows of resources* as an acquisition of net assets by the government that is applicable to a future reporting period. Deferred outflows of resources have a positive effect on net position, similar to assets, and deferred inflows of resources have a negative effect on net position, similar to liabilities. Notwithstanding those similarities, Concepts Statement No. 4 clearly establishes that deferred outflows of resources are not assets and deferred inflows of resources are not liabilities. Recognition of deferred outflows of resources and deferred inflows of resources should be limited to those instances identified by GASB in authoritative pronouncements.

15.14 According to GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, amounts that are required to be reported as deferred outflows of resources should be reported in a statement of net position in a separate section following assets. Similarly, amounts that are required to be reported as deferred inflows of resources should be reported in a separate section following liabilities. The netting of deferred inflows of resources and deferred outflows of resources generally is not permitted.⁹ However, the total for deferred outflows of resources may be added to the total for assets, and the total for deferred inflows of resources may be added to the total for liabilities to provide subtotals.

15.15 Balances of deferred outflows of resources and deferred inflows of resources reported in a statement of net position or a governmental fund balance sheet may be aggregations of different types of deferred amounts. If significant

⁸ See paragraph 92 of GASB Statement No. 34.

⁹ In certain cases, there are exceptions to the general rule that deferred inflows and outflows should not be netted. For example, GASB Statement No. 68, *Accounting and Financial Reporting for Pensions—an Amendment of GASB Statement No. 27*, and GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, require that deferred outflows of resources and deferred inflows of resources arising from differences between projected and actual pension and OPEB plan investment earnings in different measurement periods should be aggregated and reported as a net deferred outflow of resources or a net deferred inflow of resources.

components of the total deferred amounts are obscured by aggregation, governments should provide details of the different types of deferred amounts in the notes to the financial statements. If a component of net position is significantly affected by deferred outflows of resources and deferred inflows of resources, an explanation of the effect of the deferred amounts on the net position component should be provided in the notes to the financial statements. Because liquidity concepts do not apply to deferred inflows of resources and outflows of resources, those financial statement elements are not classified as current or noncurrent.

15.16 Assets and liabilities must be presented in a classified format that distinguishes between current and long-term assets and liabilities, as discussed in paragraphs 29–44 of GASB Statement No. 62.¹⁰ Paragraph 99 of GASB Statement No. 34 states that restricted assets should be reported when *restrictions*, as defined in paragraph 34 of GASB Statement No. 34, on asset use change the nature or normal understanding of the availability of the asset. Restrictions¹¹ may require assets that normally would be reported as current, such as cash and cash equivalents, short-term investments, and certain receivables, to be classified as noncurrent for financial reporting purposes. Paragraph 31(a) of GASB Statement No. 62 states that current assets should exclude cash and claims to cash that are restricted regarding withdrawal or use for other than current operations, designated for disbursement in the acquisition or construction of noncurrent assets, or segregated for the liquidation of long-term debt. When such constraints exist (for example, when cash or short-term investments are held as collateral on debt obligations, set aside within debt sinking funds and debt service reserve funds, donor restricted for the construction or purchase of property and equipment, or donor restricted for permanent or term endowment), the assets should be reported as noncurrent. Question 7.71.1 of GASB Implementation Guide No. 2015-1, *Implementation Guidance Update—2015* (IG 2015-1) discusses the reporting of restricted assets in a classified statement of net position. GASB Statement No. 34 does not otherwise require restricted assets to be displayed separately from unrestricted assets on the face of the statement of net position.

15.17 The term *net position* is used to refer to the residual of all other elements presented in the statement of net position— that is, assets, deferred outflows of resources, liabilities, deferred inflows of resources, and net position. Net position is required to be reported in three broad components: net investment in capital assets; restricted; and unrestricted. When a portion of restricted net position is required to be retained in perpetuity or minority interest in a component unit exists, restricted net position should be displayed in two components: expendable and nonexpendable.¹² The individual components of net position are discussed in more detail in paragraphs 15.131–132.

¹⁰ The requirements of GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, related to the classification of items as current or noncurrent are similar to those applied by nongovernmental entities. To the extent that other chapters of this guide discuss the balance sheet classification of certain specific assets or liabilities (for example, investments and long-term debt) as current or noncurrent, that information may be helpful to governmental health care entities, provided that it does not conflict with or contradict GASB pronouncements.

¹¹ The term *restricted* is defined by paragraphs 34, as amended, and 99 of GASB Statement No. 34. As discussed in paragraph 15.126, 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.

¹² See paragraph 35 of GASB Statement No. 34.

15.18 Some governmental health care entities may be organized and operated on a fund basis (for example, they use several separate enterprise funds for the purpose of carrying on specific activities or attaining certain objectives in accordance with regulatory restrictions or limitations). Interfund receivable and payable balances are eliminated in the "Total Primary Government" column. Paragraph 14 of GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, requires disclosure of certain information pertaining to inter-fund balances.

Statement of Revenues, Expenses, and Changes in Net Position

15.19 A governmental health care entity's statement of revenues, expenses, and changes in net position presents the same types of activities and transactions that are reported in a nongovernmental not-for-profit (NFP) health care entity's statement of operations and statement of changes in net assets. The required format for this statement is illustrated in paragraph 101 of GASB Statement No. 34, as follows:

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 position

Net position—beginning of period

Net position—end of period

Although this prescribed sequence, including the provision of required subtotals, should be adhered to, paragraph 434 of the nonauthoritative basis for conclusions of GASB Statement No. 34 indicates that it does not preclude governments from presenting additional subtotals before the comprehensive performance measure, such as the increase (decrease) in net position.

15.20 The format of the governmental statement of revenues, expenses, and changes in net position does not disaggregate transactions by components of net position (for example, it does not segregate transactions that increase restricted net position from those that increase unrestricted net position). The statement does not require disaggregated reporting of transactions based on the types of restrictions that may exist, such as unrestricted, restricted expendable, or restricted nonexpendable. For example, restricted contributions are not reported separately from unrestricted contributions, except for those that are restricted for capital acquisition or endowments, as discussed subsequently. Because of this all-inclusive focus, reclassifications of net position representing the expiration of restrictions are not reported. Therefore, reclassifications and subtotals, such as net assets released from restrictions, changes in temporarily-restricted net assets, and changes in permanently-restricted net

assets, that are customarily seen in NFP health care entities' statements of activities are not displayed in a governmental health care entity's statement of revenues, expenses, and changes in net position.

15.21 Governmental health care entities should distinguish between operating revenues and expenses and nonoperating revenues and expenses and provide an intermediate subtotal for operating income or loss. This is a difference from the NFP model in which entities are permitted, but not required, to classify transactions as operating or nonoperating. GASB requires entities to establish a policy for defining operating revenues and expenses that is appropriate to the nature of the activities being reported; however, the determination of which revenues and expenses should be classified as operating should consider how the underlying transactions would be classified in the statement of cash flows.¹³ Using this approach, transactions that are considered investing, capital and related financing, and noncapital financing activities in the statement of cash flows (for example, investment revenues and interest expense, as well as most nonexchange transactions, including taxes and noncapital grants and contributions) would be classified as nonoperating, rather than operating. Once established, this policy should be consistently applied and should be disclosed in the notes to the financial statements.

15.22 Contributions of capital assets or financial resources required to be used to acquire capital assets, contributions of term and permanent endowments, special and extraordinary items, and transfers are reported separately after nonoperating revenues and expenses. The determination of whether a transaction is an extraordinary item is made based on the guidance in paragraphs 45–50 of GASB Statement No. 62. Special items should be reported separately after capital contributions and contributions to permanent and term endowments but before extraordinary items, if any. Paragraph 56 of GASB Statement No. 34 defines a *special item* as a significant transaction or other event that is within the control of management and that meets one, but not both, of the criteria for classification as an extraordinary item (that is, it is either unusual in nature or infrequent in occurrence). Similar transactions that are beyond the control of management are not special items but should be disclosed in accordance with paragraph 56 of GASB Statement No. 34.

15.23 As discussed in paragraph 15.18, some governmental health care entities may be organized and operated on a fund basis. Those entities should display interfund transfers, such as capital contributions from other funds within the primary government, if any, after special and extraordinary items. Paragraph 15 of GASB Statement No. 38 requires disclosure of certain information pertaining to interfund transfers. As discussed in question 7.74.4 of IG 2015-1, if capital assets are reassigned from governmental activities to a governmental health care entity that is operated on a fund basis, the transaction is not "interfund" because it involves only one fund; consequently, the governmental health care entity would report the receipt of the capital assets as a capital contribution from governmental activities (in the last section of the statement of revenues, expenses, and changes in net position). In the reverse situation, in which a capital asset is reassigned from a governmental health care entity that is operated on a fund basis to governmental activities, the disposal of the capital asset would be reported by the governmental health care entity as a nonoperating expense.

¹³ See paragraph 102 of GASB Statement No. 34.

15.24 If a governmental health care entity has a change in accounting principle during a reporting period, as described in paragraphs 63–89 of GASB Statement No. 62, the effect of the change should be reported as a restatement of net position at the beginning of the period, not a separately identified cumulative effect in the current-period statement of revenues, expenses, and changes in net position.¹⁴ If a governmental health care entity must correct a prior-period's error, question 7.22.16 of IG 2015-1 states that the entity should report the correction by displaying either (a) the amount of the change as an adjustment to beginning net position on the face of the statement of revenues, expenses, and changes in net position, as previously reported, or (b) beginning net position restated on the face of the statement of revenues, expenses, and changes in net position, with the details of the restatement provided in the notes to the financial statements.

15.25 GASB Statement No. 69, *Government Combinations and Disposal of Government Operations*, provides accounting and financial reporting guidance for disposals of government operations that have been transferred or sold. Gains or losses on the disposal of operations should be reported as a special item, as discussed in paragraph 15.22 and illustrated in paragraph 15.19, in the period in which the disposal occurs, based on either the effective transfer date (for a transfer of operations) or the date of sale (for operations that are sold). Only those costs that are directly associated with the disposal of operations are included when determining the amount of the gain or loss to report. The amount of the gain or loss on the disposal of operations should not include adjustments and costs associated with the normal operating activities of the operation up to the measurement date. Thus, governmental health care entities do not present "discontinued operations" separately from "continuing operations" in the manner of nongovernmental NFP health care entities. Instead, total expenses of the disposed operations and total revenues of the disposed operations are presented in the notes to the financial statements, distinguishing between operating and nonoperating amounts.

15.26 FASB ASC 220, *Comprehensive Income*, conflicts with the all-inclusive format required by GASB Statement No. 34, and should not be applied by governmental health care entities. Gains and losses that private-sector standards classify as elements of other comprehensive income should be reported no differently than other gains and losses. As previously described, they are classified by governmental health care entities as operating, nonoperating, special, or extraordinary.

Statement of Cash Flows

Ⓢ Update 15-1 *Accounting and Reporting: Fiduciary Activities*

GASB Statement No. 84, *Fiduciary Activities*, issued January 2017, is effective for reporting periods beginning after December 15, 2018. Earlier application is encouraged.

GASB Statement No. 84 establishes criteria for identifying fiduciary activities of all state and local governments. The focus of the criteria generally is on (a) whether a government is controlling the assets of the fiduciary activity and (b) the beneficiaries with whom a fiduciary relationship exists, although control

¹⁴ See footnote 13 to paragraph 17 of GASB Statement No. 34.

is not a factor in determining whether a component unit is a fiduciary component unit. GASB Statement No. 84 permits a business-type activity to report assets and liabilities of custodial funds in its statement of net position, provided that it normally expects to hold the custodial assets for three months or less and it separately reports additions and deductions, if significant, as cash inflows and cash outflows, respectively, in the operating activities category of its statement of cash flows.

This edition of the guide has not been updated to reflect changes as a result of this statement; however, the section that follows will be updated in a future edition. Readers are encouraged to consult the full text of the Statement on GASB's website at www.gasb.org.

15.27 GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*, as amended, establishes standards for cash flow reporting for governmental entities. The requirements of GASB Statement No. 9 differ from those of FASB ASC 230, *Statement of Cash Flows*. Those differences are as follows:

- GASB Statement No. 9, as amended, requires the use of the direct method of presenting operating cash flows,¹⁵ with a reconciliation provided of operating cash flows to operating income (loss).
- GASB Statement No. 9 requires two categories of financing activities—noncapital financing and capital and related financing—for a total of four categories in the statement of cash flows. The capital and related financing category is used for acquiring and disposing of capital assets, borrowing money for acquiring capital assets, and repaying the borrowed amounts. All other financing is classified as noncapital.¹⁶
- Some transactions are classified differently by GASB and FASB. For example, under GASB Statement No. 9, unrestricted contributions are classified as noncapital financing, interest expense is classified as either capital and related financing or noncapital financing, and investment income is classified as investing. Under FASB ASC 220, unrestricted contributions, interest expense, and investment income are all operating cash flows. Similarly, capital asset purchases are classified under GASB Statement No. 9 as capital and related financing activities. Under FASB ASC 220, they are investing activities.
- Paragraph 8 of GASB Statement No. 9 provides that a statement of cash flows should explain the change in all cash and cash equivalents, regardless of any restrictions on their use. This would include any cash and cash equivalents classified as noncurrent, as discussed in paragraph 15.16. The total amount of cash and cash equivalents in the statement of cash flows should be easily traceable to similarly-titled line items in the statement of net position. If it is not, a reconciliation should be provided on the face of the statement or in the notes.

¹⁵ See paragraph 105 of GASB Statement No. 34.

¹⁶ Paragraph 29 of GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*, provides criteria for distinguishing between capital and noncapital financing activities.

Paragraph 6 of IG 2015-1 discusses implementation issues regarding GASB Statement No. 9.

Segment Reporting

15.28 If applicable, governmental health care entities should comply with the segment reporting requirements of GASB Statement No. 34.¹⁷ GASB's definition of *segment* differs from that in FASB ASC 280, *Segment Reporting*. GASB's definition focuses solely on information about activities financed by revenue-backed debt. GASB Statement No. 34 defines a *segment* as an identifiable activity or grouping of activities reported as or within an enterprise fund or another stand-alone entity that (a) has one or more outstanding bonds or other debt instruments, such as certificates of participation, with a revenue stream pledged in support of that debt and (b) is required by an external party, such as through a bond indenture, to separately account for that activity's assets, liabilities, revenues, and expenses. Segment disclosures are not required if the activity is not financed with revenue-backed debt; the requirement to separately report is not imposed by an external party; or separate reporting is required for only a portion of the activity's transactions, such as for only the revenues and expenses.

15.29 Paragraph 122 of GASB Statement No. 34, as amended, details the disclosures required for segments. Additional information on segment reporting can be found in chapter 8, "Expenses or Expenditures and Liabilities," of the AICPA Audit and Accounting Guide *State and Local Governments* and questions 7.86.1–7.86.6 of IG 2015-1.

RSI, Including MD&A

15.30 Some GASB standards require the presentation of certain specified information to accompany the basic financial statements. This RSI differs from other types of information that accompanies the basic financial statements because RSI is considered an essential part of financial reporting, and GASB has established authoritative guidelines for measuring and presenting that information. At present, RSI applicable to governmental health care entities consists of MD&A (paragraphs 15.31–32) and certain information related to employer-sponsored benefit plans (paragraph 15.122). RSI other than MD&A should be presented immediately following the notes to the financial statements.¹⁸ Paragraphs 8–11 of GASB Statement No. 34, as amended, provide the standards for MD&A, which should precede the basic financial statements.

15.31 GASB standards require MD&A to introduce the basic financial statements by presenting certain financial information, as well as management's analytical insights on that information. That analysis provides users with the information they need to help them assess whether the government's financial position has improved or deteriorated as a result of a given year's operations. Paragraphs 8–11 of GASB Statement No. 34, as amended, establish eight required elements of MD&A for general-purpose governments. Because certain of those elements would not apply to special-purpose governments engaged only in business-type activities, governmental health care entities should

¹⁷ See paragraphs 122–123 of GASB Statement No. 34 and paragraph 17 of GASB Statement No. 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus—an amendment of GASB Statements No. 21 and No. 34*.

¹⁸ See paragraph 6 and footnote 5 of GASB Statement No. 34.

limit their MD&A to only those required elements that are applicable to their activities. The information to be presented in MD&A should be confined to the topics discussed in paragraphs 8–11, as amended, of GASB Statement No. 34.

15.32 When a governmental health care entity presents comparative financial statements, MD&A is also required to be comparative, which would include comparative, condensed financial information and related analyses for both years, as discussed in question 7.5.4 of IG 2015-1. MD&A should provide data so that each of the two years presented in the comparative financial statements can be compared with its prior year. Therefore, there should be three years of comparative data and accompanying analyses: the current year, the prior year, and the year preceding the prior year. If only comparative financial data is presented for the prior year, as distinguished from a complete set of comparative statements, notes, and RSI, MD&A requirements apply only to the current year, with comparisons to the prior year, as discussed in question 7.5.6 of IG 2015-1.

15.33 Inclusion of information relating to discretely-presented component units in MD&A or other RSI is a matter of professional judgment. If component unit information is provided, the RSI should focus on the governmental health care entity that is the primary government (or serves as the nucleus for the reporting entity) and distinguish between information pertaining to the primary government (or nucleus) and information pertaining to the component unit(s).

Measurement Attributes

15.34 Assets and liabilities are measured using one of the following measurement attributes:

- *Historical cost*, which is the price paid to acquire an asset or the amount received pursuant to the incurrence of a liability in an actual exchange transaction. Historical cost is an entry price. Assets and liabilities presented at historical cost reflect prices at the dates of transactions, rather than at the financial statement date (paragraph 35 of GASB Concepts Statement No. 6, *Measurement of Elements of Financial Statements*).
- *Fair value*, which is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It is a market-based measurement, not an entity-specific measurement (paragraph 5 of GASB Statement No. 72, *Fair Value Measurement and Application*). Although fair value is defined similarly by FASB and GASB, the details associated with implementing the measure's definition differ somewhat.
- *Acquisition value*, which is the price that would be paid for acquiring similar assets, having similar service capacity, or discharging the liabilities assumed as of the acquisition date. Acquisition value is a market-based entry price. An entry price is assumed to be based on an orderly transaction entered into on the acquisition date (paragraph 32 of GASB Statement No. 69).
- *Settlement amount*, which is the amount at which an asset could be realized or a liability could be liquidated with the counterparty, other than in an active market. Settlement value differs from fair value in that it is not based on an active market but rather, is

based on a transaction with a specific buyer or creditor. A measurement of a liability at the initial transaction date using the settlement amount measurement attribute is sometimes referred to as *acquisition value* (paragraph 42 of GASB Concepts Statement No. 6). An example of a settlement amount is the measurement of an asset retirement obligation (paragraphs 19-21 and B37-B38 of GASB Statement No. 83, *Certain Asset Retirement Obligations*).

Historical cost can be used to measure only initial amounts, but the other three can be used to measure either initial amounts or remeasured amounts.

15.35 Concepts Statement No. 6 provides additional details about each of the measurement attributes and discusses situations in which the use of each would be appropriate.

Cash, Cash Equivalents, and Investments

Cash and Cash Equivalents

15.36 In accordance with paragraph 9 of GASB Statement No. 9, cash and cash equivalents include all cash and highly liquid investments that are both (a) readily convertible to known amounts of cash and (b) so near to their maturity that they present an insignificant risk of changes in value because of changes in interest rates. Cash equivalents generally are limited to investments with original maturities of three months or less from the date of purchase, although paragraph 11 of GASB Statement No. 9 provides that not all investments that meet GASB's definition of *cash equivalents* are required to be accounted for as such. Paragraph 8 of GASB Statement No. 9 states that the total amounts of cash and cash equivalents at the beginning and end of the period in the statement of cash flows should be easily traceable to similarly-titled items or subtotals shown in the statement of net position as of those dates.

15.37 Cash and cash equivalents are considered to be restricted¹⁹ when limitations on the use of those assets change the nature or normal understanding of the availability of the asset. For example, cash normally is classified as current assets, and a normal understanding of those assets presumes that no limitations exist on the government's ability to use those resources to satisfy current liabilities. However, cash held by a trustee that can only be used to pay bond principal and interest and that cannot be used to pay other current liabilities would be considered restricted assets. See paragraph 15.126 for a discussion of classification of net position when the use of assets is restricted. Such restrictions or constraints may require cash and cash equivalents to be classified as noncurrent for financial reporting purposes, as discussed in paragraph 15.16.

15.38 Governmental health care entities are required by GASB standards to provide disclosures related to cash and deposit accounts. For example, paragraph 8 of GASB Statement No. 40, *Deposit and Investment Risk Disclosures— an amendment of GASB Statement No. 3*, requires certain disclosures related to deposit accounts that are exposed to custodial credit risk. Deposits are exposed to custodial credit risk if they are not covered by depository insurance, and the deposits are (a) uncollateralized, (b) collateralized with securities held

¹⁹ See footnote 11.

by the pledging financial institution, or (c) collateralized with securities held by the pledging financial institution's trust department or agent but not in the depositor-government's name. Paragraph 11 of GASB Statement No. 9 requires disclosure of the governmental health care entity's policy for determining which investments are treated as cash equivalents. Paragraph 113 of GASB Statement No. 62 requires disclosure of any pledge of cash and cash equivalents as security for loans. Additional GASB disclosures related to deposit accounts are discussed in paragraph 15.61.

Investments and Certain Equity Interests

15.39 A number of GASB pronouncements provide guidance to governmental health care entities for accounting and reporting of investments, primarily GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, and GASB Statement No. 72. Paragraphs 4–5 and paragraphs 11–12 of IG 2015-1, and questions 4.1 to 4.8 and 4.25 to 4.53 of IG 2016-1 provide useful guidance for specific situations. The following paragraphs summarize guidance for the types of investments commonly held by governmental health care entities, but are not a substitute for reading the authoritative literature. Additional guidance can be found in chapter 5, "Investments, Certain Equity Interests, and Derivatives," of the AICPA Audit and Accounting Guide *State and Local Governments*.

15.40 Paragraph 64 of GASB Statement No. 72 defines an investment as a security or other asset that (a) a government holds primarily for the purpose of income or profit and (b) has present service capacity based solely on its ability to generate cash or to be sold to generate cash. Paragraphs 6567 of GASB Statement No. 72 provide additional guidance on what it means for an asset to be held "primarily for the purpose of income or profit" and to have "present service capacity based solely on its ability to generate cash or to be sold to generate cash." A governmental health care entity that acquires an asset uses that guidance and paragraph 64 of GASB Statement No. 72 to determine whether the asset should be classified as an investment. In accordance with paragraph 68 of GASB Statement No. 72, the determination of whether an asset meets the definition of an investment is made at acquisition; and once the governmental health care entity determines whether the asset is an investment or another type of asset, the classification should be retained for financial reporting purposes, even if the usage of the asset changes over time. That is, the classification of the asset as an investment or as another type of asset carries forward as long as the asset is held. The classification of an asset as an investment or another type of asset is important because of measurement differences. (For additional information, see paragraph 15.60 for derivative instruments, paragraph 15.68 for capital assets, and paragraph 15.75 for intangible assets.)

15.41 The importance of the intent is explained in question 4.11 of IG 2016-1. If a governmental health care entity acquires an equity interest in a legally separate entity, the intent of the health care entity in acquiring the interest determines whether it is an investment or is a component unit. If the governmental health care entity intends to use the equity interest to directly enhance its ability to provide services to the public (for example, to provide patient care to its citizens), the entity should be evaluated as a potential component unit. (Paragraphs 15.148, 154 provide further discussion.) However, if the governmental health care entity acquires the equity interest primarily for the purpose of income or profit and the present service capacity of the equity interest is based solely on its ability to generate cash (or to be sold to generate

cash), the governmental health care entity should account for its equity ownership interest as an investment, regardless of the extent of its ownership. If the acquisition meets the definition of an investment, it should be measured in conformity with the provisions of paragraph 77 of GASB Statement No. 72 (which is discussed further in paragraphs 15.44-.45). Regardless of whether the acquired equity interest is an investment or a component entity, the governmental health care entity recognizes an asset. For additional information about recognizing equity interests in component units, see paragraphs 15.155-.162.

Measurement of Investments

15.42 Most investments should be measured at fair value by governmental health care entities. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, in accordance with paragraph 5 of GASB Statement No. 72. GASB Statement No. 72 provides guidance for determining a fair value measurement for financial reporting purposes and for applying fair value to certain investments and disclosures related to fair value measurements.

15.43 The following investments are exceptions to the requirement that investments be measured at fair value (paragraphs 69, 71–74, and 77–78 of GASB Statement No. 72):

Exhibit 15-1**Investments Commonly Held by Governmental Health Care Entities That are Measured at Other than Fair Value**

<i>Investment</i>	<i>Accounting</i>
Equity interest in common stock if the investment in voting stock gives the investor the ability to exercise significant influence over the operating and financial policies of the investee ^a	The equity method as described in paragraphs 202 – 210 of GASB Statement No. 62, (see paragraphs 7778 of GASB Statement No. 72, <i>Fair Value Measurement and Application</i> , and paragraphs 15.44-.46). However, common stock held by an endowment is measured at fair value.
Investments in certain entities that calculate the net asset value per share (NAV or its equivalent, such as member units or an ownership interest in partners' capital to which a proportionate share of net assets is attributed	Provided that the investment does not have a readily determinable fair value, the NAV per share (or its equivalent) is permitted if that measure is calculated in a manner consistent with the Financial Accounting Standards Board's measurement principles for investment companies (see paragraphs 7174 and 82 of GASB Statement No. 72 and paragraph 15.47)
Investments in nonparticipating interest-earning investment contracts	Cost-based measure (see paragraph 8 of GASB Statement No. 31, <i>Accounting and Financial Reporting for Certain Investments and for External Investment Pools</i>)
Investments in unallocated insurance contracts	Reported as interest-earning investment contracts (see paragraph 8 of GASB Statement No. 31 and paragraph 4 of GASB Statement No. 59, <i>Financial Instruments Omnibus</i>)
Money market investments and participating interest-earning investment contracts with remaining maturity at time of purchase of one year or less and are held by governments other than external investment pools	Amortized cost (permitted but not required per paragraph 9 of GASB Statement No. 31)
Investments <i>in</i> qualified external investment pools	Amortized cost if the pool meets the criteria in paragraph 4 of GASB Statement No. 79 and measures its investments at amortized cost (see paragraph 41 of GASB Statement No. 79)

**Investments Commonly Held by Governmental Health Care Entities
That are Measured at Other than Fair Value—continued**

<i>Investment</i>	<i>Accounting</i>
Investments in internal investment pools	The equity position in an internal investment pool is reported as an asset by the participant (GASB Statement No. 31, par. 14). Typically, the position would be measured as a pro-rata allocation of the pool's equity among the participants.
Synthetic guaranteed investment contracts (SGICs) that are fully benefit responsive	Contract value (see paragraph 67 of GASB Statement No. 53, <i>Accounting and Financial Reporting for Derivative Instruments</i>)
Investments in life insurance contracts	Cash surrender value (see paragraph 69(g) of GASB Statement No. 72)
^a If the equity interest in common stock does not meet the definition of an investment and does not provide the investor with significant influence (that is, does not meet the criteria in paragraphs 205–208 of GASB Statement No. 62), the equity interest should be measured using the cost method in paragraph 203 of GASB Statement No. 62.	

Equity Interests in Common Stock

15.44 Paragraph 77 of GASB Statement No. 72 requires the use of the equity method if an investment in voting stock gives the governmental health care entity the ability to exercise significant influence over the operating and financial policies of an investee, even though the governmental health care entity holds 50 percent or less of the voting stock. It provides a few exceptions to using the equity method, including the following types of interests held by governmental health care entities:

- Common stock held by endowments (including permanent and term endowments) or permanent funds, which is reported at fair value
- Investments in certain entities that calculate the net asset value per share or its equivalent (NAV), as discussed further in paragraphs 15.47–.49
- Equity interest ownership in joint ventures, as discussed further in paragraphs 15.166.168
- Component units, as discussed further in paragraphs 15.148.162 (When an ownership interest is entered into to directly enhance the governmental health care entity's ability to provide services, the investee should be evaluated for inclusion as a potential component unit.)

15.45 As noted in paragraph 205 of GASB Statement No. 62, determining the ability to exercise significant influence is not always clear, and applying judgment is necessary to assess the status of each investment. The ability to exercise significant influence may be indicated in several ways, such as representation on the governing body of the investee, participation in policy-making

processes, significant intra-entity transactions, interchange of managerial personnel, or technological dependency. There is a presumption, in the absence of evidence to the contrary, that the ability to exercise significant influence over operating and financial policies of an investee exists if the health care entity owns 50 percent or less of the voting stock of an investee, but more than 20 percent. Another important consideration is the extent of ownership by the governmental health care entity in relation to the concentration of other shareholdings, but substantial or majority ownership of the voting stock of an investee by another investor does not necessarily preclude the ability to exercise significant influence by the governmental health care entity.

15.46 Paragraph 209 of GASB Statement No. 62 describes the procedures that should be followed in applying the equity method of accounting.

Investments in Certain Entities That Calculate the Net Asset Value per Share (or Its Equivalent)

15.47 Governmental health care entities may invest in private-sector investment companies that are structured as limited liability companies, limited partnerships, institutional trusts, common and collective trusts, or financial instruments and that do not have a readily determinable fair value. These types of investments are commonly referred to as alternative investments. If an investment in a nongovernmental entity does not have a readily determinable fair value, a governmental health care entity is permitted to establish the fair value by using the NAV per share (or its equivalent), as discussed in paragraph 71 of GASB Statement No. 72. Examples of NAV per share include member units or an ownership interest in partners' capital to which a proportionate share of net assets is attributed. This method of determining fair value is permitted if the NAV per share (or its equivalent) of the investment is calculated as of the governmental health care entity's measurement date generally in a manner consistent with FASB's measurement principles for investment companies. A governmental health care entity should determine that the NAV per share (or its equivalent) provided by the investee is determined in that manner. Investments should not be valued using NAV per share (as a practical expedient for fair value) if they have a readily determinable fair value, as defined in paragraph 86 of GASB Statement No. 72, or if the investment is in another governmental entity (for example, a government external investment pool).

15.48 As discussed in paragraph 72 of GASB Statement No. 72, if the NAV per share (or its equivalent) of an investment obtained from the investee is not determined as of a governmental health care entity's measurement date or is not calculated in a manner consistent with the measurement principles for investment companies, the health care entity should consider whether an adjustment to the most recent NAV per share (or its equivalent) is necessary. The objective of any adjustment is to determine the NAV per share (or its equivalent) for the investment that is calculated as of the governmental health care entity's measurement date in a manner consistent with the measurement principles for investment companies. In accordance with paragraph 73 of GASB Statement No. 72, the ability to establish fair value using NAV as a practical expedient should be determined on an investment-by-investment basis.

15.49 In accordance with paragraph 74 of GASB Statement No. 72, the method of determining fair value using NAV should not be applied if, as of the governmental health care entity's measurement date, it is probable that the health care entity will sell the investment for an amount different from the

NAV per share (or its equivalent). A sale is considered probable only if all of the criteria in paragraph 74 of GASB Statement No. 72 have been met as of the government's measurement date.

Participation in an Investment Pool

15.50 Governmental health care entities often combine (pool) their cash and investments with those of other entities to enhance investment opportunities, operating efficiency, and physical custody and control. Those investment pools may be either external or internal. Paragraph 22 of GASB Statement No. 31 defines an *external investment pool* as an arrangement that commingles (pools) the monies of more than one legally separate entity and invests in an investment portfolio on the participants' behalf; one or more of the participants is not part of the sponsor's reporting entity. With one exception, the pool's participants measure their investments in an external investment pool at fair value, as provided in paragraph 11 of GASB Statement No. 31, as amended. However, an exception to fair value measurement is found in paragraph 41 of GASB Statement No. 79, *Certain External Investment Pools and Pool Participants*. If an external investment pool qualifies to measure all of its investments at amortized cost, the pool's participants also measure their investments in that external investment pool at amortized cost. Typically, the amortized cost is measured at the NAV per share provided by the qualifying pool, and that NAV per share is calculated on an amortized-cost basis.

15.51 Paragraph 22 of GASB Statement No. 31 defines an *internal investment pool* as "an arrangement that commingles (pools) the moneys of more than one fund or component unit of a reporting entity. Investment pools that include participation by legally separate entities that are not part of the same reporting entity as the pool sponsor are not internal investment pools, but rather are external investment pools." Thus, if a government-sponsored pool includes only the primary government and its component units, it is an internal investment pool and not an external investment pool. Some governmental health care entities, primarily those that are part of a governmental college or university, invest in an internal investment pool. In their stand-alone financial statements, the governmental health care entity should report its equity position in the internal investment pool as, for example, equity in cash management pool, equity in internal investment pool, cash and cash equivalents, or investments, as appropriate. Typically, this would be measured as a pro-rata allocation of the pool's equity among the participants. As discussed in question 4.4 of IG 2016-1, a component unit's position in an internal investment pool is an investment, and "looking through" to the underlying investments of the pool is not appropriate in separately issued component unit financial statements. Therefore, a component unit should make its investment disclosures with respect to its position in the internal investment pool and not the underlying investments of the pool in separately issued component unit financial statements.

Certain Land and Other Real Estate Held by Endowments

15.52 GASB Statement No. 52 requires that certain land and other real estate held as investments by endowments be reported at fair value, with changes in fair value reported as investment income. GASB Statement No. 52 applies to permanent and term endowments and permanent funds; it does not apply to quasi-endowments.

Impairment of Investments

15.53 Other-than-temporary impairment is not an issue for investments reported at fair value, as that valuation already considers potential impairments. For investments covered by GASB Statement No. 31 that are reported using cost-based measures, such as money market investments and certain investment contracts, paragraphs 8–9 of GASB Statement No. 31 require the cost-based measure to be reevaluated if the fair value of the investment is significantly affected by the impairment of the credit standing of the issuer or other factors. Determining the amount and timing of a write-down of those investments is a matter of professional judgment.

15.54 Question 6.12.2 of IG 2015-1 discusses impairment of investments covered by GASB Statement No. 31 that are reported using cost-based measures. Although some believe that GASB Statement No. 31 implies that the unrealized loss represented by the impairment should be recognized, it does not specifically require it. Paragraph 76 of the basis for conclusions of GASB Statement No. 31 states that when there is an impairment, the cost-based measure should be reevaluated. Therefore, professional judgment should be applied in determining the amount and timing of a write-down. For investments in common stock that are accounted for using the equity method, paragraph 209 of GASB Statement No. 62 requires that a decline in value of an investment that is other than temporary be accounted for in the same manner as a loss in value of other long-term assets. In making impairment evaluations for these investments, health care entities might consider as nonauthoritative accounting literature (see paragraph 15.07) the guidance in FASB ASC 320-10-35 for other-than-temporary impairments of investments.

Investment Return

15.55 Investment income arises from interest and dividend income, sales of investments at a gain or loss, and changes in the fair value of investments during the holding period. Under the GASB Statement No. 34 reporting model, all investment income of governmental health care entities, regardless of any restrictions placed upon its use, is reported as nonoperating revenue.²⁰ This differs significantly from the private-sector standards described in paragraphs 4.30–34 of this guide. GASB Statement No. 31 permits the change in fair value of investments, such as the difference between the fair value of investments at the beginning of the year and end of the year, taking into consideration investment purchases, sales, and redemptions, to be presented separately or combined with other investment income as a single amount. If the change in the fair value of investments is displayed as a separate element within investment income, it should be captioned "Net Increase (Decrease) in the Fair Value of Investments." GASB Statement No. 31 prohibits displaying realized gains and losses separately from other fair value changes on the face of the statement. However, note disclosure of realized gains and losses is permitted, provided that certain information about the nature of those amounts and their relationship to the amounts reported in the financial statements also is disclosed, as illustrated in appendix C of GASB Statement No. 31.

²⁰ As discussed in questions 7.73.5 and 7.74.3 of GASB Implementation Guide No. 2015-1, *Implementation Guidance Update—2015* (IG 2015-1), interest earned on endowments generally should be classified as nonoperating revenue. This includes investment income restricted to increase permanent or term endowments. It is not appropriate to report such amounts as additions to permanent or term endowments.

15.56 Cash flows from purchases, sales, maturities, and income of investments should be classified as cash flows from investing activities in the statement of cash flows.

Securities Lending and Reverse Repurchase Agreements

15.57 Governmental health care entities account for securities lending transactions in accordance with GASB Statement No. 28 and reverse repurchase agreements in accordance with GASB Statement No. 3 and GASB Interpretation No. 3. That accounting differs from the private-sector standards of FASB ASC 860, *Transfers and Servicing*.

Financial Reporting and Disclosure

15.58 Investments held by governmental health care entities should be reported as either current or noncurrent, as appropriate, under the provisions of paragraphs 29–44 of GASB Statement No. 62. Entities are required to disclose information about their investments in accordance with certain GASB statements. Among the required disclosures are the following:

- The types of deposits or investments authorized by legal or contractual provisions. See paragraph 65 of GASB Statement No. 3, as amended.
- Disclosures related to deposit and investment risks, including credit risk, interest rate risk, and foreign currency risk, and the policies that address the entity's exposures to those risks. If a government has no investment policy that addresses a specific type of risk to which it is exposed, the disclosure should indicate that fact. See paragraphs 417 of GASB Statement No. 40.
- Significant violations during the period of legal or contractual provisions for deposits and investments and the actions taken to address such violations. See paragraph 66 of GASB Statement No. 3 and paragraph 9 of GASB Statement No. 38.
- Assets and liabilities measured at fair value have required disclosures. See paragraph 81 of GASB Statement No. 72. The following are among the required disclosures:
 - For recurring and nonrecurring fair value measurements:
 - Fair value measurement at end of reporting period
 - Fair value hierarchy level (except for investments that are measured at the net asset value per share or its equivalent)
 - Description of valuation techniques used
 - Change in valuation technique, if applicable, that has a significant impact on measurement, including the reason for making the change
 - For nonrecurring fair value measurements, the reason for the measurement
- Investments that meet the criteria for reporting at net asset value per share (or its equivalent) as a practical expedient for fair value have required disclosures. See paragraph 82 of GASB Statement No. 72.

- Valuation and reporting of investments have required disclosures. See paragraph 15 of GASB Statement No. 31, as amended. The following are among the required disclosures:
 - Policy for determining which investments, if any, are reported at amortized cost
 - For any investments in external investment pools that are not SEC-registered, a brief description of any regulatory oversight for the pool and whether the fair value of the position in the pool is the same as the value of the pool shares
 - Any involuntary participation in an external investment pool
 - If an entity cannot obtain information from a pool sponsor to allow it to determine the fair value of its investment in the pool, the methods used and significant assumptions made in determining that fair value and the reasons for having had to make such an estimate
 - Any income from investments associated with one fund that is assigned to another fund
- For entities with donor-restricted endowments, disclosures about the use of investment income generated by those endowments. See paragraph 121 of GASB Statement No. 34.
- For reverse repurchase agreements, whether the maturities of investments made with the proceeds of reverse repurchase agreements generally are matched to the maturities of the agreements, as well as the extent of such matching. See paragraph 6 of GASB Interpretation No. 3.
- For securities lending transactions, the authority for securities lending activities and any violations, a description of the securities lending activities, whether the maturities of investments made with invested collateral generally are matched to the maturities of the securities loans, the extent of such matching, the amount of assumed credit risk, and losses arising from securities lending. See paragraphs 12–15 of GASB Statement No. 28, as amended.
- For equity interests in common stock that are reported using the equity method of accounting, the following disclosures are required; see paragraph 210 of GASB Statement No. 62:
 - Name of each investee and percentage of ownership of common stock
 - Accounting policies of the government with respect to investments in common stock
 - Difference, if any, between amount at which investment is carried and amount of underlying equity in net assets and the accounting treatment of the difference
 - For those investments in common stock for which a quoted market price is available, the aggregate value of each identified investment based on the quoted market price should be disclosed

- Summarized information about assets, liabilities, and results of operations of the investees (if significant in relation to the financial position or results of operations of a government)
- Significant effects, if applicable, of possible conversions, exercise of options and warrants, or contingent issuances

Derivatives

15.59 A *derivative instrument* is a financial instrument or other contract with all three of the characteristics in the following list:

- *Settlement factors.* It has one or more reference rates and one or more notional amounts or payment provisions, or both. Those terms determine the amount of the settlement(s) and, in some cases, whether a settlement is required.
- *Leverage.* It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- *Net settlement.* Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

15.60 A derivative instrument that (a) is held primarily for the purpose of income or profit and (b) has a present service capacity based solely on its ability to generate cash or to be sold to generate cash is an investment derivative instrument. In addition, a derivative instrument that does not meet the criteria of a hedging derivative instrument is considered an investment derivative instrument. GASB Statement No. 53, as amended, requires that governments report derivative instruments in the statement of net position at fair value. An exception exists to fair value measurement for fully benefit-responsive, synthetic guaranteed investment contracts; they are measured at contract value. The scope of GASB Statement No. 53 excludes derivative instruments that are normal purchases and normal sales contracts; insurance contracts accounted for under GASB Statement No. 10, as amended; certain financial guarantee contracts; certain contracts that are not exchange traded; and loan commitments. The definition of *derivative* and the scope of the statement are similar to that used by private-sector entities.

15.61 GASB Statement No. 53 divides derivative instruments into two types, which determines how changes in the fair value of a derivative instrument are reported, as follows:

- *Hedging derivative instruments* are derivative instruments associated with a hedgeable item and significantly reduce an identified financial risk by substantially offsetting changes in cash flows or fair values of that hedgeable item. Changes in fair values of hedging derivative instruments should be recognized through the application of hedge accounting, with deferred inflows of resources and deferred outflows of resources reported in the statement of net position.

- *Investment derivative instruments* are derivative instruments that are entered into primarily for the purpose of obtaining income or profit or a derivative instrument that does not meet, or no longer meets, the definition of a *hedging derivative instrument*. Changes in fair values of investment derivative instruments should be reported within investment revenue (nonoperating) in the statement of revenues, expenses, and changes in net position. See paragraph 15.55 for further discussion.

15.62 GASB Statement No. 64 provides additional guidance on determining whether a derivative continues to meet the requirements for hedge accounting in the event that the swap counterparty or swap counter party's credit support provider commits or experiences an act of default or termination event. GASB Statement No. 64 states that an effective hedge relationship continues when all of the following criteria are met:

- a. Collectability of swap payments is considered to be probable.²¹
- b. The swap counterparty of the interest rate swap or commodity swap, or the swap counterparty's credit support provider, is replaced with an assignment or in-substance assignment.
- c. The government enters into the assignment or in-substance assignment in response to the swap counterparty, or the swap counterparty's credit support provider, either committing or experiencing an act of default or a termination event as both are described in the swap agreement.

15.63 Paragraphs 36–62 of GASB Statement No. 53 provide guidance on methods to be used for evaluating the effectiveness of a potential hedging derivative instrument. Users of this guide should refer to GASB Statement No. 53, chapter 5 of the AICPA Audit and Accounting Guide *State and Local Governments*, and paragraph 16 of IG 2015-1 for additional guidance related to these methods.

15.64 An effective hedging derivative instrument entered into in connection with issuance of debt (for example, an interest rate swap entered into in connection with issuance of municipal bonds) would not "follow the debt" for purposes of calculating components of net position, as discussed in question 10.13.9 of IG 2015-1. Even if the debt proceeds are used for capital-related purposes, the outlays associated with a swap typically are associated with managing interest rate risk, rather than with acquiring, constructing, or improving capital assets. Because a deferred outflow of resources or a deferred inflow of resources related to a hedging derivative instrument will often be the same amount as the reported fair value of the derivative instrument itself, hedging derivatives typically will not have a significant impact on the calculation of components of net position.

15.65 A health care entity that holds derivative instruments should disclose the information required by paragraphs 69–79 of GASB Statement No. 53. Those disclosures include summary information about derivative instrument activity during the reporting period, information about the objectives for entering into hedging derivative instruments, their significant terms, contingent

²¹ When collectability of payments is not probable, such as when a swap counterparty, or a swap counterparty's credit support provider, has entered into bankruptcy and the swap is not collateralized or does not remain insured, an effective hedging relationship does not continue.

features of the derivative instruments, and information about the entity's exposure to various types of risk that is caused by holding derivative instruments at the end of the reporting period. In addition, paragraphs 80–81 of GASB Statement No. 72 require disclosures related to fair value. Disclosures are also required for the companion instrument of any embedded derivatives and about synthetic guaranteed investment contracts.

Property and Equipment and Other Assets

15.66 The accounting requirements for capital assets and intangible assets of governmental health care entities are summarized in paragraphs 15.67–.85. Accounting for supplies inventories and other assets of governmental health care entities is similar to that used by nongovernmental health care entities, as described in chapter 6, "Property and Equipment and Other Assets," of this guide.

Capital Assets—General

15.67 *Capital assets* are defined in paragraph 19 of GASB Statement No. 34 as "land, improvements to land, easements, buildings, building improvements, vehicles, machinery, equipment, works of art and historical treasures, infrastructure, and all other tangible or intangible assets that are used in operations and that have initial useful lives extending beyond a single reporting period." Acquired or donated capital assets are capitalized and depreciated over their estimated useful lives. Works of art and historical treasures need not be capitalized if they are added to collections that meet the requirements of paragraph 27 of GASB Statement No. 34. Chapter 7, "Capital Assets," of the AICPA Audit and Accounting Guide *State and Local Governments* contains additional information.

15.68 A governmental health care entity that acquires an asset uses the definition of an investment in paragraph 64 of GASB Statement No. 72 (included in paragraph 15.40) to determine whether the asset should be classified as an investment or as a capital asset. Once a determination is made at the time of acquisition, the classification of the asset carries forward as long as the asset is held by the governmental health care entity, regardless of any changes in management's usage of the asset. For example, if an office building is initially used to provide health care services to patients and, therefore, it is classified as a capital asset, it remains a capital asset, even if in later years its use changes to rental property. The classification of an asset as an investment or a capital asset is important because of measurement differences. Investments are measured at fair value. Capital assets are measured at historical cost and depreciated over their estimated useful lives unless they are inexhaustible or are intangible assets with indefinite useful lives.

15.69 Questions 4.364.41 of IG 2016-1 provide additional guidance on classification of assets as investments or capital assets, including a situation in which a single building is used in part for operations and in part as rental property and a situation in which an asset produces income but is, nevertheless, classified as a capital asset.

15.70 The following capital assets should be initially measured at acquisition value, as described in paragraph 79 of GASB Statement No. 72, because an entry price measurement is more appropriate than fair value (an exit price measurement):

- Donated capital assets, as provided in paragraph 18 of GASB Statement No. 34, as amended
- Donated works of art, historical treasures, and similar assets, as provided in paragraph 27 of GASB Statement No. 34
- Capital assets received in a service concession arrangement, as provided in paragraph 9 of GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*. (Paragraphs 15.81–84 provide more information about service concession arrangements.)

Capital Asset Impairment

15.71 If the potential exists that a capital asset has been impaired, governmental health care entities should consider the guidance in GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. These standards differ significantly from the model applied by private-sector entities for the impairment of tangible capital assets. FASB ASC 360-10-35 should not be applied by governmental health care entities. GASB Statement No. 42 establishes accounting and financial reporting standards for the impairment of capital assets, including standards for the assessment of the impairment of capital assets and the measurement of impairment. It requires the evaluation of prominent events or changes in circumstances affecting a capital asset's use to determine whether impairment has occurred. A capital asset generally should be considered impaired if both the decline in service utility of the capital asset is large in magnitude, and the event or change in circumstances is unexpected (for example, outside the normal life cycle of the capital asset).

15.72 If the governmental health care entity will continue to use the impaired asset, it should measure the amount of impairment by one of three methods that most appropriately reflect the decline in service utility of the asset. The three methods, which are described more fully in paragraph 12 of GASB Statement No. 42, are as follows:

- The restoration cost approach, which derives the amount of the impairment from the estimated costs to restore the service utility of the capital asset
- The service units approach, which isolates the historical cost of the service utility of the capital asset that cannot be used due to the impairment event or change in circumstances
- The deflated depreciated replacement cost approach, which replicates the historical cost of the produced service

The restoration cost approach generally should be used to measure impairments resulting from physical damage. The service units approach generally should be used to measure impairments resulting from the enactment or approval of laws or regulations or other changes in environmental factors or from technological development or obsolescence. The deflated depreciated replacement cost or the service units approach generally should be used to measure impairments identified from a change in manner or duration of use. An impairment loss recognized in accordance with GASB Statement No. 42 should not be reversed in future years, even if the events or circumstances causing the impairment have changed.

15.73 Impairment losses should be reported in the statement of revenues, expenses, and changes in net position as an operating expense, special item, or extraordinary item, in accordance with the guidance in paragraphs 41–46, 55–56, and 101–102 of GASB Statement No. 34 and paragraphs 45–50 of GASB Statement No. 62. If not otherwise apparent from the face of the financial statements, a general description, the amount, and the financial statement classification of the impairment loss should be disclosed in the notes to the financial statements. Additional guidance related to reporting impairment losses is provided in chapter Z.42 of IG 2015-1.

Intangible Assets

15.74 Many governmental health care entities have intangible assets. Some are capital assets because they are used in operations; others are investments because they are held primarily for the purpose of income or profit and their present service capacity is based solely on its ability to generate cash or to be sold to generate cash, as discussed in paragraph 15.68. GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*, as amended, provides guidance for accounting for intangibles, other than right-to-use lease assets, that are capital assets. Accounting for intangible assets that are investments is discussed in paragraphs 15.40.58. Accounting for excess consideration provided in a governmental acquisition (known as goodwill in nongovernmental entities) is discussed in paragraphs 15.77–.79 and 15.185–.187.

15.75 Because the intangible assets within the scope of GASB Statement No. 51 are capital assets, authoritative guidance related to accounting and financial reporting for capital assets, such as recognition, measurement, depreciation or amortization, impairment, presentation, and disclosure, applies to intangible assets within its scope. For example, intangible assets should be included in the roll-forward disclosure of capital assets by major classes. See paragraph 15.85 for further discussion.

15.76 An intangible asset that is a capital asset should be recognized only if it is *identifiable*, meaning that the asset either (a) is capable of being separated or divided from the governmental health care entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, asset, or liability, or (b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or other rights and obligations. Intangible assets that are internally generated are capitalized only if they meet the conditions in paragraph 8 of GASB Statement No. 51. Paragraphs 9–15 of GASB Statement No. 51 provide additional guidance for internally-generated software. GASB Statement No. 51 also provides guidance on determining the useful life of intangibles that are limited by legal or contractual provisions. Intangible assets with a finite useful life are amortized over that life. If no factors exist that indicate a limitation on the useful life of an intangible asset, the asset has an indefinite useful life. Indefinite-lived intangibles should not be amortized, unless their useful life is subsequently determined to be finite due to a change in circumstances.

Excess Consideration Provided in a Governmental Acquisition (Known as Goodwill in Nongovernmental Entities)

15.77 A deferred outflow of resources is reported if the consideration provided exceeds the net position acquired in a transaction that is a governmental

acquisition, as defined in GASB Statement No. 69. The calculation of the excess is discussed in paragraphs 15.183.187.

15.78 The deferred outflow of resources should be attributed to future periods in a systematic and rational manner, based on professional judgment, considering the relevant circumstances of the acquisition. The length of the attribution period may be determined by considering such factors as the following:

- The estimated service lives of capital assets acquired, when acquisitions are largely based on the expected use of those capital assets (including remaining service life of an acquired landfill)
- The expected length of contracts acquired
- The estimated remaining service life of technology acquired, if the acquisition is based on the expected efficiencies of a technology system

15.79 A government should periodically review and revise its estimate of the attribution period in subsequent reporting periods.

Leased Assets

Ⓢ Update 15-2 Accounting and Reporting: Leases

GASB Statement No. 87, *Leases*, issued June 2017, is effective for reporting periods beginning after December 15, 2019. Earlier application is encouraged. GASB Statement No. 87 establishes a single model for lease accounting based on the foundational principle that leases are financings of the right to use an underlying asset.

Under GASB Statement No. 87, a lessee is required to recognize a lease liability and an intangible right-to-use lease asset, unless the lease is a short-term lease or it transfers ownership of the underlying asset. The lease liability should be measured at the present value of payments expected to be made during the lease term (less any lease incentives receivable). The lease asset should be measured at the amount of the initial measurement of the lease liability, plus any payments made to the lessor at or before the commencement of the lease term (less any lease incentives received at or before the lease commencement) and certain direct costs. A lessee should reduce the lease liability as payments are made and recognize an outflow of resources (for example, expense) for interest on the liability. The lessee should amortize the lease asset in a systematic and rational manner over the shorter of the lease term or the useful life of the underlying asset.

A lessor should recognize a lease receivable and a deferred inflow of resources at the commencement of the lease term, with certain exceptions for leases of assets held as investments, certain regulated leases, short-term leases, and leases that transfer ownership of the underlying asset. A lessor should not derecognize the asset underlying the lease. The lease receivable should be measured at the present value of lease payments expected to be received during the lease term (less any lease incentives payable). The deferred inflow of resources should be measured at the value of the lease receivable plus any payments received at or before the commencement of the lease term that relate to future periods (less any lease incentives paid at or before the lease commencement). A lessor should recognize interest revenue on the lease receivable and an inflow of resources (for example, revenue) from the deferred

inflows of resources in a systematic and rational manner over the term of the lease.

This edition of the guide has not been updated to reflect changes as a result of this statement; however, the section that follows will be updated in a future edition. Readers are encouraged to consult the full text of the statement on GASB's website at www.gasb.org.

15.80 Paragraphs 211–271 of GASB Statement No. 62, as amended, provide essentially the same guidance as FASB Statement No. 13, *Accounting for Leases*, as amended and interpreted as of November 30, 1989, and they provide additional guidance on specific matters unique to governmental entities. GASB Statement No. 13, *Accounting for Operating Leases with Scheduled Rent Increases*, provides additional guidance for operating leases of governmental health care enterprises.

Service Concession Arrangements

15.81 A service concession arrangement (SCA) is defined in GASB Statement No. 60 as an arrangement between a transferor (government) and an operator in which all of the following criteria are met:

- a. The transferor conveys to an operator the right and related obligation to provide public services through the use and operation of a capital asset (a *facility*) in exchange for significant consideration, such as an up-front payment, installment payments, a new facility, or improvements to an existing facility.
- b. The operator collects and is compensated by fees from third parties.
- c. The transferor determines or has the ability to modify or approve what services the operator is required to provide, to whom the operator is required to provide the services, and the prices or rates that can be charged for the services.
- d. The transferor is entitled to significant residual interest in the service utility of the facility at the end of the arrangement.

Paragraphs 8–12 of GASB Statement No. 60 address transferor accounting and financial reporting for facilities and related payments received from an operator, and paragraphs 13–14 address governmental operator accounting and financial reporting for the right to access facilities and related payments to a transferor. The leasing standards of GASB Statement No. 13 and paragraphs 211–271 of GASB Statement No. 62 should not be applied to SCAs.

15.82 Governmental health care entities may obtain the right to operate a facility under an SCA. In those situations, the governmental health care operator should report an intangible asset for the right to access the facility and collect third-party fees from its operation. The intangible asset is initially recognized at cost (for example, the amount of an up-front payment or the cost of construction of or improvements to the facility). The cost of improvements to the facility made by the governmental operator during the term of the SCA should increase the governmental operator's intangible asset if the improvements increase the capacity or efficiency of the facility. The intangible asset

should be amortized over the term of the arrangement in a systematic and rational manner.²²

15.83 Some agreements require a facility to be returned in a specified condition. If information that is prominent—that is, conspicuous or known to the governmental operator—indicates the facility is not in the specified condition and the cost to restore the facility to that condition is reasonably estimable, then a liability and, generally, an expense to restore the facility should be reported. Governmental operators are not required to perform additional procedures to identify potential condition deficiencies beyond those already performed as part of their normal operations or those that may be required by the agreement.

15.84 Disclosure requirements for SCAs include a general description of the arrangement, including management's objectives for entering into the arrangement, the nature and amounts of assets, liabilities and other items related to an SCA that are recognized in the financial statements; and the nature and extent of rights retained by the transferor or granted to the operator in the arrangement.

Disclosures

15.85 Governmental standards require specific disclosures pertaining to capital assets, as follows:

- The policy for capitalizing assets and estimating the useful lives of those assets in the entity's summary of significant accounting policies. See paragraph 115(e) of GASB Statement No. 34.
- A general description of the method(s) used to compute depreciation with respect to major classes of depreciable assets. See paragraph 95 of GASB Statement No. 62.
- Information about major classes of capital assets presented in a roll-forward format, including beginning and ending balances, capital acquisitions, sales or other dispositions, current period depreciation expense, and accumulated depreciation. Intangible assets, if any, should be included in this disclosure as a major class(es) of capital assets. See paragraphs 116–117 and 120 of GASB Statement No. 34 and question Z.51.29 of IG 2015-1.
- If significant, capital assets that are not being depreciated, including construction in progress,²³ should be reported on the face of the statement of net position separately from capital assets being depreciated. These two categories of capital assets should also be disclosed separately in the roll-forward disclosure. See paragraph 20 of GASB Statement No. 34.
- Construction commitments. See paragraph 158 of National Council on Governmental Accounting (NCGA) Statement 1, *Governmental Accounting and Financial Reporting Principles*, as amended, and paragraph 4 of NCGA Interpretation 6, *Notes to the Financial Statements Disclosure*.

²² The intangible assets referred to throughout GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*, are not subject to the provisions of GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*, and should be reported outside of the capital asset classification.

²³ See question 7.11.1 of IG 2015-1.

- Pertinent data regarding leases. See paragraphs 223, 231, 239, 255–256, and 270 of GASB Statement No. 62.
- If not otherwise apparent from the face of the financial statements, a general description, the amount, and the financial statement classification of capital asset impairment losses. See paragraph 17 of GASB Statement No. 42.
- The carrying amount of impaired capital assets that are idle at year-end, if any, regardless of whether the impairment is considered permanent or temporary. See paragraph 20 of GASB Statement No. 42.
- Information related to service concession arrangements by transferors and governmental operators. (See paragraphs 16–18 of GASB Statement No. 60.)

Municipal Bond Financing and Other Long-Term Debt

15.86 Like NFP health care entities, governmental health care entities typically finance their acquisitions, additions, and renovations with tax-exempt debt. Thus, many of the general considerations discussed in chapter 7, "Municipal Bond Financing," of this guide will also apply to governmental health care entities, including its discussion of auditor involvement with municipal securities filings and letters for underwriters and certain other requesting parties.²⁴ The primary differences arise with respect to measurement and disclosure; when they exist, such differences are highlighted in the discussion that follows.

15.87 In accordance with paragraph 42 of NCGA Statement 1, as amended, when a financing authority issues tax-exempt bonds or similar debt instruments and uses the proceeds for the benefit of a governmental health care entity, the obligation is reported as a liability in the health care entity's statement of net position if the health care entity 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 entity has no obligation to make payments of principal and interest on the debt or capital or operating lease payments on related buildings or equipment** (for example, if general obligation debt is issued on behalf of the governmental enterprise), the health care entity should not reflect the liability on its statement of net position. In those circumstances, **proceeds from the bond issue are reported as contributions from the sponsoring government.**

15.88 Among the many provisions normally included in the bond indentures of tax-exempt issues are the requirements to annually set aside funds from operations to ensure that bond principal and interest payments and other requirements are met. Cash, cash equivalents, and investments that can only

²⁴ In determining the extent of subsequent event procedures to perform in connection with a governmental health care municipal securities offering, and the related management representations to request as addressed in paragraph .10b of AU-C section 945, *Auditor Involvement With Exempt Offering Documents* (AICPA, *Professional Standards*), the auditor may consider the structure of the government and which component units relate to the debt offering. A component unit not guaranteeing the repayment is ordinarily not a relevant entity to the users of the debt offering. Alternatively, if the debt is offered solely by a particular component unit, the scope of subsequent event procedures would likely be limited to the applicable component unit responsible for the repayment of the debt. However, if the full set of financial statements for the reporting entity were included in the official statement, the scope of subsequent event procedures would likely also encompass the primary government (or the governmental entity that acts as the nucleus of the financial statements).

be used to pay debt principal and interest would be reported as restricted assets, as discussed in paragraph 15.37. The classification of net position relating to assets set aside based on the requirements of debt-financing instruments is discussed in questions 7.24.1, 7.24.2, 7.24.7, and 7.24.25 of IG 2015-1 and paragraphs 15.123–130. The restricted component of net position represents restricted assets reduced by liabilities related to those assets plus or minus any associated deferred inflows or outflows of resources; thus, the residual of assets restricted to debt service less the related debt plus or minus any associated deferred inflows of resources or deferred outflows of resources is included in the restricted component of net position. This differs from the financial reporting requirements applicable to NFP health care entities under which such resources are part of the entity's unrestricted net assets, unless restricted by a donor for debt service, and the related assets generally are reported as assets whose use is limited.

Debt Defeasance and Extinguishment

15.89 GASB Statement No. 7, *Advance Refundings Resulting in Defeasance of Debt*, and No. 23, *Accounting and Financial Reporting for Refundings of Debt Reported by Proprietary Activities*, as amended, provide accounting and financial reporting guidance for refundings that result in the defeasance of debt. In a refunding, a government issues new debt to finance the repayment of previously-issued (old) debt. The repayment of the old debt may either be immediate (a current refunding) or at some future time (an advance refunding).

GASB Statement No. 7, *Advance Refundings Resulting in Defeasance of Debt*, No. 23, *Accounting and Financial Reporting for Refundings of Debt Reported by Proprietary Activities*, as amended, and No. 86, *Certain Debt Extinguishment Issues*, provide accounting and financial reporting guidance for defeasance of debt. In the more common situation, defeasance of debt occurs via a refunding. In a refunding, a government issues new debt to finance the repayment of previously-issued (old) debt. The repayment of the old debt may either be immediate (a current refunding) or at some future time (an advance refunding). However, a defeasance of debt can also occur if the governmental health care entity irrevocably places cash and other monetary assets acquired with only existing resources—that is, resources other than the proceeds of refunding debt—with an escrow agent in a trust to be used solely for satisfying scheduled payments of both interest and principal of the defeased debt.²⁵

15.90 An advance refunding may defease the old debt, either legally or in substance, as described in paragraphs 3–4 of GASB Statement No. 7, as amended. A legal defeasance occurs when debt is legally satisfied based on certain provisions in the debt instrument, even though the debt is not actually paid. In-substance defeasance occurs if the government irrevocably places cash or other qualifying assets with an escrow agent in a trust to be used solely to satisfy scheduled interest and principal payments of the debt, and the possibility that the government will be required to make future payments on the debt is remote.²⁶ When debt is defeased, neither that liability nor the escrowed assets are reported in the financial statements; only the new debt is reported. That

²⁵ GASB Statement No. 86, *Certain Debt Extinguishment Issues*, issued in May 2017, is effective for fiscal years beginning after June 15, 2017. Earlier application is encouraged.

²⁶ See paragraph 4 of GASB Statement No. 7, *Advance Refundings Resulting in Defeasance of Debt*.

accounting is different in the private sector. Private-sector standards require the debt to be reported as a liability until it is legally defeased.

Defeasance of debt can be either legal or in substance. A legal defeasance occurs when debt is legally satisfied based on certain provisions in the debt instrument, even though the debt is not actually paid. In-substance defeasance occurs if the government irrevocably places cash or other qualifying assets with an escrow agent in a trust to be used solely to satisfy scheduled interest and principal payments of the debt, and the possibility that the government will be required to make future payments on the debt is remote.²⁷ When debt is defeased, by either legal or in-substance defeasance, the debt should no longer be reported as a liability in the financial statements, and the escrowed assets are not reported as assets in the financial statements. For an in-substance defeasance, the trust into which the assets are placed must meet the criteria in paragraph 4 of GASB Statement No. 7, as amended (if the source of the escrowed assets includes new debt or the criteria in paragraph 4 of GASB Statement No. 86 (if the source of the escrowed assets is only existing resources)). That accounting is different in the private sector. Private-sector standards require the old debt to be reported as a liability until it is legally defeased.

15.91 GASB Statement No. 23, as amended by GASB Statement No. 65, requires that the difference between the reacquisition price and net carrying amount of the old debt should be reported as a deferred inflow of resources or a deferred outflow of resources and recognized as a component of interest expense in a systematic and rational manner over the remaining life of the old debt or the life of the new debt, whichever is shorter. GASB Statement No. 23 provides additional standards for debt that refunds previous refunding debt.

If the source of the escrowed assets includes new debt, GASB Statement No. 23, as amended, requires that the difference between the reacquisition price and net carrying amount of the old debt be reported as a deferred inflow of resources or a deferred outflow of resources and recognized as a component of interest expense in a systematic and rational manner over the remaining life of the old debt or the life of the new debt, whichever is shorter.²⁸ If the source of the escrowed assets is only existing resources, paragraph 5 of GASB Statement No. 86 requires that the difference between the reacquisition price and net carrying amount of the old debt, together with any deferred outflows of resources or deferred inflows of resources from prior refundings, be recognized as a separately identified gain or loss in the period of the in-substance defeasance.²⁹ Regardless of whether debt is extinguished through a legal extinguishment or through an in-substance defeasance, the governmental health care entity should include the amount of any remaining prepaid

²⁷ See paragraph 4 of GASB Statement No. 7, *Advance Refundings Resulting in Defeasance of Debt*, and paragraph 4 of GASB Statement No. 86.

²⁸ For refundings of prior refundings resulting in defeasance of debt, the difference, together with any deferred outflows of resources or deferred inflows of resources from the prior refundings, should continue to be deferred and recognized in expense over the shorter of the original amortization period remaining from the prior refundings or the life of the latest refunding debt (that is, the new debt). See paragraph 5 of GASB Statement No. 23, as amended.

²⁹ Governmental health care entities that do not report as special-purpose governments engaged only in business-type activities should refer to paragraphs 5–6 of GASB Statement No. 86 for their reporting requirements.

insurance related to the extinguished debt in the net carrying amount of that debt for the purpose of calculating the difference between the reacquisition price and the net carrying amount of the extinguished debt.

15.92 Paragraphs 124–127 of GASB Statement No. 62 require that a gain or loss in the period of extinguishment be recognized if debt is extinguished by means other than defeasance in a current or an advanced refunding or a troubled debt restructuring.³⁰ The gain or loss should be identified as a separate item in the statement of revenues, expenses, and changes in net position. That accounting and reporting is similar to the private-sector standards of FASB ASC 470-50-40.

Debt Issuance Costs

15.93 Paragraph 187 of GASB Statement No. 62, as amended by GASB Statement No. 65, establishes standards of accounting and financial reporting for debt issuance costs. Paragraph 12 of GASB Statement No. 7 indicates that debt issuance costs include all costs incurred to issue the bonds, including but not limited to insurance costs (net of rebates from the old debt, if any), financing costs (such as rating agency fees), and other related costs (such as printing, legal, administrative, and trustee expenses). Paragraph 15 of GASB Statement No. 65 requires that debt issuance costs, except any portion related to prepaid insurance costs, be recognized as an expense in the period incurred, rather than as a direct deduction from the carrying amount of the debt liability (as required for nongovernmental health care entities). Prepaid insurance costs should be reported as an asset and recognized as interest expense in a systematic and rational manner over the duration of the related debt, as required by question 4.75 of IG 2016-1.

Disclosures

15.94 GASB standards require certain disclosures about debt, including the following:

- Information about long-term debt, such as bonds payable, including beginning and ending balances, increases, decreases, and the portions of each item that are due within one year. See paragraphs 116 and 119–120 of GASB Statement No. 34.
- Debt service requirements to maturity presented separately 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. See paragraphs 10–11 of GASB Statement No. 38.
- For governmental health care entities with conduit debt obligations, a general description of the conduit debt transactions, the aggregate amount of all conduit debt obligations outstanding at the financial statement date, and a clear indication that the

³⁰ A debtor applies paragraphs 128–148 of GASB Statement No. 62 if debt is extinguished in a troubled debt restructuring. That accounting and reporting is similar to the private-sector standards of FASB *Accounting Standards Codification* (ASC) 470-60.

entity has no obligation for the debt beyond the resources provided by related leases or loans. See paragraph 3 of GASB Interpretation No. 2, *Disclosure of Conduit Debt Obligations—an interpretation of NCGA Statement 1*.

- 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. See paragraph 12 of GASB Statement No. 38.
- Disclosure of actions taken to remedy significant violations of finance-related legal or contractual provisions. See paragraph 9 of GASB Statement No. 38.
- In all periods following an advance refunding during which debt that was defeased in substance remains outstanding, governments should disclose the outstanding amount of that debt, if any, at the financial statement date. See paragraph 14 of GASB Statement No. 7.
- The following disclosures are required for all defeasances in the year of refunding: (a) a general description of the transaction, (b) the difference between the cash flow required to service the old debt and the cash flow required to service the new debt and complete the refunding, and (c) the economic gain or loss resulting from the transaction. These are similar to disclosures required of private-sector entities. Paragraph 11 of GASB Statement No. 7 provides guidance on the various measures needed for those disclosures.
- The following disclosures are required for all defeasances for which governments use only existing resources to defease the debt: (a) a general description of the transaction, (b) the amount of that debt defeased in substance that remains outstanding, if any, at period-end, which may be combined with the amount of debt defeased in substance through refunding transactions that remains outstanding. See paragraphs 89 of GASB Statement No. 86.
- For any period in which debt is defeased in substance, regardless of how the escrowed cash and other monetary assets were acquired: (a) the risk, if applicable, that substitution of essentially risk-free monetary assets with monetary assets that are not essentially risk-free is not prohibited, and (b) the amount of debt defeased in substance that remains outstanding, if any, for which the substitution is not prohibited. (That amount should be disclosed separately from the total amount of debt defeased in substance that remains outstanding.) See paragraphs 1011 of GASB Statement No. 86.³¹

³¹ GASB Statement No. 86, *Certain Debt Extinguishment Issues*, issued in May 2017, is effective for fiscal years beginning after June 15, 2017. Earlier application is encouraged.

Contingencies and Other Liabilities

Insurance-Related Contingencies

15.95 Governmental health care entities are generally exposed to the same risks of loss that are described in chapter 8, "Contingencies and Other Liabilities," of this guide. The most common losses arise from medical malpractice, worker's compensation, and medical benefits provided to employees. GASB has issued standards that governmental health care entities should apply in accounting for insurance-related contingencies (primarily GASB Statement No. 10, as amended). Paragraphs 52–80 of GASB Statement No. 10 apply to health care entities and include the following standards:

- General principles for recognition, measurement, and disclosure of claims liabilities (paragraphs 52–58), which are discussed in paragraph 15.96
- Incurred but not reported losses (paragraph 56 and footnote 5), which are recognized if the loss can be reasonably estimated, and it is probable that a claim will be asserted
- Discounting of claims liabilities (paragraphs 59–60), which is neither mandated nor prohibited
- Annuity contracts purchased to satisfy a claim liability (paragraph 61)
- Investments that are separately maintained for risk financing (paragraph 62), which are accounted for in the same manner as all other investments, as discussed in paragraphs 15.40–.65
- Participation in a public-entity risk pool (paragraphs 69–71), which is discussed in paragraph 15.99
- Claims-made policies (paragraph 72), which are discussed in paragraph 15.97
- Retrospectively-rated policies and contracts (paragraph 73–74), which are discussed in paragraph 15.98
- Disclosures (paragraphs 77–80)

General Principles for Recognition, Measurement, and Disclosure of Contingencies

15.96 The recognition and measurement requirements in paragraphs 53–56 and the disclosure requirements in paragraph 58 of GASB Statement No. 10 are primarily those of FASB guidance that was incorporated into GASB Statement No. 62. Therefore, much of the insurance-related guidance in chapter 8 of this guide applies to governmental health care entities. However, recognition and measurement of claims liabilities differ because GASB Statement No. 10 looks to whether risk has, in fact, been transferred to an unrelated third party when determining whether to recognize a loss. An estimated loss from a claim is reported as an expense and a liability if risk has not been transferred to an unrelated third party, and claims expenses and liabilities should be reduced by amounts expected to be recovered through insurance. Private-sector standards require that the amount of a contingency be determined independently from any potential claim for recovery and that possible insurance recoveries be reported separately as assets.

Claims-Made Policies

15.97 Paragraph 72 of GASB Statement No. 10 states that a claims-made policy represents a transfer of risk within the policy limits for incidents reported to the insurer. Consequently, a health care entity should account for the estimated cost of claims and incidents that are not reported to the insurer, unless the entity has purchased tail coverage and included the cost of the premium or required contribution as an expense for the period. This accounting is similar to the private-sector standards described in paragraphs 8.34–.36 of this guide, except that amounts recoverable through insurance reduce the liability, rather than being reported as a receivable.

Retrospectively-Rated Policies and Contracts

15.98 Paragraph 73 of GASB Statement No. 10 states that an entity with a retrospectively-rated policy or contract whose ultimate premium or required contribution is based on the entity's loss experience should account for the minimum premium as an expense over the period of coverage and accrue estimated losses from reported and unreported claims in excess of the minimum premium. However, losses should not be accrued in excess of the stipulated maximum premium or contribution requirement. If the entity cannot estimate those losses, the entity should disclose the contingency, in accordance with paragraph 58 of GASB Statement No. 10. Paragraph 74 of GASB Statement No. 10 provides guidance when the premium or contribution amount is based on the experience of a group of entities.

Participation in Public-Entity Risk Pools

15.99 GASB Statement No. 10 specifically addresses situations in which governmental health care entities participate in risk-financing programs sponsored by other governments (for example, a public-entity risk pool). That guidance is summarized as follows. A governmental health care entity that participates in a public-entity risk pool in which risk is transferred or pooled with other entities should present its premium or required contribution as insurance expense, as discussed in paragraphs 69–70 of GASB Statement No. 10. Entities that participate in public-entity risk pools that do not involve transfer or pooling of risk should report payments made to pools as deposits and recognize and measure claims liabilities, in accordance with paragraphs 53–58 of GASB Statement No. 10, as discussed in paragraph 15.95. Governmental health care entities that are component units of a state or local governmental reporting entity and participate in that entity's risk-financing internal-service fund should report the charges from the internal service fund as claims expenses if those charges meet the requirements of paragraphs 65–68 of GASB Statement No. 10.

Irrevocable Self-Insurance Trusts

15.100 The risk-financing techniques of some governmental health care entities include risk retention (sometimes referred to as self-insurance). A governmental health care entity that has not transferred risk to a third party should evaluate its exposure to losses arising from all claims and incidents and recognize liabilities and expenses, in accordance with paragraphs 53–56 of GASB Statement No. 10. Assets that have been contributed to irrevocable self-insurance trusts are reported as restricted assets, such as assets limited regarding use or otherwise segregated, in its statement of net position. This restricted classification is due to the limited use of the funds as defined in the

trust fund document and the fact that the funds are not available to finance other activities of the government. A governmental health care entity would also report restricted net position to the extent that the assets exceed the associated self-insured liability and will be used to liquidate the liability. See paragraph 15.127 for a discussion on calculating restricted net position. Private-sector NFP health care entities report the net assets related to the excess of self-insurance assets over related liabilities in unrestricted net assets because the limitations on use are not imposed by a donor.

Physician Guarantees and Other Agreements

15.101 Risk of loss due to guarantees, including guarantees of the indebtedness of others in an exchange or exchange-like transaction, should be evaluated by applying the loss contingency standards in paragraphs 96–113 of GASB Statement No. 62. The private-sector standards for guarantees, including indirect guarantees of indebtedness of others and minimum revenue guarantees, in FASB ASC 460-10 conflict with the requirements of NCGA Statement 4, *Accounting and Financial Reporting Principles for Claims and Judgments and Compensated Absences*, as amended, and, therefore, should not be applied by governmental health care entities.

Nonexchange Financial Guarantees

15.102 GASB Statement No. 70, *Accounting and Financial Reporting for Nonexchange Financial Guarantees*, applies to governmental entities that enter into nonexchange financial guarantees in which they extend or receive financial guarantees on obligations of other entities without receiving or paying equivalent value for the guarantees. It establishes accounting standards for the recognition, measurement, and disclosures of nonexchange financial guarantees. The guidance in GASB Statement No. 70 does not apply to joint-and-several liabilities, which is not a guarantee for an obligation of another entity or individual, but is instead the government providing assurance of performance on its own obligations.

15.103 The guarantor should recognize a liability if it is more likely than not that payment will be required. The liability should be measured at the best estimate of the discounted present value of the future outflows expected to be incurred. If an estimate cannot reasonably be determined but there is a range, the liability should be measured at the minimum amount of that range. An entity released as an obligor in a nonexchange financial guarantee should recognize revenue.

15.104 GASB Statement No. 70 requires certain disclosures in accordance with paragraphs 14–17 by type of guarantee. Type of guarantee is determined by using professional judgment.

Asset Retirement and Pollution Remediation Obligations

Ⓢ Update 15-3 *Accounting and Reporting: Asset Retirement Obligations*

GASB Statement No. 83, issued November 2016, is effective for reporting periods beginning after June 15, 2018. Earlier application is encouraged.

GASB Statement No. 83 addresses accounting and financial reporting for certain asset retirement obligations (AROs). An ARO is a legally enforceable

liability associated with the retirement of a tangible capital asset. The decommissioning of nuclear reactors, removal and disposal of wind turbines in wind farms, dismantling and removal of sewage treatment plants, and removal and disposal of x-ray machines are examples of assets whose retirements generate AROs. A government that has legal obligations to perform future asset retirement activities related to its tangible capital assets should recognize a liability and a corresponding deferred outflow of resources based on the guidance in this Statement. Recognition occurs when the liability is both incurred and reasonably estimable. The determination of when the liability is incurred should be based on the occurrence of external laws, regulations, contracts, or court judgments, together with the occurrence of an internal event that obligates a government to perform asset retirement activities.

This edition of the guide has not been updated to reflect changes as a result of this statement; however, the section that follows will be updated in a future edition. Readers are encouraged to consult the full text of the statement on GASB's website at www.gasb.org.

15.105 When evaluating asset retirement and pollution remediation obligations, such as asbestos removal, governmental health care entities consider the guidance in GASB Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*. Those standards differ from the private-sector standards of FASB ASC 410, *Asset Retirement and Environmental Obligations*. GASB Statement No. 49 provides guidance on reporting the costs of, and obligations for, pollution remediation (for example, the cleanup of pollution or asbestos contamination). GASB Statement No. 49 does not require governmental entities to search for pollution remediation obligations but, instead, sets forth triggers that would signal that a governmental entity should determine if it has to report a remediation liability.

15.106 The scope of GASB Statement No. 49 includes obligations that address the current or potential detrimental effects of existing pollution by participating in pollution remediation activities, such as obligations to clean up spills of hazardous wastes or substances and obligations to remove contamination, such as asbestos. The scope of GASB Statement No. 49 excludes pollution prevention or control obligations with respect to current operations. It also excludes future pollution remediation activities that are required upon retirement of an asset, such as landfill closure and postclosure care and nuclear power plant decommissioning. However, GASB Statement No. 49 applies to activities at the retirement of an asset if an obligating event occurs, and pollution-related asset retirement obligations have not been previously recognized.

Other Contingencies

15.107 Governmental health care entities are also exposed to loss contingencies that are outside the scope of GASB Statement No. 10. The criteria in paragraphs 96–113 of GASB Statement No. 62 are used as guidelines for recognizing certain liabilities that arise from loss contingencies, including collectability of receivables; agreements to repurchase receivables (or the related property) that have been sold; and breach of contract or similar actions, such as claims for delays or inadequate specifications on contracts or guarantees of the indebtedness of others in an exchange or exchange-like transaction,

property tax appeals, and unemployment compensation claims.³² Those criteria are similar to the private-sector standards in FASB ASC 450-20.

Compensation and Related Benefits

15.108 GASB pronouncements require governmental health care entities to present information related to compensation and related benefits beyond or different from that presented by NFP and investor-owned entities. The primary standards related to compensation and employee benefits are highlighted subsequently. Chapter 8 of the AICPA Audit and Accounting Guide *State and Local Governments* contains more expansive discussions of these standards.

Pensions

15.109 Governmental health care entities that provide defined benefit pensions through a plan that is administered through a trust or equivalent arrangement are required to recognize net pension liability, pension expense, and certain deferred outflows of resources and deferred inflows of resources (pension amounts) in their financial statements in accordance with GASB Statement No. 68, *Accounting and Financial Reporting for Pensions—an Amendment of GASB Statement No. 27*, as amended. GASB Statement No. 68 identifies the methods and assumptions that should be used to project benefit payments, discount projected benefit payments to their actuarial present value, and attribute that present value to periods of employee service.

15.110 GASB Statement No. 73, *Accounting and Financial Reporting for Pensions and Related Assets That Are Not within the Scope of GASB Statement 68, and Amendments to Certain Provisions of GASB Statements 67 and 68*, extends to all pensions the approach to accounting and financial reporting established in GASB Statement No. 68, with modifications as necessary to reflect that for accounting and financial reporting purposes, any assets accumulated for pensions that are provided through pension plans that are not administered through trusts that meet the criteria specified in GASB Statement No. 68 should not be considered pension plan assets.

15.111 GASB Statement No. 78, *Pensions Provided through Certain Multiple-Employer Defined Benefit Pension Plans*, establishes requirements for recognition and measurement of pension expense, expenditures, and liabilities; note disclosures; and required supplementary information for pensions provided via certain multiple-employer defined benefit pension plans as defined by GASB Statement No. 78, such as certain labor union plans.

15.112 Chapter 13, "Defined Benefit Pension Plans (Plan & Employer Considerations)," of the AICPA Audit and Accounting Guide *State and Local Governments* contains extensive guidance on accounting, financial reporting, and auditing considerations related to pensions.

Postemployment Benefits Other Than Pensions—Employer Accounting

15.113 GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, as amended, provides guidance on employer accounting and financial reporting for OPEB.

³² See paragraphs 9 and 14 of National Council on Governmental Accounting Statement No. 4, *Accounting and Financial Reporting Principles for Claims and Judgments and Compensated Absences*, as amended.

OPEB include postemployment health care benefits (such as illness, dental, vision, and hearing), even if those benefits are provided through a pension plan. OPEB also include, for example, life insurance, disability income, tuition assistance, legal services, and other assistance programs unless the benefits are provided through a defined benefit pension plan. Employers may or may not advance-fund OPEB by setting aside assets on an actuarially determined or other basis to pay future benefits as they become due.

GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, as amended, provides guidance on employer accounting and financial reporting for employees who are provided with OPEB, as well as for certain nonemployer governments that have a legal obligation to provide financial support for OPEB provided to the employees of other entities.³³ OPEB include postemployment health care benefits (such as illness, dental, vision, and hearing), even if those benefits are provided through a pension plan. OPEB also include, for example, life insurance, disability income, tuition assistance, legal services, and other assistance programs unless the benefits are provided through a defined benefit pension plan. Employers may or may not advance-fund OPEB by setting aside assets on an actuarially determined or other basis to pay future benefits as they become due.

15.114 GASB Statement No. 45 requires systematic, accrual-basis measurement and recognition of OPEB cost over a period that approximates employees' years of service. GASB Statement No. 45 also requires information related to the funded status of the plan to be presented in the notes and RSI, not reflected on the face of the statement of net position as a liability or an asset. Paragraph 14 of IG 2015-1 provides additional guidance on GASB Statement No. 45.

GASB Statement No. 75, as amended, requires the OPEB liability to be reported on the face of the statement of net position. Governmental health care entities that provide OPEB through an OPEB plan that is administered through an eligible trust (that is, a trust that meets the criteria in paragraph 4 of GASB Statement No. 75, as amended) are required to recognize the OPEB liability net of the amount of the OPEB plan's fiduciary net position. Measurement of the OPEB liability includes discounting future benefit payments for current and former employees and their beneficiaries, if applicable, to present value and allocating the present value over past and future periods of the employee services (total OPEB liability), less the amount of the OPEB plan's fiduciary net position, using the entry age actuarial cost method with each period's service cost determined as a level percentage of pay. (However, if fewer than 100 employees—active and inactive—are provided with OPEB through the plan, a specified alternative measurement method maybe used.)

Changes in the net OPEB liability that have not been included in OPEB expense are required to be reported as deferred outflows of resources or deferred inflows of resources related to OPEB. Employer contributions subsequent to the measurement date of the net OPEB liability are required to be reported as

³³ GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, issued in June 2015, is effective for periods beginning after June 15, 2017. GASB Statement No. 85, *Omnibus 2017*, which amends GASB Statement No. 75, is effective for the same periods. Earlier application is encouraged.

deferred outflows of resources. Governmental health care entities that do not provide OPEB through an eligible trust use a similar approach for measurement of OPEB liabilities, OPEB expense, and deferred outflows of resources and deferred inflows of resources related to OPEB; however, the requirements incorporate modifications to reflect the absence of OPEB plan assets for financial reporting purposes, such as a modification that requires the total OPEB liability be recognized in the financial statements. GASB Statement No. 75, as amended, also provides accounting and financial reporting requirements for defined contribution OPEB.

15.115 Employers that provide postretirement prescription drug coverage benefits may receive federal subsidy payments related to Medicare Part D prescription drug coverage. Governmental health care entities should account for those payments as a voluntary nonexchange transaction received based on the requirements of GASB TB No. 2006-1, *Accounting and Financial Reporting by Employers and OPEB Plans for Payments from the Federal Government Pursuant to the Retiree Drug Subsidy Provisions of Medicare Part D*, as amended. That accounting is different in the private sector. Private-sector health care entities net the subsidy payments against the related OPEB costs and liabilities.

15.116 Chapter 14, "Postemployment Benefits Other than Pensions (Plan & Employer Considerations)," of the AICPA Audit and Accounting Guide *State and Local Governments* contains extensive guidance on accounting, financial reporting, and auditing considerations related to OPEB.

Sabbaticals and Other Compensated Absences

15.117 Compensated absences, such as holidays, vacations, sick leave, and sabbaticals, should be accounted for in accordance with GASB Statement No. 16, *Accounting for Compensated Absences*. The underlying concepts of GASB Statement No. 16 are similar to those of FASB ASC 710-10 for compensated absences, with some differences, such as the following:

- GASB Statement No. 16 does not require accrual prior to the occurrence of the illness, unless it is probable that the employer will compensate the employee for unused sick leave or similar benefits with cash payment at termination or retirement. FASB ASC 710-10-25 addresses sick leave in the context of the vesting of sick leave benefits; it does not require the accrual of a liability for non-vesting rights to receive sick pay.
- GASB Statement No. 16 requires accrual of payments that an employer expects to make that will be directly and incrementally associated with payments made for compensated absences at termination or retirement, such as FICA or Medicare tax. FASB ASC 710-10 has no similar requirement.
- GASB Statement No. 16 mandates the use of certain rates of pay for calculating the liability, and it limits the liability to amounts that employers will pay at termination or retirement. FASB ASC 710-10 has no similar requirement.

Termination Benefits and Restructuring Costs

15.118 GASB Statement No. 47, *Accounting for Termination Benefits*, establishes accounting standards for the measurement, recognition, and disclosures of voluntary and involuntary termination benefits. Section Z.47 of IG

2015-1, as amended, provides additional helpful guidance. GASB Statement No. 69 provides guidance on costs included in and excluded from disposals of government operations and reporting thereof.

Tax Considerations

15.119 Health care entities owned and operated by a state or local government typically are exempt from federal income tax, pursuant to IRC Section 115, and also are exempt from the federal income tax filing requirements. Such entities 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 properly organized to preserve qualification of the tax exemption, pursuant to IRC Section 115.

15.120 In some cases, state or local governmental entities will secure tax-exempt status as an IRC Section 501(c)(3) organization.³⁴ If such an exemption is secured, the entity may become subject to federal unrelated business income tax and filing requirements on the same basis as other tax-exempt entities, as discussed in chapter 8 of this guide.

Disclosures

15.121 Paragraph 3 of GASB Statement No. 10 and NCGA Statement 4, as amended, require various disclosures related to claims and judgments. Paragraphs 116 and 119–120 of GASB Statement No. 34 require disclosure of certain information related to liabilities associated with claims and judgments. These include beginning and ending liability balances, increases, decreases, and the portion that is expected to be due within one year.

15.122 GASB standards require certain disclosures related to other liabilities, including the following:

- Detailed disclosures about accounts payable balances when significant components of those balances have been obscured by aggregation. See paragraph 13 of GASB Statement No. 38.
- Information about long-term operating liabilities, such as compensated absences and claims and judgments, including beginning and ending balances, increases, decreases, and the portions of each item that are due within one year. See paragraphs 116 and 119–120 of GASB Statement No. 34.
- Disclosures about pension benefits provided to employees of governmental health care entities, including certain multiyear actuarial data required to be presented as RSI. See GASB Statement No. 68 (for pensions provided using eligible trusts, which are trusts that meet the criteria in paragraph 4 of GASB Statement No. 68), GASB Statement No. 73, (for pensions provided without using eligible trusts), or GASB Statement No. 78 (for multiple-employer defined benefit pension plans).

³⁴ This is sometimes done to facilitate fundraising because IRC Section 501(c)(3) status assures potential donors that their contributions will be tax deductible.

- Disclosures about other postemployment benefits, including certain multiyear actuarial data required to be presented as RSI. See paragraphs 24–27 and 34 of GASB Statement No. 45.
- Disclosures about termination benefits. See paragraphs 18–21 of GASB Statement No. 47.
- Disclosure of actions taken to remedy significant violations of finance-related legal or contractual provisions. See paragraph 9 of GASB Statement No. 38.

GASB standards require certain disclosures related to other liabilities, including the following:

- Detailed disclosures about accounts payable balances when significant components of those balances have been obscured by aggregation. See paragraph 13 of GASB Statement No. 38.
- Information about long-term operating liabilities, such as compensated absences and claims and judgments, including beginning and ending balances, increases, decreases, and the portions of each item that are due within one year. See paragraphs 116 and 119–120 of GASB Statement No. 34.
- Disclosures about pension benefits provided to employees of governmental health care entities, including certain multiyear actuarial data required to be presented as RSI. See GASB Statement No. 68 (for pensions provided using eligible trusts, which are trusts that meet the criteria in paragraph 4 of GASB Statement No. 68), GASB Statement No. 73 (for pensions provided without using eligible trusts), or GASB Statement No. 78 (for multiple-employer defined benefit pension plans).
- Disclosures about other postemployment benefits, including certain multiyear actuarial data required to be presented as RSI. See GASB Statement No. 75, as amended.³⁵
- Disclosures about termination benefits. See paragraphs 18–21 of GASB Statement No. 47.
- Disclosure of actions taken to remedy significant violations of finance-related legal or contractual provisions. See paragraph 9 of GASB Statement No. 38.

Net Position

15.123 GASB Statement No. 34, as amended, establishes requirements for reporting net position that differ in several respects from the requirements for NFP health care entities. Under GASB Statement No. 34, net position is reported in three components: restricted (distinguishing between major categories of restrictions); net investment in capital assets; and unrestricted. When a portion of restricted net position is required to be retained in perpetuity or

³⁵ GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, issued in June 2015, is effective for periods beginning after June 15, 2017. GASB Statement No. 85, *Omnibus 2017*, which amends GASB Statement No. 75, is effective for the same periods. Earlier application is encouraged.

minority interest in a component unit exists, restricted net position should be displayed in two additional components: expendable and nonexpendable.³⁶

15.124 The unrestricted component is the residual category of net position. It includes all assets, deferred outflows of resources, liabilities, and deferred inflows of resources that are not included in the determination of the net investment in capital assets or the restricted components of net position. The unrestricted component of net position is available to finance day-to-day operations free of constraints imposed by debt covenants, donor restrictions, irrevocable trusts, and so on. Assets that are board- or management-designated for specific purposes are reported in this component.³⁷

15.125 The net investment in capital assets component is not used by NFP health care entities. As discussed in paragraph 9 of GASB Statement No. 63, this component represents the sum of capital assets shown in the statement of net position (net of accumulated depreciation) less any related debt used to finance those assets (for example, the outstanding balances of any bonds, mortgages, notes, or other borrowings that are attributable to the acquisition, construction, or improvement of those assets). Deferred outflows of resources and deferred inflows of resources that are attributable to the acquisition, construction, or improvement of those assets or related debt also should be included in this component of net position. If capital debt exceeds the carrying value of capital assets, a negative amount should be reported, as discussed in question 7.23.9 of IG 2015-1. Paragraph 15.127 provides additional guidance about calculating the amount of the net investment in capital assets component of net position.

15.126 Governmental-restricted net position differs in several respects from the restricted net assets reported by NFP health care entities. First, GASB's definition of *restricted* is broader. In the NFP sector, restrictions relate solely to limitations imposed by donors or grantors. In the governmental sector, restrictions arise from constraints on the use of assets that are imposed (a) by external parties (for example, creditors, grantors, and contributors) or laws or regulations of other governments³⁸ or (b) by law through constitutional provisions or enabling legislation.³⁹ Thus, in addition to resources restricted for purposes identified by donors and grantors, governmental-restricted net position includes restricted assets, as discussed in paragraph 15.37, such as unexpended debt proceeds held by trustees, bond sinking and debt service reserve funds, assets set aside to meet statutory reserve requirements, and assets held in irrevocable malpractice self-insurance trusts. The underlying concept is that the government itself cannot unilaterally establish a restriction, except by enabling legislation, and cannot remove a restriction, except by fulfilling it. Thus, board designations on the use of assets are not restrictions. Under GASB Statement No. 34, assets and net position are reported as restricted until the resources have been used for the specified purpose or, in the case of time requirements, as long as the resource provider requires (for example, in perpetuity).

³⁶ See paragraph 35 of GASB Statement No. 34, as amended.

³⁷ However, these designations should not be displayed on the face of the statement of net position. See paragraph 15.132.

³⁸ See paragraphs 34–35 of GASB Statement No. 34.

³⁹ See GASB Statement No. 46, *Net Assets Restricted by Enabling Legislation—an amendment of GASB Statement No. 34*.

15.127 Another difference is that GASB focuses on identifying specific assets that are restricted, along with any related liabilities; thus, restricted net position represents restricted assets reduced by the liabilities related to those assets and associated deferred inflows or outflows of resources, if any. In NFP reporting, the concept of restriction focuses on a donor's restriction of the use of net assets versus restricting specific assets, as discussed in paragraph 9.08 of this guide. Question 7.24.7 of IG 2015-1 states that generally, a liability relates to restricted assets if the asset results from incurring the liability, or the liability will be liquidated with the restricted assets. For example, unexpended debt proceeds that must be used to acquire or construct capital assets are restricted assets, and the portion of the debt attributable to the unexpended proceeds is a related liability that should be offset, if significant, in calculating restricted net position.⁴⁰ If a bond indenture requires a portion of the proceeds to be used to establish a reserve for the payment of principal and interest, the assets of the reserve account are restricted assets, and the portion of debt related to the establishment of the reserve is included in the calculation of restricted net position.⁴¹ However, some exceptions exist. If, for example, a bond sinking fund contains assets held in trust that are restricted for principal and interest payments on capital-related debt, the capital-related debt would not be offset against the restricted sinking fund assets in calculating restricted net position. Instead, it is required to be netted against the capital assets that were financed with the debt in calculating the net investment in capital assets component of net position.⁴²

15.128 To determine the amount reported in the restricted component of net position, the financial statement preparer first compares individual restricted asset line items with their related liabilities and then aggregates the results. If any deferred inflows of resources relate to those restricted assets, they are also included in this calculation. In comparing individual restricted asset line items with related liabilities, negative amounts should never be reported.⁴³ If liabilities that relate to specific restricted assets exceed those assets, the net position balance for that line item would be zero, and the deficit would reduce the unrestricted net position component.

15.129 Financial reporting of permanently-restricted net position is another area where GASB and FASB standards differ. When a portion of restricted net position is required to be retained in perpetuity, restricted net position should be subdivided into expendable and nonexpendable components. In the governmental sector, restricted nonexpendable net position should represent the reported amount of restricted assets (typically endowments) subject to a donor-imposed time requirement that they be invested and reinvested in perpetuity less any related liabilities. If no related liabilities exist, then the amount of restricted nonexpendable net position equals the value of the restricted investments, even if that value has fallen below the amount of the original gift.⁴⁴ This differs from the NFP reporting model that focuses on maintaining permanently-restricted net position at the amount determined at the time of the original gift (see paragraphs 9.26–32 of this guide). In calculating net position balances associated with permanent endowments, care should

⁴⁰ See question 7.23.2 of IG 2015-1.

⁴¹ See question 7.24.25 of IG 2015-1.

⁴² See question 7.24.2 of IG 2015-1.

⁴³ See question 7.24.13 of IG 2015-1.

⁴⁴ See questions 7.24.29 and 7.24.30 of IG 2015-1.

be exercised to appropriately reflect the expendable and nonexpendable components if endowment assets include both corpus and spendable accumulated net appreciation (for example, nonexpendable restricted assets are commingled with spendable restricted assets).

15.130 GASB's guidance related to the calculations of the components of net position is prescriptive, and care should be employed when linking liabilities or deferred inflows to specific restricted or capital assets for purposes of calculating the components. Paragraph 13 of IG 2015-1 contains guidance regarding the GASB staff's views on how the standards should be applied in various scenarios.

Financial Reporting of Net Position

15.131 The supporting details of restricted net position (for example, major categories of restrictions) should be displayed on the face of the statement of net position; note disclosure is not an acceptable alternative.⁴⁵ NFP health care entities are permitted to provide that information in either the notes to the financial statements or on the face of the balance sheet.

15.132 Paragraphs 37 and 98 of GASB Statement No. 34, as amended, prohibit reporting internal designations of net position separately within unrestricted net position on the face of the statement of net position but allow disclosure in the notes to the financial statements. Designations are management's plans for the use of resources, which should not be afforded the same status as restrictions. No prohibition exists against displaying the associated designated assets (for example, investments set aside for future expansion or quasi-endowment) on the face of the statement of net position. NFP health care entities are permitted to display designations within unrestricted net position on the face of the balance sheet or in the notes.

Health Care Service Revenue and Receivables

15.133 As discussed in chapter 10, "Health Care Service Revenue and Related Receivables," of this guide, under most third-party payor arrangements, governmental health care entities receive payment amounts that are less than their full established rates. The amount paid may be based on government regulations, such as Medicare, Medicaid, and other government programs, or contractual arrangements, such as preferred provider organizations, Blue Cross and Blue Shield plans, health maintenance organizations, and commercial insurers. Under this guide, provisions recognizing contractual and other adjustments are recorded on an accrual basis and deducted from gross service revenue to determine net service revenue. **Charity care represents health care services that are provided but never expected to result in cash flows; therefore, charity care does not qualify for recognition as revenue. For financial reporting purposes, gross service revenue does not include charity care, and net service revenue is reported net of contractual and other adjustments in the statement of revenues, expenses, and changes in net position.**

15.134 Footnote 41 to paragraph 100 of GASB Statement No. 34 states "[r]evenues should be reported net of discounts and allowances with the discount or allowance amount parenthetically disclosed on the face of the statement or in a note to the financial statements. Alternatively, revenues may be

⁴⁵ See question 7.22.8 of IG 2015-1.

reported gross, with the related discounts and allowances reported directly beneath the revenue amount." For purposes of that display and disclosure, discounts and allowances include the difference between a health care provider's full established rates and its negotiated or contractual payment amounts previously described. However, allowances, as used in footnote 41, also include increases or decreases in the estimate of uncollectible accounts. As a result, the financial statements of governmental health care entities display changes in the estimate of uncollectible accounts differently from the display of similar amounts in financial statements of private-sector entities. Governmental health care entities report those amounts as a deduction from revenue. Private-sector entities report them as bad debt expense or as a deduction from patient service revenue if the entity recognizes significant amounts of patient service revenue at the time services are rendered even though it does not assess the patient's ability to pay, as discussed in paragraphs 10.34–36 of this guide.

15.135 Governmental health care entities that enter into arrangements in which they finance or sell their patient accounts receivable as a cash flow management strategy apply criteria in GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*, in determining when transactions should be reported as a collateralized borrowing or sale. Determining whether a transaction should be reported as a sale, rather than a collateralized borrowing, requires an assessment of a government's continuing involvement with the receivables or future transferred revenues. A significant aspect of that assessment is the degree to which the selling or pledging government (the transferor) retains or relinquishes to the transferee control over the receivables or future transferred revenues. FASB ASC 860 should not be applied as nonauthoritative accounting literature by governmental health care entities because it conflicts with GASB Statement No. 48.

15.136 Governmental health care entities are required to disclose certain information about revenue and receivables, as follows:

- The accounting policies used for recognizing revenues, as discussed in paragraph 69 of NCGA Statement 1 and paragraphs 90–94 of GASB Statement No. 62.
- The policy for defining operating and nonoperating revenues, as discussed in paragraphs 102 and 115 of GASB Statement No. 34.
- Information about specific revenues pledged to collateralize or secure debt, as discussed in paragraph 21 of GASB Statement No. 48.
- Detailed disclosures about receivable balances when significant components of those receivables have been obscured by aggregation, as discussed in paragraph 13 of GASB Statement No. 38.
- Separate disclosure of significant receivable balances not expected to be collected within one year of the statement of net position date, as discussed in paragraph 13 of GASB Statement No. 38.
- The allowance for estimated uncollectible receivables should be disclosed on the face of the financial statement either parenthetically or as a separate line item or in the notes to the financial statements, as discussed in paragraph 33 of GASB Statement No. 62.

- **Management's policy for providing charity care, as well as the level of charity care provided, measured based on the governmental health care entity's costs, units of service, or other statistical measure.** Private-sector health care entities disclose the information in paragraph 10.28 of this guide.

Chapter 6, "Revenues and Receivables," of the AICPA Audit and Accounting Guide *State and Local Governments* contains additional guidance on accounting, financial reporting, and auditing considerations related to revenue and receivables.

Contributions and Other Nonexchange Transactions

15.137 Governmental health care entities may receive contributions, grants, or tax support in transactions with no direct and equivalent exchange of value with the resource provider. Governmental health care entities follow GASB Statement No. 33, as amended, which establishes accounting and financial reporting standards for the recognition of nonexchange transactions involving financial or capital resources.⁴⁶

15.138 Nonexchange transactions are classified into one of four classes based on their principal characteristics, as discussed in paragraph 7 of GASB Statement No. 33. Most contributions and grants received by governmental health care entities are classified as voluntary nonexchange transactions. Revenue from voluntary nonexchange transactions should be recognized when all applicable eligibility requirements have been met. Eligibility requirements comprise one or more of the following:

- Required characteristics of recipients
- Time requirements
- Reimbursements
- Contingencies

Detailed guidance on the application of eligibility requirements is provided in paragraphs 20–26 of GASB Statement No. 33.

15.139 Voluntary nonexchange transactions may be received with associated time or purpose restrictions. As discussed in paragraph 14 of GASB Statement No. 33, purpose restrictions imposed on nonexchange revenues, such as grants, contributions, and endowments, do not affect when revenues are recognized. Rather, resulting net position should be reported as restricted until the resources have been used for the specified purpose or for as long as the resource provider requires (for example, for endowments). Paragraph 10 of GASB Statement No. 65 states that resources transmitted before the eligibility requirements are met (excluding time requirements) should be reported as assets by the provider and as liabilities by the recipient. Resources received before time requirements are met, but after all other eligibility requirements have been met, should be reported as a deferred outflow of resources by the provider and a deferred inflow of resources by the recipient.

15.140 If the transaction is a permanent or term endowment, the resource provider's stipulation that the resources should be maintained intact in perpetuity for a specified number of years or until a specific event has occurred (for

⁴⁶ To date, GASB has not issued any guidance related to noncapital gifts-in-kind or contributed services.

example, the donor's death) is a time requirement, as described in paragraph 20(b) of GASB Statement No. 33. In such situations, the time requirement is considered met as soon as the recipient begins to honor the provider's stipulation not to sell, disburse, or consume the resources, which occurs upon receipt of the resources. Therefore, revenues from term or permanent endowments should be recognized at the time the resources are received, provided that all other eligibility requirements have been met. The associated net position should be reported as restricted for as long as the donor's time requirements and purpose restrictions, if applicable, remain in effect.

15.141 Promises of cash or other assets that nongovernmental entities, including individuals, voluntarily make to governments may be referred to as pledges, promises to give, promised donations, or 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. Governmental health care entities that receive promises to give should recognize receivables and revenues net of estimated uncollectible amounts only after all eligibility requirements are met, provided that the promise is verifiable, and the resources are measurable and probable of collection.⁴⁷ As noted in question Z.33.19 of IG 2015-1, governmental standards neither require nor prohibit the discounting of promises to give that are to be received over an extended period of time. Private-sector standards require discounting of such promises. In accordance with paragraph 11 of GASB Statement No. 33, transactions that are not recognizable because they are not measurable should be disclosed. For term or permanent endowments, the health care entity cannot begin to honor a provider's stipulation that the resources not be sold, disbursed, or consumed until the resources are actually received. Therefore, promises to give term or permanent endowments are not recognized in financial statements.⁴⁸

15.142 In some cases, it may become apparent after revenue has been recognized in the financial statements that the GASB Statement No. 33 eligibility criteria are no longer met (for example, because an audit of a particular grant program determined that certain expenses did not meet purpose restrictions). Paragraph 26 of GASB Statement No. 33 provides that if it is probable that the recipient will return all or part of the transferred resources, a liability or reduction of a receivable and an expense should be recognized for the amount that the resource provider (grantor) is expected to cancel or reclaim.

15.143 Governmental health care entities may be beneficiaries of charitable gifts structured as split-interest agreements. Common forms of split-interest agreements include charitable gift annuity contracts, pooled life income trusts, charitable remainder unitrusts, charitable remainder annuity trusts, and charitable lead annuity trusts.⁴⁹ Question 7.72.11 of IG 2015-1 provides guidance to governmental health care entities in situations in which the

⁴⁷ See paragraph 25 and examples 21 and 21(a) in appendix D of GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*.

⁴⁸ See examples 24–25 in appendix D of GASB Statement No. 33.

⁴⁹ These and other types of split-interest agreements are described in the AICPA Audit and Accounting Guide *Not-for-Profit Entities*. The accounting and financial reporting guidance in that guide for those agreements does not constitute category B guidance for governmental entities because the AICPA did not make that guide applicable to governmental entities and GASB did not clear the guidance therein. (See paragraphs 15.05–.08 for a discussion of the GAAP hierarchy for governments.)

health care entity is the trustee, as well as the beneficiary; thus, the trust assets are under their control. The governmental health care entity should recognize an asset for the fair value of the trust assets and a liability for the obligation to the beneficiary. The difference between the assets in the trust and the liability owed to the other beneficiary(ies) would be reported as restricted net position that is expendable or nonexpendable based on the nature of the donor's restrictions. Changes should be reflected in the statement of revenues, expenses, and changes in net position.

Governmental health care entities may be beneficiaries of charitable gifts structured as split-interest agreements. Common forms of split-interest agreements include charitable gift annuity contracts, pooled life income trusts, charitable remainder unitrusts, charitable remainder annuity trusts, and charitable lead annuity trusts. GASB Statement No. 81, *Irrevocable Split-Interest Agreements*, requires that a governmental health care entity that receives resources pursuant to an irrevocable split-interest agreement recognize assets, liabilities, and deferred inflows of resources at the inception of the agreement. Furthermore, a governmental health care entity recognizes an asset for its beneficial interests in irrevocable split-interest agreements that are administered by a third party, if the governmental health care entity controls the present service capacity of the beneficial interests. Revenue is recognized when the resources become applicable to the reporting period.⁵⁰

15.144 Foundations, businesses, and other types of entities may provide resources to health care entities under programs referred to as grants, awards, or sponsorships. The asset transfers are likely exchange or exchange-like transactions if the potential public benefit is secondary to the resource providers' potential direct benefits. The transfers are likely contributions (voluntary nonexchange transactions) if the resource providers receive no value in exchange for the transferred assets or if the value received by the resource provider is incidental to the potential public benefit from using the transferred assets. For example, a research grant made by a foundation to a governmental 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. However, if 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.⁵¹ Question Z.33.1 in IG 2015-1 also discusses considerations related to determining whether a grant is an exchange or a nonexchange transaction.

15.145 Statement of Position (SOP) 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising* (AICPA, Professional Standards, ACC sec. 10), provides guidance for state and local governmental entities, including health care entities, that conduct fund-raising activities with activities related to other functions, such as program activities or supporting services (joint activities). FASB ASC 958-720 superseded SOP 98-1, *Accounting for the Costs of Computer*

⁵⁰ GASB Statement No. 81, *Irrevocable Split-Interest Agreements*, issued March 2016, is effective for periods beginning after December 15, 2016, and should be applied retroactively. Earlier application is encouraged.

⁵¹ See example 22 in appendix D of GASB Statement No. 33.

Software Developed or Obtained for Internal Use, as it relates to nongovernmental entities; however, SOP 98-2 is still applicable to governmental entities. SOP 98-2 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 those joint costs. Certain sections of SOP 98-2 are category B of the governmental GAAP hierarchy. Those sections are noted in appendix F, "Category B Guidance."

15.146 GASB Statement No. 34 provides guidance related to the presentation of nonexchange transactions in financial statements. Contributions of capital assets or financial resources required to be used to acquire capital assets are reported separately after nonoperating revenues and expenses in the statement of revenues, expenses, and changes in net position, as illustrated in paragraph 15.18. Contributions of term and permanent endowments should be reported in the same manner. All other contributions (both restricted and unrestricted) are reported as nonoperating revenues and expenses. As discussed in paragraph 15.19, net position released from restriction are not reported in the statement of revenues, expenses, and changes in net position, as is done in the NFP reporting model.

15.147 In the statement of net position, an amount equal to unexpended restricted contributions at the reporting date should be included in the restricted net position component of net position. GASB Statement No. 34 does not require that restricted resources be used first when an expenditure is made for a purpose for which both unrestricted and temporarily-restricted assets are available. Instead, each entity is required to establish a policy for whether restricted or unrestricted resources will be used first when both sources are available and to disclose that policy in the notes to the financial statements.⁵²

The Reporting Entity and Related Entities

© Update 15-4 Accounting and Reporting: Fiduciary Activities

GASB Statement No. 84, *Fiduciary Activities*, issued January 2017, is effective for reporting periods beginning after December 15, 2018. Earlier application is encouraged.

GASB Statement No. 84 establishes criteria for identifying fiduciary activities of all state and local governments. The focus of the criteria generally is on (a) whether a government is controlling the assets of the fiduciary activity and (b) the beneficiaries with whom a fiduciary relationship exists. It requires all types of pension plans or OPEB plans (single-employer, agent multiple-employer, and cost-sharing multiple employer) to be reported as component units if the financial benefit or burden criterion is met and either (a) the majority of the plan's board is appointed by the government or (b) the plan is fiscally dependent on the government.

This edition of the guide has not been updated to reflect changes as a result of this statement; however, the section that follows will be updated in a future edition. Readers are encouraged to consult the full text of the Statement on GASB's website at www.gasb.org.

⁵² See paragraph 115 of GASB Statement No. 34.

15.148 Governmental health care entities and private-sector health care entities use different definitions of the *financial reporting entity*. GASB Statement No. 14, *The Financial Reporting Entity*, as amended, establishes standards for defining and reporting the governmental financial reporting entity and addresses issues related to the display of entities included within the reporting entity, including accounting and reporting considerations for various types of joint ventures entered into by governmental entities. Unlike the private sector, which employs variable interest and voting interest models for defining the *reporting entity*, GASB's reporting entity model is based on the concept of financial accountability.⁵³

15.149 Under paragraph 12 of GASB Statement No. 14, as amended, the governmental financial reporting entity consists of the primary government, or the entity that serves as the nucleus of the reporting entity,⁵⁴ and legally separate organizations for which the primary government (or nucleus) is *financially accountable* (as discussed in paragraphs 15.151.153). In addition, the primary government (or entity that serves as the nucleus) may determine, through exercise of management's professional judgment, that the inclusion of an organization that does not meet the financial accountability criteria is necessary in order to prevent the reporting entity's financial statements from being misleading. Questions 4.26.1–4.26.3 of IG 2015-1 provide guidance for making the "misleading to include" determination.

Identifying Component Units

15.150 *Component units* are legally separate organizations for which the elected officials of the primary government are financially accountable. In addition, component units can be other organizations for which the nature and significance of their relationship with a primary government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete. A nonauthoritative flowchart in appendix C of GASB Statement No. 61, *The Financial Reporting Entity: Omnibus—an amendment of GASB Statements No. 14 and No. 34*, as amended, aids in the evaluation of whether an entity is a component unit.

15.151 Financial accountability can be demonstrated in several ways. According to paragraph 21 of GASB Statement No. 14, as amended, a governmental health care entity is financially accountable for a legally separate organization if it appoints a voting majority of the organization's governing body, and

- a. is able to impose its will on that organization, or
- b. there is a potential to provide specific financial benefits to, or impose specific financial burdens on, the governmental health care entity.

15.152 A governmental health care entity also is financially accountable if an organization is fiscally dependent on it and there is a potential for the organization to provide specific financial benefits to, or impose specific financial burdens on, the governmental health care entity regardless of whether the organization has

⁵³ See paragraphs 10–11 and 21 of GASB Statement No. 14, *The Financial Reporting Entity*.

⁵⁴ The nucleus of a financial reporting entity usually is a primary government. However, a governmental organization other than a primary government (such as a component unit, a joint venture, a jointly governed organization, or another stand-alone government) serves as the nucleus for its own reporting entity when it issues separate financial statements.

- a. a separately elected governing board,
- b. a governing board appointed by a higher level of government, or
- c. a jointly appointed board.

15.153 If a governmental health care entity owns a majority of the equity interest in a legally separate organization (for example, through acquisition of its voting stock), the governmental health care entity's intent for owning the equity interest should determine whether the organization should be presented as a component unit or an investment of the governmental health care entity. If the governmental health care entity's intent for owning a majority equity interest is to directly enhance its ability to provide governmental services, the organization should be reported as a component unit. Paragraphs 15.40-.41 further discuss the definition of an investment and importance of intent in determining whether an equity interest is an investment or a component unit.⁵⁵

15.154 GASB Statement No. 39, *Determining Whether Certain Organizations Are Component Units—an amendment of GASB Statement No. 14*, amended GASB Statement No. 14 to provide additional guidance for determining whether certain entities (for example, institutionally-related fund-raising foundations) for which the primary government is not financially accountable should be evaluated to determine if they are component units based on the nature and significance of their relationship with the primary government. Paragraph 5 of GASB Statement No. 39 requires reporting a legally separate, tax-exempt organization as a discretely-presented component unit if an organization meets all three of the following criteria:

- The economic resources received or held by the separate organization are entirely or almost entirely for the direct benefit of the governmental health care entity, its component units, or its constituents.
- The governmental health care entity or its component units is entitled to, or has the ability to otherwise access, a majority of the economic resources received or held by the separate organization.
- The economic resources held by the separate organization are significant to the governmental health care entity.

Additional considerations related to applying GASB Statement No. 39 are discussed in paragraphs 15.170–.175.

Presentation of Component Units

15.155 Component units are displayed in a governmental health care entity's financial statements through blending or discrete presentation, in accordance with the requirements of GASB Statement No. 14, as amended. Paragraph 53 of GASB Statement No. 14, as amended, requires component units to be blended with the financial information of the primary government (similar

⁵⁵ For example, in paragraph 55 of GASB Statement No. 14, as amended, a government that purchases 100 percent of the stock of a concrete plant to provide a controlled source of concrete for its capital projects should report the concrete company as a component unit. If, however, the government owns the equity interest for the purpose of obtaining income or profit rather than to directly enhance its ability to provide governmental services, it should report its equity interest as an investment, regardless of the extent of its ownership, as discussed in paragraph 15.41.

to the presentation of consolidated subsidiaries in the private sector) in any of these circumstances:

- The component unit's governing body is substantively the same as the governing body of the governmental health care entity and (1) there is a financial benefit or burden relationship between the health care entity and the component unit or (2) management of the health care entity has operational responsibility for the component unit.
- The component unit provides services entirely, or almost entirely, to the governmental health care entity or otherwise exclusively, or almost exclusively, benefits the health care entity even though it does not provide services directly to it.
- The component unit's total debt outstanding, including leases, is expected to be repaid entirely or almost entirely with resources of the governmental health care entity.
- The component unit is organized as a not-for-profit corporation in which the governmental health care entity is the sole corporate member, as identified in the component unit's articles of incorporation or bylaws, and the component unit is included in the financial reporting entity because of financial accountability. Question 4.2 of GASB Implementation Guide No. 2017-1, *Implementation Guidance Update—2017* (IG 2017-1), provides an example of a hospital that is the sole member of a legally separate entity that is a limited liability company that provides rehabilitation services to patients.

15.156 For governments engaged only in business-type activities that use a single column for financial statement presentation, paragraph 9 of GASB Statement No. 61, as amended, states that a component unit may be blended by consolidating its financial statement data within the single column of the primary government and presenting condensed combining information in the notes to the financial statements.

For governments engaged only in business-type activities that use a single column for financial statement presentation, paragraph 9 of GASB Statement No. 61, as amended, states that a component unit may be blended by consolidating its financial statement data within the single column of the primary government and presenting condensed combining information in the notes to the financial statements. GASB Statement No. 85, *Omnibus 2017*, clarifies that a primary government that is a business-type activity that uses a single column for financial statement presentation of its business-type activities, may blend a component unit only if the component unit meets a criterion for blending in paragraph 53 of Statement No. 14, as amended.⁵⁶

15.157 If none of the criteria for blending are met, component units are discretely presented. In discrete presentation, the financial information of the component unit is displayed separately from the financial information of the primary government (that is, in a separate column or on a separate page; a total

⁵⁶ GASB Statement No. 85, *Omnibus 2017*, issued March 2017, is effective for periods beginning after June 15, 2017. Earlier application is encouraged.

column for the entity as a whole may be presented but is not required).⁵⁷ Component units included as a result of meeting the criteria in GASB Statement No. 39 (included in paragraph 15.154) should always be discretely presented. In accordance with paragraph 55 of GASB Statement No. 14, as amended by paragraph 10 of GASB Statements No. 61, when a component unit is discretely presented, in addition to the separate column or separate page, the equity interest in that component unit should be reported as an asset of the primary government (or the entity that serves as the nucleus of the reporting entity). As noted in GASB Statement No. 72, the accounting for equity interests in component units described in GASB Statement 14, as amended, is similar to what would be portrayed under the equity method, but that accounting is not explicitly referred to as the equity method. Changes in the equity interest should be reported pursuant to the requirements for joint ventures in paragraph 73 of GASB Statement No. 14, as amended. (See paragraph 15.168.)

15.158 An integral part of this discrete presentation is that supporting information should be presented about each major component unit included in the financial reporting entity, except for component units that are fiduciary in nature. The determination that a discretely presented component unit is "major" should be based on the nature and significance of its relationship to the governmental health care entity that is the primary government (or that serves as the nucleus of the reporting entity). This determination generally would be based on any of the following factors:

- a. the services provided by the component unit to the citizenry are such that separate reporting as a major component unit is considered to be essential to financial statement users,
- b. there are significant transactions with the primary government, or
- c. there is a significant financial benefit or burden relationship with the primary government.

15.159 Major component unit reporting requirements should be satisfied by any one of the following:

- a. presenting each major component unit in a separate column in the reporting entity's statements of net position and activities,
- b. including combining statements of major component units in the reporting entity's basic financial statements after the fund financial statements, if any, or
- c. presenting condensed financial statements in the notes to the reporting entity's financial statements.

Nonmajor component units should be aggregated in a single column. A combining statement for the nonmajor component units is not required but may be presented as supplementary information.

15.160 If a primary government and its component units have different fiscal year-ends, the financial reporting entity reports using the primary government's fiscal year and incorporates financial statements for the component

⁵⁷ Some governmental health care entities may be organized and operated on a fund basis (for example, they use several separate enterprise funds for the purpose of carrying on specific activities or attaining certain objectives in accordance with regulatory restrictions or limitations). Question 4.28.10 of IG 2015-1 discusses various financial statement display options for discretely-presented component units of governments engaged only in business-type activities.

units' fiscal years ending during the reporting entity's fiscal year. If a component unit's fiscal year ends within the first quarter of the reporting entity's subsequent fiscal year, the component unit's financial statements for that subsequent year may be used if doing so does not adversely affect the timely and accurate presentation of the reporting entity's financial statements. The fiscal year of the component units included in the reporting entity should be consistent from year to year.⁵⁸ If transactions between component units that have different fiscal years result in inconsistencies in amounts reported as intra-entity receivables or payables, the governmental health care entity should disclose the nature and amount of those transactions in the notes to the financial statements.⁵⁹

15.161 Because of the separate nature of discretely-presented component units, GASB Statement No. 34 generally requires that transactions between a primary government and its discretely-presented component units (intra-entity transactions) be reported as if they were transactions with external parties.⁶⁰ However, GASB Statement No. 48 requires that intra-entity transfers of capital and financial assets should be reported based on the carrying value of the transferor.⁶¹ In separately-issued financial statements of discretely-presented component units, amounts receivable from, or payable to, the primary government should be reported on a separate line from other receivables (payables). Chapter 9, "Interfund, Internal, and Intra-Entity Activity and Balances," of the AICPA Audit and Accounting Guide *State and Local Governments* contains a detailed discussion of accounting and financial reporting considerations related to intra-entity activity and balances. Section Z.48 of IG 2015-1, as amended, provides implementation guidance for GASB Statement No. 48.

15.162 Additional guidance is provided in chapter 3, "The Financial Reporting Entity," of the AICPA Audit and Accounting Guide *State and Local Governments* and Appendix B4 of IG 2015-1, which provide nonauthoritative illustrations, examples, disclosures, and financial statement presentations.

Equity Interests

Equity Ownership in Common Stock

15.163 When an equity ownership interest is entered into to directly enhance the governmental health care entity's ability to provide services, the investee should be evaluated for inclusion as a potential component unit, as described in paragraphs 15.148–.154. If the investee meets the criteria for reporting as a discretely presented component unit, the accounting for equity interests in component units described in GASB Statement 14 is used instead of the equity method of accounting. (That accounting is described in paragraph 15.157.)

15.164 If the investee does not meet the criteria for reporting as a component unit, the governmental health care entity should consider the form of the investment. If the ownership interest is represented by common stock, paragraphs 202–210 of GASB Statement No. 62 provides guidance on application of

⁵⁸ See paragraphs 59–60 of GASB Statement No. 14.

⁵⁹ See paragraph 60 of GASB Statement No. 14.

⁶⁰ See paragraph 61 of GASB Statement No. 34.

⁶¹ See paragraph 15 of GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*.

the equity method. (For additional discussion of the equity method, see paragraphs 15.44–46.) Equity interests in common stock that meet the definition of an investment and (a) do not have readily determinable fair values and (b) do not meet the criteria for applying the equity method should be accounted for using the cost method.

15.165 However, if the governmental healthcare entity owns the equity interest as an investment rather than to directly enhance its ability to provide governmental services, it should report its equity interest as an investment, regardless of the extent of its ownership, as discussed in paragraphs 15.40–41.

Equity Interest in Joint Ventures

15.166 A joint venture is a legal entity or other organization that results from a contractual arrangement and that is owned, operated, or governed by two or more participants as a separate and specific activity subject to joint control, in which the participants retain (a) an ongoing financial interest or (b) an ongoing financial responsibility. Question 4.48.1 in IG 2015-1 states that an equity interest is evidenced either by ownership in the joint venture's stock or by an explicit and measurable right to the joint venture's net resources. For example, if an agreement specifically spells out a participant's rights to the joint ventures's net resources based on the original contributions, this would represent an equity interest. Generally, the purpose of a joint venture is to pool resources and share the costs, risks, and rewards of providing goods or services to the venture participants directly, or for the benefit of the general public or specific service recipients. Joint control means that no single participant has the ability to unilaterally control the financial or operating policies of the joint venture. If the organization is jointly controlled but the participants do not have an ongoing financial interest or ongoing financial responsibility, as defined in paragraphs 7071 of GASB Statement No. 14, it is a jointly governed organization, rather than a joint venture.⁶²

15.167 An equity interest ownership in a joint venture is one of the exceptions to the equity method of accounting for investments in paragraph 77 of GASB Statement No. 72. However, the accounting for an interest in a joint venture, as required by paragraph 73 of GASB Statement No. 14, as amended, is similar to the equity method. An "equity interest in joint venture" account, reported in the statement of net position, reports the governmental health care entity's equity interest, calculated in accordance with the joint venture agreement.

15.168 Initially, the equity interest in the joint venture should be reported at cost. If the joint venture agreement provides for the governmental health care entity to share in the operating results of the joint venture, the equity interest should be adjusted for the health care entity's share of the joint venture's change in net position, regardless of whether the amount is actually remitted. In calculating that share of the change in net position of the joint venture, any profit on the operating transactions between the governmental health care entity and the joint venture and any capital contributions from the joint venture participants should be eliminated. The equity interest should be reported in statement of net position as a single amount. The health care entity's share of

⁶² If the organization is jointly controlled but the participants do not have an ongoing financial interest or ongoing financial responsibility—that is, a jointly governed organization—only related party disclosures are required.

the joint venture's change in net position should be reported in the health care entity's statement of revenues, expenses, and changes in fund net position as a single amount.

15.169 An organization may be similar to a joint venture in that it has several participants, but one participating government appoints a voting majority of the organization's governing body (and, thus, joint control is precluded because one participant has the power to make decisions unilaterally). The organization is either a component unit (if it meets the criteria for a component unit) or a related organization of that participating government that appoints the voting majority, as discussed in paragraph 78 GASB Statement No.14, as amended. The other (minority) governmental participants should report their participation in the organization as described in the previous paragraph. The organization itself, when included as a component unit in the majority participant's financial reporting entity, should report any equity interests of the minority participants as "restricted net position, nonexpendable."

Institutionally-Related Foundations

15.170 Legally separate NFP foundations may be established to raise, hold, and invest funds on behalf of a governmental health care entity. Because of its close relationship to the governmental health care entity, a foundation should be evaluated to determine whether it is a component unit of the governmental health care entity, as described in paragraphs 15.148.154.

15.171 If the fundraising foundation is a component unit because it meets the three criteria in paragraph 5 of GASB Statement No. 39, as discussed in paragraph 15.154, the governmental health care entity is required to report the fundraising foundation as a discretely-presented component unit. Distributions made or promised by the foundation to the health care entity are reported as expenses by the foundation and contribution revenue by the health care entity. The nonauthoritative exhibits E-1 and E-2 of GASB Statement No. 39 illustrate discretely presenting the foundation by displaying the foundation's financial statements in their original formats on separate pages. The nonauthoritative exhibits E-3 and E-4 of GASB Statement No. 39 illustrate one way in which a discretely-presented component unit could be displayed side-by-side on the face of the health care entity's statement of net position and statement of revenues, expenses, and changes in net position.

15.172 If the foundation does not meet the three criteria in paragraph 5 of GASB Statement No. 39, but instead is included in the reporting entity for one of the other two reasons in paragraph 15.149 (that is, because the governmental health care entity is financially accountable or because, without it, the financial statements of the governmental health care entity are misleading), the fundraising foundation will be either blended or discretely presented. The method to use is determined by applying the criteria in paragraph 53 of GASB Statement No. 14, as amended (which is included in paragraph 15.155). If none of the criteria for blending is met, the fundraising foundation is discretely presented.

15.173 In many cases, the foundation prepares its financial statements in accordance with FASB standards because it does not have the characteristics of a governmental entity, as discussed in paragraph 1.08. If a nongovernmental foundation's stand-alone financial statements state that the foundation and governmental health care entity are financially interrelated, as described in FASB ASC 958-20, then as explained in footnote a to paragraph 5 of GASB

Statement No. 39 (which added paragraph 40(a) to GASB Statement No. 14), the governmental health care entity is able to otherwise access the majority of the economic resources received or held by the financially-interrelated entity (the foundation). If the foundation meets the other two criteria in paragraph 5 of GASB Statement No. 39, it is a component unit. Paragraph 29 of the nonauthoritative basis for conclusions of GASB Statement No. 39 also states that in these circumstances, the health care entity's financial statements would be rendered misleading if the financial statements of the financially-interrelated entity (foundation) were excluded, particularly if the financially-interrelated entity holds the majority of the primary government's endowments, gifts, and contributions whereby the gift or earnings thereon are restricted by donors for the activities of the primary government or its component units. A nongovernmental foundation that is financially interrelated with a health care entity reports contributions according to the guidance discussed in paragraph 11.45 of this guide. The governmental health care entity that is the specified beneficiary does not report an interest in the net assets of the foundation, as is done by private-sector health care entities; instead, a governmental health care entity recognizes contributions received from, or pledged by, the foundation, in accordance with the standards in paragraphs 19–25 of GASB Statement No. 33.

15.174 If a nongovernmental foundation's stand-alone FASB financial statements do not indicate whether the foundation and governmental health care entity are financially interrelated, the governmental health care entity's ability to otherwise access a majority of the economic resources received or held by the separate organization might be demonstrated in other ways. For example, historically, the health care entity may have directly or indirectly received a majority of the economic resources provided by the foundation, or previously, the foundation may have received and honored requests to provide resources to the health care entity. If the ability to otherwise access the economic resources is demonstrated, and the foundation meets the other two criteria in paragraph 5 of GASB Statement No. 39, it is a component unit. If the foundation does not meet the three criteria in GASB Statement No. 39, the foundation should be evaluated for inclusion as a component unit using the remaining two tests described in paragraph 15.149. If the foundation does not meet any of those three tests, then the foundation is not a component unit of the health care entity. The health care entity recognizes contributions received from, or pledged by, the foundation, in accordance with the standards in paragraphs 19–25 of GASB Statement No. 33.⁶³

15.175 Section 4.33 of IG 2015-1 describes various ways in which the financial statements of nongovernmental component units can be displayed in the financial statements of the governmental reporting entity.

Government Combinations

15.176 Governmental health care entities may participate in business combination transactions with other governmental entities or private-sector entities. Although the standards for governmental health care entities and the

⁶³ If the foundation prepares its financial statements in accordance with FASB standards, it uses the standards in the "Transfers of Assets to a Not-for-Profit Entity or Charitable Trust that Raises or Holds Contributions for Others" sections of FASB ASC 958-605 to determine whether to recognize contribution revenue or a liability when it receives contributions for the governmental health care entity's use or benefit. Those standards are discussed in paragraphs 11.41–.48 of this guide.

standards for nongovernmental health care entities use similar terms for their combination transactions (merger and acquisition), differences exist between the standards. Governmental health care entities apply the guidance in GASB Statement No. 69 to a government combination.

15.177 GASB Statement No. 69 addresses accounting and financial reporting for government combinations and disposals of government operations. Government combinations include (1) mergers, (2) acquisitions, and (3) transfers of operations that do not constitute entire legally separate entities and in which no significant consideration is exchanged. It does not apply to transfers of assets and liabilities that do not constitute an operation, or combinations in which a government acquires another organization that continues to exist as a separate entity. (In the governmental financial reporting model, organizations that retain separate legal standing may be required to be included in a financial reporting entity as component units, as discussed in paragraphs 15.148–162.)

15.178 GASB Statement No. 69 defines the three types of combinations as follows:

- A *government merger* is a government combination of legally separate entities in which no significant consideration is exchanged and either (a) two or more governments (or one or more governments and one or more nongovernmental entities) cease to exist as legally separate entities and are combined to form one or more new governments, or (b) one or more legally separate governments or nongovernmental entities cease to exist and their operations are absorbed into, and provided by, one or more continuing governments.
- A *government acquisition* is a government combination in which a government acquires another entity, or the operations of another entity, in exchange for significant consideration. The consideration provided should be significant in relation to the assets and liabilities acquired. The acquired entity or operation becomes part of the acquiring government's legally separate entity.
- A *transfer of operations* is a government combination involving the operations (as defined in paragraph 4 of GASB Statement No. 69) of a government or nongovernmental entity, rather than a combination of legally separate entities, in which no significant consideration is exchanged. Operations may be transferred to another existing entity or to a new entity.

When determining the type of combination, negative net position of an entity recognized in a government merger or a transfer of operations (that is, a net liability assumed by the combined government) does not, by itself, constitute consideration given.

15.179 Note that in all three types of combinations, one or more of the combining entities ceases to exist. If the entities continue to exist as a separate legal entities (for example, if one becomes a component unit of the other), the transaction is outside the scope of GASB Statement No. 69.

Mergers

15.180 Paragraphs 1319, 55, and 56 of GASB Statement No. 69 describe the standards for government mergers that result in the formation of one or more new governments. The new government, as of the merger date, should

recognize the assets, deferred outflows of resources, liabilities, or deferred inflows of resources of the merging entities. Those elements should be measured at the carrying values as reported in the separate financial statements of the merging entities.

15.181 Paragraphs 20–27 of GASB Statement No. 69 describe the standards for government mergers that result in the one government being absorbed into one or more continuing governments. Continuing governments should recognize the combined assets, deferred outflows of resources, liabilities, and deferred inflows of resources, results of operations, and cash flows, if applicable, of the merging entities for the reporting period in which the combination occurs as though the entities had been combined at the beginning of the continuing government's reporting period. Those elements generally are measured at the carrying values as reported in the separate financial statements of the merging entities.

15.182 Regardless of the type of merger, the new government or the continuing government should not recognize additional assets, deferred outflows of resources, liabilities, or deferred inflows of resources that authoritative guidance for state and local governments does not require or permit the merging governments to recognize. If the merging entities measured assets, deferred outflows of resources, liabilities, or deferred inflows of resources by applying different, but acceptable, methods of accounting in their separate financial statements, the amounts of those elements may be adjusted to reflect a consistent method of accounting, as long as those methods comply with the accounting and financial reporting requirements for state and local governments. Those adjustments should be applied to the opening balances carried forward into the financial statements. If the merging entities decide before the actual date of the merger to dispose of capital assets of the dissolving government but the continuing government will use those capital assets until the disposal occurs, those capital assets should be measured and reported at their carrying values by the continuing government. However, if the continuing government plans to dispose of capital assets that it will not use, those capital assets should be evaluated for impairment in accordance with GASB Statement No. 42, as amended.

Acquisitions

15.183 Paragraphs 2944, 55 and 57 of GASB Statement No. 69 describe the standards for government acquisitions. The acquiring government should recognize the assets, deferred outflows of resources, liabilities, or deferred inflows of resources acquired or assumed at the acquisition date, which may result in the acquiring government recognizing assets, deferred outflows of resources, liabilities, or deferred inflows of resources that the acquired organization was not required to recognize.

15.184 For acquiring governments, paragraph 32 of GASB Statement No. 69 states that they should measure the acquired assets, deferred outflows of resources, liabilities, or deferred inflows of resources (except for balances noted in paragraphs 31 and 33 – 36 of GASB Statement No. 69) at acquisition value as of the acquisition date. For purposes of GASB Statement No. 69, acquisition value is a market-based entry price. An entry price is assumed to be based on an orderly transaction entered into on the acquisition date. Acquisition value represents the price that would be paid for acquiring similar assets, having similar service capacity, or discharging the liabilities assumed as of the acquisition date.

15.185 If the acquired entity had recognized deferred outflows of resources from previous acquisition transactions (or goodwill, if the acquired entity is a nongovernmental entity) in its statement of net position (or balance sheet or statement of financial position if the acquired entity is a nongovernmental entity), the acquiring government should not recognize those deferred outflows of resources (or goodwill). Instead, the deferred outflow of resources or goodwill that was previously recognized by the acquired entity will ultimately be included within the deferred outflow amount of the acquiring government via the calculation of the excess consideration, as discussed in paragraph 97 of GASB Statement No. 69.

As clarified in paragraph 5 of GASB Statement No. 85, if the acquired entity had recognized deferred outflows of resources from previous acquisition transactions (or goodwill, if the acquired entity is a nongovernmental entity) in its statement of net position (or balance sheet or statement of financial position if the acquired entity is a nongovernmental entity), the acquiring government should not recognize those deferred outflows of resources (or goodwill).⁶⁴ Instead, the deferred outflow of resources or goodwill that was previously recognized by the acquired entity will ultimately be included within the deferred outflow amount of the acquiring government via the calculation of the excess consideration, as discussed in paragraph 97 of GASB Statement No. 69.

15.186 The consideration provided by the acquiring government should be measured as of the acquisition date as the sum of the values of the assets remitted or liabilities incurred to the former owners of the acquired entity. Contingent consideration should be recognized in conformity with the accounting and financial reporting requirements for contingencies.

15.187 If the consideration provided exceeds the net position acquired, the acquiring government should report the difference as a deferred outflow of resources. (Subsequent accounting for the deferred outflow of resources is discussed in paragraphs 15.77–.79.) If the consideration provided is less than the net position acquired, the acquiring government should eliminate the excess net position acquired by reducing the acquisition values assigned to the noncurrent assets (other than financial assets) that are acquired, unless a contribution should be recognized by the acquiring government. (The acquiring government should recognize a contribution if the seller intends to accept a lower price in order to provide economic aid to the acquiring government without directly receiving equal value in exchange.) If the allocation reduces the acquisition value of the acquired noncurrent assets (other than financial assets) to zero, the remainder of the excess should be recognized as a special item in the statement of revenues, expenses, and changes in net position.

15.188 GASB Statement No. 69 also provides guidance if the initial measurement of certain assets, deferred outflows of resources, liabilities, or deferred inflows of resources is not finalized by the end of the reporting period in which the government acquisition occurs.

15.189 The acquiring government should recognize an expense for acquisition costs in the periods in which the costs are incurred and the services are received.

⁶⁴ GASB Statement No. 85, issued March 2017, is effective for periods beginning after June 15, 2017. Earlier application is encouraged.

Transfers of Operations

15.190 Paragraphs 4649, 55 and 56 of GASB Statement No. 69 describe the standards for transfers of operations. The transferee government should recognize the carrying values of assets, deferred outflows of resources, liabilities, and deferred inflows of resources of the operations of the transferor government or nongovernmental entity as of the effective transfer date. The transferee government should not recognize additional assets, deferred outflows of resources, liabilities, or deferred inflows of resources that authoritative guidance for state and local governments does not require or permit the transferor to recognize. Transferee governments may adjust the amounts of those assets, deferred outflows of resources, liabilities, or deferred inflows of resources to reflect a consistent method of accounting as long as those methods comply with the accounting and financial reporting requirements for state and local governments. If decisions are made before the effective transfer date to dispose of capital assets and the transferee government will use those capital assets until the disposal occurs, those capital assets should be measured and reported at the carrying values by the transferee government. However, if the transferee government will not use those capital assets identified for disposal, they should be evaluated for impairment in accordance with GASB Statement No. 42, as amended. The net position received or assumed by a continuing transferee government should be reported as a special item.

General Auditing Considerations for Governmental Health Care Entities

15.191 Chapter 2, "General Auditing Considerations," of this guide provides guidance on the unique application of generally accepted auditing standards to health care entities, including guidance for audits conducted in accordance with financial audit standards contained in *Government Auditing Standards*, issued by the Comptroller General of the U.S. Government Accountability Office. The AICPA Audit and Accounting Guide *State and Local Governments* discusses in detail the requirements for a generally accepted auditing standards audit of financial statements prepared in accordance with the governmental GAAP hierarchy described in paragraph 15.05. It contains information about auditing considerations that are unique to the governmental financial reporting model that are not contemplated in this guide. Therefore, in performing audits of separately-issued financial statements of governmental health care entities, the auditing guidance contained in both the AICPA Audit and Accounting Guide *State and Local Governments* and this guide will be useful.

15.192 Paragraph 4.73 of the AICPA Audit and Accounting Guide *State and Local Governments* states that an auditor's consideration of whether a government's basic financial statements are presented fairly, in all material respects in accordance with GAAP, should be based on opinion units. Auditors apply the concept of opinion units in planning, performing, evaluating the results of, and reporting on audits of governmental entities, including governmental health care entities. The concept of opinion units is unique to audits of state and local governmental entities. Chapters 4, "General Auditing Considerations;" 15, "Concluding the Audit;" and 16, "Audit Reporting," of the AICPA Audit and Accounting Guide *State and Local Governments* define *opinion units* and discuss the nature and effect of opinion units in planning, performing,

evaluating the results of, and reporting on the audit of such entities' basic financial statements.

15.193 The number of opinion units will depend on whether the governmental health care entity (a) accounts for and reports its activities in a single enterprise fund or multiple enterprise funds⁶⁵ and (b) has any discretely-presented component units (see paragraphs 15.148–.162). A governmental health care entity that reports its activities in a single enterprise fund and has no discretely-presented component units will have a single opinion unit. A governmental health care entity that operates in a single enterprise fund and has one or more discretely-presented component units will have more than one opinion unit: one for the primary government (the health care entity) and another for the discretely-presented component unit. If more than one discretely-presented component unit exists, the opinion unit is referred to as aggregate discretely-presented component units. A governmental health care entity that reports its activities in multiple enterprise funds will have an opinion unit for each major enterprise fund and an additional opinion unit for all nonmajor funds in the aggregate (aggregate remaining fund information). If that entity also has one or more discretely-presented component units, there will be an additional opinion unit for the aggregate discretely-presented component unit(s).⁶⁶

15.194 Paragraphs 2.15–.18 of this guide provide general guidance on the concept of materiality. In accordance with paragraph .10 of AU-C section 320, *Materiality in Planning and Performing an Audit* (AICPA, *Professional Standards*), when establishing the overall audit strategy the auditor should determine materiality for the financial statements as a whole. As discussed in paragraph .A4 of AU-C section 320, for most state or local governments, a governmental entity's applicable financial reporting framework is based on multiple reporting units, and generally, the auditor expresses or disclaims an opinion on a government's financial statements as a whole by providing opinions or disclaimers of opinion on each opinion unit. That is, a state or local governmental entity's applicable financial reporting framework requires the presentation of financial statements for its varied activities in various reporting units. Consequently, a reporting unit, or aggregation of reporting units, of the governmental entity represents an opinion unit to the auditor. Accordingly, in these cases, materiality is established for each opinion unit. Chapter 4 of the AICPA Audit and Accounting Guide *State and Local Governments* provides detailed guidance on audit materiality determinations for governmental entities, including guidance on assessing materiality based on the concept of opinion units. The materiality evaluation for one opinion unit should not be affected by OI in the government's financial statements or, if applicable, quantitative or qualitative factors relating to other opinion units.

15.195 Paragraphs 2.77–.83 of this guide discuss management's representations for financial statements. Paragraphs 15.10–.11 of the AICPA

⁶⁵ Some governmental health care entities may be organized and operated on a fund basis (for example, they use several separate enterprise funds for the purpose of carrying on specific activities or attaining certain objectives in accordance with regulatory restrictions or limitations).

⁶⁶ As discussed in chapter 4, "General Auditing Considerations," of the AICPA Audit and Accounting Guide *State and Local Governments*, if either the aggregate discretely-presented component units opinion unit or the aggregate remaining fund information opinion unit is not quantitatively or qualitatively material to the primary government, those two units may be combined and titled the "Aggregate Discretely-Presented Component Unit and Remaining Fund Information Opinion Unit."

Audit and Accounting Guide *State and Local Governments* list the types of representations that are particularly important in a governmental engagement. Paragraph .05 of AU-C section 730 states that the auditor should obtain written representations from management (a) that it acknowledges its responsibility for the RSI; (b) about whether the RSI is measured and presented in accordance with prescribed guidelines; (c) about whether the methods of measurement or presentation have changed from those used in the prior period and, if so, the reasons for such changes; and (d) about any significant assumptions or interpretations underlying the measurement or presentation of the RSI.

15.196 Governmental health care entities are subject to various legal and contractual provisions (compliance requirements) that may affect their financial statements. As discussed in paragraph 12.10 of the AICPA Audit and Accounting Guide *State and Local Governments*, the auditor should consider whether it is necessary to evaluate the entity's compliance with those requirements as part of the financial statement audit.

Independent Auditor's Reports

15.197 Paragraph .19 of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*), requires the auditor to express an unmodified opinion when the auditor concludes the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework. Paragraph .20 of AU-C section 700 requires the auditor to modify the opinion in the auditor's report, in accordance with AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report* (AICPA, *Professional Standards*), if the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are materially misstated or the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement. As discussed in chapter 16 of the AICPA Audit and Accounting Guide *State and Local Governments*, auditors of governmental health care entities express or disclaim opinions on a government's financial statements as a whole by providing in the aggregate separate opinions or disclaimers of opinion on the financial statements of each opinion unit. Examples 15-1 and 15-2 are illustrative reports for a governmental health care entity that accounts for and reports its activities in a single enterprise fund. Note that in these illustrative reports, auditors do not express opinions on results of operations, as is done for private-sector health care entities. Instead, auditors of governmental health care entities opine on the change in financial position. Chapter 16 of the AICPA Audit and Accounting Guide *State and Local Governments* contains numerous additional report examples, including examples for entities that use multifund reporting and a number of situations unique to government reporting (for example, reporting on a single fund or department and reporting when a component unit is omitted).

15.198 The auditor's primary responsibility is to report on the results of his or her audit of the basic financial statements. The auditor has additional responsibilities related to RSI and, if applicable, SI and OI under AU-C section 730, AU-C section 725, and AU-C section 720, respectively. Those responsibilities, which are discussed in detail in chapter 16 of the AICPA Audit and Accounting Guide *State and Local Governments*, are briefly described in paragraphs 15.199–206.

Supplementary Information and Supporting Information, Including RSI

15.199 There are similarities, but important differences, between how GASB defines supporting information and how the AICPA auditing standards use that same term. The following is intended to clarify the two standard-setters' descriptions of the information, and how the information is referred to in this chapter.

15.200 According to GASB Concepts Statement No. 3, *Communication Methods in General Purpose External Financial Reports That Contain Basic Financial Statements*, supporting information places basic financial statements and notes to basic financial statements in an appropriate operational, economic or historical context. The information is either (a) required by GASB as required supplementary information (RSI) to be presented with the basic financial statements and the notes thereto; (b) supplementary information (SI) which is required by law or regulation to be presented; or (c) SI presented at the election of the preparer. SI as contemplated in GASB Concepts Statement No. 3 (that is, [a] and [b] preceding) are referred to in this chapter when describing GASB requirements as "GASB defined" SI. GASB Concepts Statement No. 3 limits its discussion of supporting information to "GASB defined" SI and RSI.

15.201 In contrast to the GASB standards, the AICPA auditing standards refer to such supporting information as either RSI, other information (OI), or SI. AU-C section 730, *Required Supplementary Information* (AICPA, *Professional Standards*), defines RSI consistently with GASB literature. Therefore, references to such information in this chapter are to RSI. AU-C section 720, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*), considers OI in documents containing audited financial statements as OI except for situations when the auditor is engaged to report on whether the information is fairly stated in relation to the financial statements as a whole. When the auditor is engaged to give such an "in relation to" opinion, AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*), refers to the information as SI. Therefore, to ensure consistency with the underlying auditing standards, this chapter uses SI to describe information for which the auditor has been engaged to provide an "in relation to" opinion and OI for situations where such reporting is not being provided by the auditor.

15.202 As discussed in paragraph 15.30, GASB requires that certain information accompany the basic financial statements and be presented as RSI. Unless the auditor has been engaged to examine and express an opinion on RSI, the auditor's responsibility with respect to RSI is limited to applying certain limited procedures to RSI and reporting deficiencies in, or the omission of, such information, as described in paragraph .07 of AU-C section 730. If the deficiencies described in paragraph .07 of AU-C section 730 do not exist, the auditor should include an other-matter paragraph in the auditor's report on the financial statements to refer to the RSI in accordance with AU-C section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report* (AICPA, *Professional Standards*). Illustration 1 in the exhibit of AU-C section 730 is the basis for the following example that an auditor might use to report on the RSI when the RSI is included, the auditor has

applied the specified procedures, and no material departures from prescribed guidelines have been identified.⁶⁷

Other Matter

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the [identify required supplementary information, such as management's discussion and analysis and the budgetary comparison information] on pages XX and XX be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

15.203 If any of the deficiencies described in paragraph .07 of AU-C section 730 exist (for example, the client omits MD&A or a portion of MD&A, or the information is presented in a manner that does not meet the standards established by GAAP), this does not affect the auditor's conclusion regarding the fair presentation of the basic financial statements because RSI is not considered essential to the fair presentation of the basic financial statements. In such situations, the auditor's report should include an other-matter paragraph. Paragraph .A3 of AU-C section 730 provides examples for other circumstances, including those in which the RSI is omitted, or there are material departures from prescribed guidelines.

15.204 The auditor may be engaged to audit RSI, "GASB defined" SI, or a combination thereof—that is, express an opinion whether the information is fairly presented, in all material respects, in accordance with GAAP. For example, if the government elects to present the required budgetary comparisons (RSI) as a basic financial statement, then the auditor applies AU-C section 700. If the auditor is engaged to audit the combining and individual fund financial presentations ("GASB defined" SI) accompanying the basic financial statements, then AU-C section 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*), applies. Chapter 4 of the AICPA Audit and Accounting Guide *State and Local Governments* discusses auditor considerations in accepting such an engagement.

⁶⁷ Unless the auditor is engaged to audit the RSI as described in AU-C section 730, *Required Supplementary Information* (AICPA, *Professional Standards*), the RSI is considered unaudited, even though generally accepted auditing standards require the auditor to perform specific procedures and to report on the information as discussed in this section.

SI and OI

15.205 If the auditor is engaged to report on whether SI is fairly stated in all material respects in relation to the financial statements as a whole and meets the preconditions to do so, the auditor's reporting on SI is described in AU-C section 725 as well as certain required procedures on SI (see paragraphs .05–.08 of AU-C section 725). An opinion on whether SI is fairly stated in all material respects is made in relation to the basic financial statements as a whole, not in relation to individual opinion units. An "in relation to" opinion is possible because the audit of the basic financial statements encompasses the information presented in the SI. SI may be presented in a document containing the audited financial statements or separate from the audited financial statements. Information related to the auditor's responsibilities for SI that is presented separately from the financial statements is discussed in paragraphs .10 and .A16 of AU-C section 725. Illustration 1 in the exhibit of AU-C section 725 provides the following other-matter paragraph when the auditor is issuing an unmodified opinion on the financial statements and an unmodified opinion on the SI:

Other Matter

Other Information

Our audit was conducted for the purpose of forming an opinion⁶⁸ on the financial statements as a whole. The [*identify accompanying SI*] is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the basic financial statements. The [*identify accompanying SI*] has been subjected to the auditing procedures applied in the audit of the basic financial statements, 20X1, and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the [*identify accompanying SI*] is fairly stated in all material respects in relation to the financial statements as a whole.

Paragraph .A17 of AU-C section 725 provides examples for other circumstances, including those in which the opinion on the basic financial statements is other than an unmodified opinion, or the auditor issues a qualified opinion on the SI.

15.206 The auditor's reporting on OI is described in AU-C section 720. Although OI is not a part of the basic financial statements, auditors are required to perform certain procedures on OI. In the absence of any separate requirement in the particular circumstance of the engagement, the auditor's opinion on the financial statements does not cover OI, and the auditor has no responsibility for determining whether such information is properly stated. Instead, the auditor's responsibility is to read the OI of which the auditor is aware because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and OI. If, on reading the OI, the auditor identifies a material inconsistency, the auditor

⁶⁸ If multiple opinion units exist, this would instead refer to *opinions*.

should determine whether the audited financial statements or the OI needs to be revised. The following example is based on exhibit A of AU-C section 720 to illustrate an other-matter paragraph that the auditor may use to disclaim an opinion on OI.

Other Matter

Other Information

Our audit was conducted for the purpose of forming an opinion on the Health Care Entity's basic financial statements as a whole. The [*identify the other information*] is (are) presented for purposes of additional analysis and is (are) not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied by us in the audit of the basic financial statements, and accordingly, we do not express an opinion on it or provide any assurance on it.

Example 15-1

Unmodified Opinion on Comparative Basic Financial Statements of a Governmental Hospital (Special-Purpose Government) That Has a Single Opinion Unit Accompanied by RSI

Independent Auditor's Report

To the Board of Trustees

Sample Governmental Hospital Authority

Report on the Financial Statements⁶⁹

We have audited the accompanying financial statements of the Sample Governmental Hospital Authority (the Authority), a component unit of Feeling County, State of Union,⁷⁰ as of and for the years ended December 31, 20X1 and 20X0, and the related notes to the financial statements, which collectively comprise the Authority's basic financial statements as listed in the table of contents.⁷¹

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits.⁷² 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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

⁶⁹ According to footnote 1 to illustration 1 in the exhibit of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*), the subtitle "Report on the Financial Statements" is unnecessary in circumstances when the second subtitle, "Report on Other Legal and Regulatory Requirements," is not applicable.

⁷⁰ If the entity being reported on is a component unit of a financial reporting entity, the auditor's report should disclose that fact, as discussed in paragraph 16.58 of the AICPA Audit and Accounting Guide *State and Local Governments*.

⁷¹ As noted in paragraph .A23 of AU-C section 700, the identification of the title for each statement that the financial statements comprise may be achieved by referencing the table of contents.

⁷² Because the report is covering audits for two years, the reference is to *audits*, rather than *audit*.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Authority as of December 31, 20X1 and 20X0, and the changes in its financial position and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matter***Required Supplementary Information***

Accounting principles generally accepted in the United States of America require that the [identify required supplementary information, such as management's discussion and analysis and budgetary comparison information] on pages XX–XX be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context.

We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

[Auditor's signature]

[Auditor's city and state]

[Date of the auditor's report]

Example 15-2

Unmodified Opinions on Single-Year Basic Financial Statements of a Governmental Hospital That Has One Opinion Unit for the Primary Government and Another Opinion Unit for Its Discretely-Presented Component Unit Accompanied by RSI

Independent Auditor's Report

To the Board of Trustees

University Hospital

We have audited the accompanying financial statements of the University Hospital, a component unit of University, Any City and Any State⁷³ and *[identify the discretely presented component units]*⁷⁴ as of and for the year ended December 31, 20XY, and the related notes to the financial statements, which collectively comprise the Hospital's basic financial statements as listed in the table of contents.^{75,76,77}

Management's Responsibility for the Financial Statements

[Same paragraphs as in example 15-1]

Auditor's Responsibility

Our responsibility is to express opinions on these financial statements based on our audit. 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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

⁷³ See footnote 70.

⁷⁴ Presentation of a statement of cash flows for the discretely-presented component unit is not required.

⁷⁵ See footnote 71.

⁷⁶ Because two opinion units exist, the auditor is rendering two opinions (one on the Hospital and one on the discretely-presented component unit), and the report should refer to *opinions*, rather than *opinion*.

⁷⁷ The opinion on a set of single-year statements refers to one audit. Even though the auditor may be expressing multiple opinions, he or she is conducting only one audit of the opinion units.

Opinions⁷⁸

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the University Hospital and of its discretely presented component unit as of December 31, 20XY, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matter

Required Supplementary Information

[Same paragraph on RSI as in example 15-1]

[Auditor's signature]

[Auditor's city and state]

[Date of the auditor's report]

⁷⁸ Because two opinion units exist, the auditor is rendering two opinions (one on the Hospital and one on the discretely-presented component unit), and the report should refer to *opinions*, rather than *opinion*.

Supplement A

Statement of Position 00-1, Auditing Health Care Third-Party Revenues and Related Receivables

This supplement contains authoritative Auditing Standards Board material.

March 10, 2000

NOTE

This AICPA Statement of Position (SOP) has been developed by the AICPA Health Care Third-Party Revenue Recognition Task Force of the AICPA Auditing Standards Board (ASB) to provide guidance regarding auditing financial statement assertions about third-party revenues and related receivables of health care entities. This SOP is recognized as an interpretive publication as defined in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*. Interpretive publications are recommendations on the application of generally accepted auditing standards (GAAS) in specific circumstances, including engagements for entities in specialized industries.

An interpretive publication is issued under the authority of the ASB after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with GAAS. The members of the ASB have found this SOP to be consistent with existing GAAS.

Although interpretive publications are not auditing standards, AU-C section 200 requires the auditor to consider applicable interpretive publications in planning and performing the audit because interpretive publications are relevant to the proper application of GAAS in specific circumstances. If the auditor does not apply the auditing guidance in an applicable interpretive publication, the auditor should document how the requirements of GAAS were complied with in the circumstances addressed by such auditing guidance.

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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 related to testing third-party revenues and related receivables, and provides guidance regarding the sufficiency and appropriateness of audit evidence and reporting on financial statements, prepared in accordance with generally accepted accounting principles (GAAP), of health care entities exposed to material uncertainties. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

Introduction and Background

.01 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.

.02 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.

.03 Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 954-605-45-2 states, in part, that "service revenue shall be reported net of contractual and other adjustments in the statement of operations, including patient service revenue." 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. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.04 This SOP provides guidance to auditors regarding uncertainties inherent in health care third-party revenue recognition. It discusses auditing matters related to 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 and appropriateness of audit evidence and reporting on financial statements of health care entities exposed to material uncertainties. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Scope and Applicability

.05 This SOP applies to audits of health care entities falling within the scope of the AICPA Audit and Accounting Guide *Health Care Entities* (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

.06 Health care entities need to estimate amounts that ultimately will be realizable in order for revenues to be fairly stated in accordance with 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.

.07 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.

.08 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

.09 Management and, when appropriate, those charged with governance are responsible for the preparation and fair presentation of its financial statements in accordance with GAAP as well as for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error. 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. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.

¹ Historically, the Health Care Financing Administration contracted with Peer Review Organizations 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 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 entities 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.

Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.10 Management's assertions regarding proper valuation of its revenues and receivables are embodied in the financial statements. Management is responsible for recognizing revenues when 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. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.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 obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with an applicable financial reporting framework. Reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. In developing an opinion, the auditor should conclude whether the auditor has obtained reasonable assurance, which includes considering whether, among other matters,

- sufficient appropriate audit evidence has been obtained.
- uncorrected misstatements are material, individually or in aggregate.
- the financial statements are prepared and fairly presented, in all material respects, in accordance with GAAP.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.13 Current industry conditions, as well as specific matters affecting the entity,³ provide relevant information when planning the audit. Among a number of procedures, the auditor's procedures may 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 should perform audit procedures that respond to those risks, for example, more extensive tests covering the current period. Exhibit 10-1 of the guide includes examples of procedures auditors may perform. [Revised, June 2009, to reflect conforming changes necessary due to the

³ Risk factors for not-for-profit entities, including ones related to legislative and regulatory matters, are discussed annually in the AICPA Audit Risk Alert *Not-for-Profit Entities Industry Developments*.

issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of the 2012 edition of the Audit and Accounting Guide *Health Care Entities*.]

.14 With respect to auditing third-party revenues, a relevant consideration in addition to the usual revenue recognition considerations, is whether ultimately realizable amounts are known or will be presently known, or whether those amounts 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. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.15 As stated previously, management is responsible for preparing the estimates contained in the financial statements. The auditor should evaluate the sufficiency and appropriateness of the evidence supporting those estimates, including the facts supporting management's judgments, and the judgments made based on conditions existing at the time of the audit. The fact that net revenues recorded at the time services are rendered differ materially from amounts that ultimately are realized does not necessarily mean the audit was not properly planned or carried out. Similarly, the fact that future events may differ materially from management's assumptions or estimates does not necessarily mean that management's estimates were not valid or the auditor did not follow generally accepted auditing standards as described in this SOP with respect to auditing estimates. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

Audit Evidence

.16 The measurement of estimates is inherently uncertain and depends on the outcome of future events. AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, and AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*, provide guidance to the auditor when the ultimate outcome of uncertainties cannot be expected to exist at the time of the audit because the outcome and related audit evidence are prospective. 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. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.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 evidence supporting management's assertions is not sufficient to support management's estimates. Rather, the

auditor's professional judgment regarding the sufficiency of the audit evidence is based on the audit evidence that is, or should be, available. If, after considering the existing conditions and available evidence, the auditor concludes that sufficient appropriate audit evidence supports management's assertions about the nature of a matter involving an uncertainty (in this example, the valuation of revenues and receivables), and their presentation or disclosure in the financial statements, an unmodified opinion ordinarily is appropriate. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.18 The inability to obtain sufficient appropriate audit evidence that the auditor needs to conclude that the financial statements as a whole are free from material misstatement would require the auditor 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, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, the auditor would express a qualified opinion for a scope limitation. If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive, the auditor would disclaim an opinion. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.19 The accuracy of management's assumptions will not be known until future events occur. In evaluating the accuracy of those assumptions, the entity's historical experience in making past estimates and the auditor's experience in the industry are relevant. For certain matters, the best evidence 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. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.20 Pursuant to AU-C section 580, *Written Representations*, the auditor should request management to provide written representations that all instances of identified or suspected noncompliance with laws and regulations whose effects should be considered by management when preparing financial statements have been disclosed to the auditor. 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 home health resource group, resource utilization group, ambulatory payment classification, and diagnosis-related group assignments.

Health Care Entities

- 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 filed cost reports.
 - 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 employed reimbursement methodologies and principles 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. Although management believes that the entity is entitled to all amounts claimed on the cost reports, management also believes the amounts of these differences are appropriate.
- Contingencies
 - No violations or possible violations of laws or regulations exist, such as those related to Medicare and Medicaid antifraud and abuse statutes, in any jurisdiction, whose effects are 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. This is including, but not limited to, the anti-kickback statute of the Medicare and Medicaid Patient and Program Protection Act of 1987, limitations on certain physician referrals (the Stark law), and the False Claims Act.
 - 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 internal or external investigations relating to compliance with applicable laws and regulations, including investigations in progress, that would have an effect on the amounts reported in the financial statements or on the disclosure in the notes to the financial statements.
- There have been no oral or written communications 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 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.
- Adequate consideration has been given to, and appropriate provision made for, a continuing care retirement community's obligation to provide future services and the use of facilities to current residents.
- Adequate consideration has been given to, and appropriate provision made for, a prepaid health care provider's obligation to provide future health services.
- Guarantees, whether written or oral, under which the health care entity is contingently liable, including guarantee contracts and indemnification agreements pursuant to FASB ASC 460, *Guarantees*, have been properly recorded or disclosed in the (consolidated) financial statements.

The auditor of the health care entity also might obtain specific representations, if applicable, of the following items that are unique or pervasive in the health care industry:

- The health care entity is in compliance with the provisions of Internal Revenue Code (IRC) Section 501(c)(3) and is exempt from federal income tax under IRC Section 501(a), as evidenced by a determination letter, and from state income tax.
- Information returns (Form 990) have been filed on a timely basis.
- The health care entity is in compliance with the requirements of the provisions of IRC Section 501(r)(1), as established by the Patient Protection and Affordable Care Act, in order to be treated as an entity described in IRC Section 501(c)(3).
- 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.

- For each of its outstanding bond issues, the health care entity is in compliance with postissuance requirements, as specified in the IRC, including, but not limited to, the areas of arbitrage and private business use.
- 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 entity is in compliance with contractual agreements, grants, and donor restrictions.
- The health care entity has maintained an appropriate composition of net assets in amounts needed to comply with all donor restrictions.
- The internal controls over the receipt and recording of received contributions are adequate.
- The allocation of expenses reported in the notes to the financial statements is reasonable based on the health care entity's current operations.
- The health care entity has properly classified equity securities with readily determinable fair values and all debt securities as either trading or other-than-trading securities and reported these investments at fair value.
- The health care entity has reported to its risk management department all known asserted and unasserted claims and incidents. Adequate and reasonable provision has been made for losses related to asserted and unasserted malpractice, health insurance, worker's compensation, and any other claims.
- The health care entity is (or is not) subject to the requirements of Office of Management and Budget Title 2 U.S. *Code of Federal Regulations* (CFR) Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards*, or Title 45 U.S. CFR Part 75.501 because it expended (or did not expend) more than \$750,000 in federal awards during the year.
- The health care entity has classified net assets as unrestricted, temporarily restricted, or permanently restricted based on its assessment of the donor's intention, as specified in original donor correspondence, when available. When not available, the entity used other corroborating evidential matter, including minutes of the board, accounting records, and financial statements. To the extent that it was unable to review original donor correspondence to determine the amount of the original gift and donor additions, its determination of such amount was based on its best estimate considering the relevant facts and circumstances. Amounts classified as temporarily restricted are subject to donor-imposed purpose or time restrictions that precluded the health care entity from expending such amounts or recognizing such amounts as unrestricted as of the balance sheet date. Amounts classified as permanently restricted are subject to donor-imposed or statutory restrictions that require these amounts to be held in perpetuity. In addition, the health care entity has classified appreciation and income related to such donations in accordance with relevant donor or statutory restrictions. Losses on investments of a donor-restricted

endowment fund have been classified in accordance with FASB ASC 958-205-45. Reclassifications between net asset classes are proper.

- The health care entity has properly classified a portion of its donor-restricted endowment funds of perpetual duration as permanently restricted net assets based on explicit donor stipulations or the entity's interpretation of relevant law in the absence of explicit donor stipulations. Unless otherwise stated in the gift agreement, the entity has classified the portion of its donor-restricted endowment funds that is not classified as permanently restricted net assets as temporarily restricted net assets until appropriated for expenditure.
- There have been no changes in the health care entity's interpretation of relevant law that underlies the health care entity's net asset classification of donor-restricted endowment funds. The health care entity's policy for the appropriation of endowment assets for expenditure is consistent with that interpretation.

[Revised, December 2012, to reflect conforming changes necessary due to the issuance SAS Nos. 122–126. Revised, September 2017, to reflect conforming changes necessary due to the issuance of the 2017 edition of the Audit and Accounting Guide *Health Care Entities*.]

.21 Management's refusal to furnish written representations constitutes a limitation on the scope of the audit. Such refusal is often sufficient to preclude an unmodified opinion and may 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. [Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

Potential Departures From GAAP Related to Estimates and Uncertainties

.22 The auditor also is responsible for determining whether financial statement assertions and disclosures related to accounting estimates have been presented in accordance with GAAP. Departures from GAAP related to accounting estimates 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. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.23 As discussed in AU-C section 500, *Audit Evidence*, the objective of the auditor is to design and perform audit procedures that enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion. As discussed previously, exhibit 10-1 of the guide provides a number of sample procedures that the auditor may

perform 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 valuation allowances, in light of the involved payors, the nature of the payment mechanism, the risks associated with future audits, and other relevant factors."⁴ [Revised, September 2008, to reflect conforming changes necessary due to the issuance of SAS No. 105. Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126. Revised, September 2017, to reflect conforming changes necessary due to the issuance of the 2017 edition of the Audit and Accounting Guide *Health Care Entities*.]

Unreasonable Accounting Estimates

.24 The basis for management's assumptions regarding the nature of future adjustments and calculations as to the effects of such adjustments are relevant factors when evaluating the reasonableness of management's estimates.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. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.25 Paragraph .08c of AU-C section 540 requires the auditor to obtain an understanding of how management makes the accounting estimates, including the assumptions underlying the accounting estimates to provide a basis for the assessment of the risks of material misstatement for accounting estimates. Based on the assessed risks of material misstatement, the auditor should determine, in accordance with paragraph .12 of AU-C section 540,

- a. whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate and
- b. whether the methods for making the accounting estimates are appropriate and have been applied consistently and whether changes from the prior period, if any, in accounting estimates or the method for making them are appropriate in the circumstances.

In responding to the assessed risks of material misstatement, as required by AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, the auditor should undertake one or more of the following, in accordance with paragraph .13 of AU-C section 540, taking into account the nature of the accounting estimate:

- a. Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate.
- b. Test how management made the accounting estimate and the data on which it is based. In doing so, the auditor should evaluate whether
 - i. the method of measurement used is appropriate in the circumstances,

⁴ See paragraphs .25–.28.

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

- ii. the assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework, and
 - iii. the data on which the estimate is based is sufficiently reliable for the auditor's purposes.
- c. Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures.
- d. Develop a point estimate or range to evaluate management's point estimate. For this purpose
- i. if the auditor uses assumptions or methods that differ from management's, the auditor should obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate.
 - ii. if the auditor concludes that it is appropriate to use a range, the auditor should narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable.

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.26 The auditor should evaluate, based on the audit evidence, whether the accounting estimates in the financial statements are either reasonable in the context of the applicable financial reporting framework or are misstated. Based on the audit evidence obtained, the auditor may conclude that the evidence points to an accounting estimate that differs from management's point estimate. When the audit evidence supports a point estimate, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement. When the auditor has concluded that using the auditor's range provides sufficient appropriate audit evidence, a management point estimate that lies outside the auditor's range would not be supported by audit evidence. In such cases, the misstatement is no less than the difference between management's point estimate and the nearest point of the auditor's range. (Paragraph .A122 of AU-C section 540). When management has changed an accounting estimate, or the method in making it, from the prior period based on a subjective assessment that there has been a change in circumstances, the auditor may conclude, based on the audit evidence, that the accounting estimate is misstated as a result of an arbitrary change by management or may regard it as an indicator of possible management bias (Paragraph .A123 of AU-C section 540). [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.27 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 report⁶ 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. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.28 One of the key factors in evaluating the estimate is 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 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. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.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.

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 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.

Inappropriate Accounting Principles

.31 As previously stated, the auditor also is responsible for determining whether financial statement assertions and disclosures related to accounting estimates are presented in accordance with GAAP. When the financial statements are materially affected by a departure from GAAP, the auditor should express a qualified or adverse opinion in accordance with AU-C section 705. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.32 Valuation allowances should be recorded so that revenues are not recognized until the revenues are realizable. Valuation allowances are not established based on the provisions of FASB ASC 450, *Contingencies*. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.33 Indicators of possible measurement bias related to valuation allowances include

- valuation allowances that are not associated with any particular program, issue, or time period (for example, cost-report year or year the service was rendered).
- distorted earnings trends over time (for example, building up specific or unallocated valuation allowances in profitable years and drawing them down in unprofitable years).

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

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 accordance with GAAP, the auditor should express a qualified or adverse opinion in accordance with AU-C section 705. FASB ASC 275-10-50 provides guidance on the information that reporting entities should disclose regarding risks and uncertainties existing as of the date of the financial statements. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

.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 should be 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. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.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. FASB ASC 954-605 requires that these differences be included in the statement of operations in the period in which the revisions are made and disclosed. Such differences are not treated as prior period adjustments unless they meet the criteria for prior period adjustments as set forth in FASB ASC 250-10-45. [Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

.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 noncompliance with laws and regulations in the financial statements of health care entities is a matter that is likely to require a high level of professional judgment.

As previously discussed in this Statement of Position, the far-reaching nature of alleged fraud and abuse violations creates an uncertainty with respect to the valuation of revenues, because future allegations of noncompliance with laws and regulations 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. Financial Accounting Standards Board *Accounting Standards Codification* 450, *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 control relevant to financial reporting. However, the further that suspected noncompliance with laws and regulations is removed from the events and transactions ordinarily reflected in the financial statements, the less likely the auditor is to become aware of the suspected noncompliance, to recognize its possible noncompliance with laws and regulations, 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, because of the inherent limitations of an audit, an audit conducted in accordance with GAAS provides no assurance that all instances of noncompliance with laws and regulations will be detected.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 noncompliance with laws and regulations, may bring possible noncompliance with laws

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 Office of Management and Budget 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.

and regulations to an auditor's attention. When suspected noncompliance is detected, the auditor's responsibilities are addressed in AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*. Disclosure of noncompliance with laws and regulations 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

[Revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature. Revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

² Paragraph .A28 of AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, discusses circumstances in which a duty to notify parties outside the entity of identified or suspected noncompliance with laws and regulations may exist. [Footnote revised, December 2012, to reflect conforming changes necessary due to the issuance of SAS Nos. 122–126.]

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Appendix A

Overview of Statements on Quality Control Standards

This appendix is nonauthoritative and is included for informational purposes only.

This appendix is a partial reproduction of chapter 1 of the AICPA practice aid *Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, available at www.aicpa.org/interestareas/fr/pages/enhancingauditqualitypracticeaid.aspx.

This appendix highlights certain aspects of the quality control standards issued by the AICPA. If appropriate, readers should also refer to the quality control standards issued by the PCAOB, available at www.pcaobus.org/standards/qc/pages/default.aspx.

1.01 The objectives of a system of quality control are to provide a CPA firm with reasonable assurance¹ that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements, and that the firm or engagement partners issue reports that are appropriate in the circumstances. QC section 10, *A Firm's System of Quality Control* (AICPA, *Professional Standards*), addresses a CPA firm's responsibilities for its system of quality control for its accounting and auditing practice. That section is to be read in conjunction with the AICPA Code of Professional Conduct and other relevant ethical requirements.

1.02 A system of quality control consists of policies designed to achieve the objectives of the system and the procedures necessary to implement and monitor compliance with those policies. The nature, extent, and formality of a firm's quality control policies and procedures will depend on various factors such as the firm's size; the number and operating characteristics of its offices; the degree of authority allowed to, and the knowledge and experience possessed by, firm personnel; and the nature and complexity of the firm's practice.

Communication of Quality Control Policies and Procedures

1.03 The firm should communicate its quality control policies and procedures to its personnel. Most firms will find it appropriate to communicate their policies and procedures in writing and distribute them, or make them available electronically, to all professional personnel. Effective communication includes the following:

- A description of quality control policies and procedures and the objectives they are designed to achieve

¹ The term *reasonable assurance*, which is defined as a high, but not absolute, level of assurance, is used because absolute assurance cannot be attained. Paragraph .53 of QC section 10, *A Firm's System of Quality Control* (AICPA, *Professional Standards*), states, "Any system of quality control has inherent limitations that can reduce its effectiveness."

- The message that each individual has a personal responsibility for quality
- A requirement for each individual to be familiar with and to comply with these policies and procedures

Effective communication also includes procedures for personnel to communicate their views or concerns on quality control matters to the firm's management.

Elements of a System of Quality Control

1.04 A firm must establish and maintain a system of quality control. The firm's system of quality control should include policies and procedures that address each of the following elements of quality control identified in paragraph .17 of QC section 10:

- Leadership responsibilities for quality within the firm (the "tone at the top")
- Relevant ethical requirements
- Acceptance and continuance of client relationships and specific engagements
- Human resources
- Engagement performance
- Monitoring

1.05 The elements of quality control are interrelated. For example, a firm continually assesses client relationships to comply with relevant ethical requirements, including independence, integrity, and objectivity, and policies and procedures related to the acceptance and continuance of client relationships and specific engagements. Similarly, the human resources element of quality control encompasses criteria related to professional development, hiring, advancement, and assignment of firm personnel to engagements, all of which affect policies and procedures related to engagement performance. In addition, policies and procedures related to the monitoring element of quality control enable a firm to evaluate whether its policies and procedures for each of the other five elements of quality control are suitably designed and effectively applied.

1.06 Policies and procedures established by the firm related to each element are designed to achieve reasonable assurance with respect to the purpose of that element. Deficiencies in policies and procedures for an element may result in not achieving reasonable assurance with respect to the purpose of that element; however, the system of quality control, as a whole, may still be effective in providing the firm with reasonable assurance that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements and that the firm or engagement partners issue reports that are appropriate in the circumstances.

1.07 If a firm merges, acquires, sells, or otherwise changes a portion of its practice, the surviving firm evaluates and, as necessary, revises, implements, and maintains firm-wide quality control policies and procedures that are appropriate for the changed circumstances.

Leadership Responsibilities for Quality Within the Firm (the "Tone at the Top")

1.08 The purpose of the leadership responsibilities element of a system of quality control is to promote an internal culture based on the recognition that quality is essential in performing engagements. The firm should establish and maintain the following policies and procedures to achieve this purpose:

- Require the firm's leadership (managing partner, board of managing partners, CEO, or equivalent) to assume ultimate responsibility for the firm's system of quality control.
- Provide the firm with reasonable assurance that personnel assigned operational responsibility for the firm's quality control system have sufficient and appropriate experience and ability to identify and understand quality control issues and develop appropriate policies and procedures, as well as the necessary authority to implement those policies and procedures.

1.09 Establishing and maintaining the following policies and procedures assists firms in recognizing that the firm's business strategy is subject to the overarching requirement for the firm to achieve the objectives of the system of quality control in all the engagements that the firm performs:

- Assign management responsibilities so that commercial considerations do not override the quality of the work performed.
- Design policies and procedures addressing performance evaluation, compensation, and advancement (including incentive systems) with regard to personnel to demonstrate the firm's overarching commitment to the objectives of the system of quality control.
- Devote sufficient and appropriate resources for the development, communication, and support of its quality control policies and procedures.

Relevant Ethical Requirements

1.10 The purpose of the relevant ethical requirements element of a system of quality control is to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements when discharging professional responsibilities. Relevant ethical requirements include independence, integrity, and objectivity. Establishing and maintaining policies such as the following assist the firm in obtaining this assurance:

- Require that personnel adhere to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, the U.S. Government Accountability Office, and any other applicable regulators.
- Establish procedures to communicate independence requirements to firm personnel and, where applicable, others subject to them.
- Establish procedures to identify and evaluate possible threats to independence and objectivity, including the familiarity threat that may be created by using the same senior personnel on an audit

or attest engagement over a long period of time, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards.

- Require that the firm withdraw from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied.
- Require written confirmation, at least annually, of compliance with the firm's policies and procedures on independence from all firm personnel required to be independent by relevant requirements.
- Establish procedures for confirming the independence of another firm or firm personnel in associated member firms who perform part of the engagement. This would apply to national firm personnel, foreign firm personnel, and foreign-associated firms.²
- Require the rotation of personnel for audit or attest engagements where regulatory or other authorities require such rotation after a specified period.

Acceptance and Continuance of Client Relationships and Specific Engagements

1.11 The purpose of the quality control element that addresses acceptance and continuance of client relationships and specific engagements is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for a client. A firm's client acceptance and continuance policies represent a key element in mitigating litigation and business risk. Accordingly, it is important that a firm be aware that the integrity and reputation of a client's management could reflect the reliability of the client's accounting records and financial representations and, therefore, affect the firm's reputation or involvement in litigation. A firm's policies and procedures related to the acceptance and continuance of client relationships and specific engagements should provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where it

- is competent to perform the engagement and has the capabilities, including the time and resources, to do so;
- can comply with legal and relevant ethical requirements;
- has considered the client's integrity and does not have information that would lead it to conclude that the client lacks integrity; and
- has reached an understanding with the client regarding the services to be performed.

1.12 This assurance should be obtained before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client.

² A *foreign-associated firm* is a firm domiciled outside of the United States and its territories that is a member of, correspondent with, or similarly associated with an international firm or international association of firms.

Establishing and maintaining policies such as the following assist the firm in obtaining this assurance:

- Evaluate factors that have a bearing on management's integrity and consider the risk associated with providing professional services in particular circumstances.³
- Evaluate whether the engagement can be completed with professional competence; undertake only those engagements for which the firm has the capabilities, resources, and professional competence to complete; and evaluate, at the end of specific periods or upon occurrence of certain events, whether the relationship should be continued.
- Obtain an understanding, preferably in writing, with the client regarding the services to be performed.
- Establish procedures on continuing an engagement and the client relationship, including procedures for dealing with information that would have caused the firm to decline an engagement if the information had been available earlier.
- Require documentation of how issues relating to acceptance or continuance of client relationships and specific engagements were resolved.

Human Resources

1.13 The purpose of the human resources element of a system of quality control is to provide the firm with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary (a) to perform its engagements in accordance with professional standards and regulatory and legal requirements, and (b) to enable the firm to issue reports that are appropriate in the circumstances. Establishing and maintaining policies such as the following assist the firm in obtaining this assurance:

- Recruit and hire personnel of integrity who possess the characteristics that enable them to perform competently.
- Determine capabilities and competencies required for an engagement, especially for the engagement partner, based on the characteristics of the particular client, industry, and kind of service being performed. Specific competencies necessary for an engagement partner are discussed in paragraph .A27 of QC section 10.
- Determine the capabilities and competencies possessed by personnel.
- Assign the responsibility for each engagement to an engagement partner.

³ Such considerations would include the risk of providing professional services to significant clients or to other clients for which the practitioner's objectivity or the appearance of independence may be impaired. In broad terms, the significance of a client to a member or a firm refers to relationships that could diminish a practitioner's objectivity and independence in performing attest services. Examples of factors to consider in determining the significance of a client to an engagement partner, office, or practice unit include (a) the amount of time the partner, office, or practice unit devotes to the engagement, (b) the effect on the partner's stature within the firm as a result of his or her service to the client, (c) the manner in which the partner, office, or practice unit is compensated, or (d) the effect that losing the client would have on the partner, office, or practice unit.

- Assign personnel based on the knowledge, skills, and abilities required in the circumstances and the nature and extent of supervision needed.
- Have personnel participate in general and industry-specific continuing professional education and professional development activities that enable them to accomplish assigned responsibilities and satisfy applicable continuing professional education requirements of the AICPA, state boards of accountancy, and other regulators.
- Select for advancement only those individuals who have the qualifications necessary to fulfill the responsibilities they will be called on to assume.

Engagement Performance

1.14 The purpose of the engagement performance element of quality control is to provide the firm with reasonable assurance (a) that engagements are consistently performed in accordance with applicable professional standards and regulatory and legal requirements, and (b) that the firm or the engagement partner issues reports that are appropriate in the circumstances. Policies and procedures for engagement performance should address all phases of the design and execution of the engagement, including engagement performance, supervision responsibilities, and review responsibilities. Policies and procedures also should require that consultation takes place when appropriate. In addition, a policy should establish criteria against which all engagements are to be evaluated to determine whether an engagement quality control review should be performed.

1.15 Establishing and maintaining policies such as the following assist the firm in obtaining the assurance required relating to the engagement performance element of quality control:

- Plan all engagements to meet professional, regulatory, and the firm's requirements.
- Perform work and issue reports and other communications that meet professional, regulatory, and the firm's requirements.
- Require that work performed by other team members be reviewed by qualified engagement team members, which may include the engagement partner, on a timely basis.
- Require the engagement team to complete the assembly of final engagement files on a timely basis.
- Establish procedures to maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation.
- Require the retention of engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations.
- Require that
 - consultation take place when appropriate (for example, when dealing with complex, unusual, unfamiliar, difficult, or contentious issues);

- sufficient and appropriate resources be available to enable appropriate consultation to take place;
- all the relevant facts known to the engagement team be provided to those consulted;
- the nature, scope, and conclusions of such consultations be documented; and
- the conclusions resulting from such consultations be implemented.
- Require that
 - differences of opinion be dealt with and resolved;
 - conclusions reached are documented and implemented; and
 - the report not be released until the matter is resolved.
- Require that
 - all engagements be evaluated against the criteria for determining whether an engagement quality control review should be performed;
 - an engagement quality control review be performed for all engagements that meet the criteria; and
 - the review be completed before the report is released.
- Establish procedures addressing the nature, timing, extent, and documentation of the engagement quality control review.
- Establish criteria for the eligibility of engagement quality control reviewers.

Monitoring

1.16 The purpose of the monitoring element of a system of quality control is to provide the firm and its engagement partners with reasonable assurance that the policies and procedures related to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Monitoring involves an ongoing consideration and evaluation of the appropriateness of the design, the effectiveness of the operation of a firm's quality control system, and a firm's compliance with its quality control policies and procedures. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of the following:

- Adherence to professional standards and regulatory and legal requirements
- Whether the quality control system has been appropriately designed and effectively implemented
- Whether the firm's quality control policies and procedures have been operating effectively so that reports issued by the firm are appropriate in the circumstances

1.17 Establishing and maintaining policies such as the following assist the firm in obtaining the assurance required relating to the monitoring element of quality control:

Health Care Entities

- Assign responsibility for the monitoring process to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility.
- Assign performance of the monitoring process to competent individuals.
- Require the performance of monitoring procedures that are sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and the firm's quality control policies and procedures. Monitoring procedures consist of the following:
 - Review of selected administrative and personnel records pertaining to the quality control elements.
 - Review of engagement documentation, reports, and clients' financial statements.
 - Summarization of the findings from the monitoring procedures, at least annually, and consideration of the systemic causes of findings that indicate that improvements are needed.
 - Determination of any corrective actions to be taken or improvements to be made with respect to the specific engagements reviewed or the firm's quality control policies and procedures.
 - Communication of the identified findings to appropriate firm management personnel.
 - Consideration of findings by appropriate firm management personnel who should also determine that any actions necessary, including necessary modifications to the quality control system, are taken on a timely basis.
 - Assessment of
 - the appropriateness of the firm's guidance materials and any practice aids;
 - new developments in professional standards and regulatory and legal requirements and how they are reflected in the firm's policies and procedures where appropriate;
 - compliance with policies and procedures on independence;
 - the effectiveness of continuing professional development, including training;
 - decisions related to acceptance and continuance of client relationships and specific engagements; and
 - firm personnel's understanding of the firm's quality control policies and procedures and implementation thereof.
- Communicate at least annually, to relevant engagement partners and other appropriate personnel, deficiencies noted as a result of

the monitoring process and recommendations for appropriate remedial action.

- Communicate the results of the monitoring of its quality control system process to relevant firm personnel at least annually.
- Establish procedures designed to provide the firm with reasonable assurance that it deals appropriately with the following:
 - Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements.
 - Allegations of noncompliance with the firm's system of quality control.
 - Deficiencies in the design or operation of the firm's quality control policies and procedures, or noncompliance with the firm's system of quality control by an individual or individuals, as identified during the investigations into complaints and allegations.

This includes establishing clearly defined channels for firm personnel to raise any concerns in a manner that enables them to come forward without fear of reprisal and documenting complaints and allegations and the responses to them.

- Require appropriate documentation to provide evidence of the operation of each element of its system of quality control. The form and content of documentation evidencing the operation of each of the elements of the system of quality control is a matter of judgment and depends on a number of factors, including the following, for example:
 - The size of the firm and the number of offices.
 - The nature and complexity of the firm's practice and organization.
- Require retention of documentation providing evidence of the operation of the system of quality control for a period of time sufficient to permit those performing monitoring procedures and peer review to evaluate the firm's compliance with its system of quality control, or for a longer period if required by law or regulation.

1.18 Some of the monitoring procedures discussed in the previous list may be accomplished through the performance of the following:

- Engagement quality control review
- Review of engagement documentation, reports, and clients' financial statements for selected engagements after the report release date
- Inspection⁴ procedures

⁴ *Inspection* is a retrospective evaluation of the adequacy of the firm's quality control policies and procedures, its personnel's understanding of those policies and procedures, and the extent of the firm's compliance with them. Although monitoring procedures are meant to be ongoing, they may include inspection procedures performed at a fixed point in time. Monitoring is a broad concept; inspection is one specific type of monitoring procedure.

Documentation of Quality Control Policies and Procedures

1.19 The firm should document each element of its system of quality control. The extent of the documentation will depend on the size, structure, and nature of the firm's practice. Documentation may be as simple as a checklist of the firm's policies and procedures or as extensive as practice manuals.

Appendix B

References to AICPA Technical Questions and Answers

This appendix is nonauthoritative and is included for informational purposes only.

The following nonauthoritative questions and answers, commonly referred to as Technical Questions and Answers (Q&As), have been prepared by the AICPA staff. The questions and answers have not been approved, disapproved, or otherwise acted upon by the Financial Reporting Executive Committee or any other senior technical committee of the AICPA. They are not sources of established accounting principles¹ nor are they sources of authoritative generally accepted auditing standards. The AICPA staff believes that the questions and answers listed subsequently may be useful and relevant for users of this guide. In addition to the following Q&As, not-for-profit health care entities may find the questions and answers listed in Q&A section 6140, *Not-for-Profit Entities* (AICPA, *Technical Questions and Answers*), useful. Other Q&As may also be useful and relevant to users of this guide, depending on the facts and circumstances.

Q&A Section	Title
3700.01	"Effect of New Mortality Tables on Nongovernmental Employee Benefit Plans (EBPs) and Nongovernmental Entities That Sponsor EBPs"
6140.23	"Changing Net Asset Classifications Reported in a Prior Year"
6140.26	"Not-for-Profit Entity with For-Profit Subsidiary and Adoption of FASB ASU 2014-02 on Goodwill"
6400.04	"Hospital as Collecting Agent for Physicians [Amended]"
6400.12	"General Obligation Bonds Issued for Current Use by City Owned Hospital [Amended]"
6400.17	"Elimination of Profit on Intercompany Sales"
6400.19	"Offsetting of Limited Use Assets"
6400.20	"Format of Combined or Consolidated Financial Statements"
6400.25	"Accounting for Transfer of Assets From Not-for-Profit to For-Profit Entities"
6400.26	"Transfer of Assets From Subsidiary For-Profit Entity to Not-for-Profit Stockholder Parent"
6400.29	"Timing of Recording Transfers Between Related Entities"

(continued)

¹ See chapter 1, "Overview and Unique Considerations of Health Care Entities," of this guide for additional information regarding the hierarchy of generally accounting principles for nongovernmental health care entities.

<i>Q&A Section</i>	<i>Title</i>
6400.30	"Accounting for Transactions Involving Medicaid Voluntary Contribution or Taxation Programs [Amended]"
6400.33	"Accounting for a Joint Operating Agreement"
6400.34	"Accounting for Computer Systems Costs Incurred in Connection With the Health Insurance Portability and Accountability Act of 1996 (HIPAA)"
6400.35	"Note to Sections 6400.36–.42—Implementation of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (in the Beneficiary's Financial Statements)"
6400.36	"Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary can influence the operating and financial decisions of the foundation to such an extent that the beneficiary can determine the timing and amount of distributions from the foundation.)"
6400.37	"Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary cannot influence the operating and financial decisions of the foundation to such an extent that the beneficiary can determine the timing and amount of distributions from the foundation.)"
6400.38	"Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation—Does Common Control Lead to the Conclusion That the Beneficiary Can Determine the Timing and Amount of Distributions from the Recipient?"
6400.39	"Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (More Than One Beneficiary—Some Contributions Are Designated)"
6400.40	"Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary makes an expenditure that meets a purpose restriction on net assets held for its benefit by the recipient entity—The beneficiary can influence the operating and financial decisions of the recipient to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient.)"

Q&A Section	Title
6400.41	"Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (The beneficiary makes an expenditure that is consistent with a purpose restriction on net assets held for its benefit by the recipient entity—The beneficiary cannot influence the operating and financial decisions of the recipient to such an extent that the beneficiary can determine the timing and amount of distributions from the recipient.)"
6400.42	"Application of FASB ASC 958—Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fund-Raising Foundation (Recipient Entity)—Accounting for Unrealized Gains and Losses on Investments Held by the Foundation"
6400.43	"Application of FASB ASC 958—Classification of Distributions From a Financially Interrelated Fund-Raising Foundation (Recipient Entity) to a Health Care Beneficiary"
6400.45	"Applicability of FASB ASC 460—Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others"
6400.46	"Applicability of FASB ASC 460—Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others—Mortgage Guarantees"
6400.47	"Application of Accounting Standards Update No. 2011-07, <i>Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities</i> , in Consolidated Financial Statements"
6400.48	"Accounting for Costs Incurred During Implementation of ICD-10"
6400.49	"Presentation of Claims Liability and Insurance Recoveries—Contingencies Similar to Malpractice"
6400.50	"Accrual of Legal Costs Associated With Contingencies Other Than Malpractice"
6400.51	"Presentation of Insurance Recoveries When Insurer Pays Claims Directly"
6400.52	"Insurance Recoveries From Certain Retrospectively Rated Insurance Policies"
8100.03	"Using Current Auditing Standards for Audits of Prior Periods"
8700.03	"Auditor's Responsibilities for Subsequent Events Relative to a Conduit Debt Obligor"

(continued)

<i>Q&A Section</i>	<i>Title</i>
8800.01– .43	Various Questions and Answers on group audits
9100.07	"Naming the City and State Where the Auditor Practices"
9100.08	"Audit Firm With Multiple Offices on Their Company Letterhead and Effect on Report"
9110.15	"Reporting on Medicaid/Medicare Cost Reports"
9110.19	"Lender Comfort Letters"
9110.20	"Effective Date of AU-C Section 905 in a Compliance Audit"
9110.22	"Use of Restricted Alert Language When Financial Statements Are Audited in Accordance With GAAS and <i>Government Auditing Standards</i> "
9110.23	"Modification of Compliance Report When Financial Statements Are Audited in Accordance With GAAS"
9160.28	"Combining a Going Concern Emphasis-of-Matter Paragraph With Another Emphasis-of-Matter Paragraph"
9160.30	"Modification to the Auditor's Report When a Client Adopts a PCC Accounting Alternative That Results in a Change to a Previously Issued Report"
9170.02	"Supplementary Information That Accompanies Interim Financial Information"
9180.01	"Required Supplementary Information in Historical Prior Periods and Auditor Independence of the Entity"

Appendix C

The New Revenue Recognition Standard: FASB ASC 606

This appendix is nonauthoritative and is included for informational purposes only.

Overview

On May 28, 2014, the International Accounting Standards Board (IASB) and FASB issued a joint accounting standard on revenue recognition to address a number of concerns regarding the complexity and lack of consistency surrounding the accounting for revenue transactions. Consistent with each board's policy, FASB issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, and the IASB issued International Financial Reporting Standard (IFRS) 15, *Revenue from Contracts with Customers*. FASB ASU No. 2014-09 will amend the FASB Accounting Standards Codification[®] (ASC) by creating a new Topic 606, *Revenue from Contracts with Customers*, and a new Subtopic 340-40, *Other Assets and Deferred Costs—Contracts with Customers*. The guidance in ASU No. 2014-09 provides what FASB describes as a framework for revenue recognition and supersedes or amends several of the revenue recognition requirements in FASB ASC 605, *Revenue Recognition*, as well as guidance within the 900 series of industry-specific topics.

As part of the boards' efforts to converge U.S. generally accepted accounting principles (GAAP) and IFRSs, the standard eliminates the transaction- and industry-specific revenue recognition guidance under current GAAP and replaces it with a principles-based approach for revenue recognition. The intent is to avoid inconsistencies of accounting treatment across different geographies and industries. In addition to improving comparability of revenue recognition practices, the new guidance provides more useful information to financial statement users through enhanced disclosure requirements. FASB and the IASB have essentially achieved convergence with these standards, with some minor differences related to the collectibility threshold, interim disclosure requirements, early application and effective date, impairment loss reversal, and non-public entity requirements.

The standard applies to any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets, unless those contracts are within the scope of other standards (for example, insurance or lease contracts).

Effective or Applicability Date

The guidance in ASU No. 2014-09 was originally effective for annual reporting periods of public entities beginning after December 15, 2016, including interim periods within that reporting period. Early application was not permitted for public entities, including not-for-profit entities (NFPs) that have issued, or are

conduit bond obligors for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market and for employee benefit plans that file or furnish financial statements to the SEC.

For nonpublic entities, the amendments in the new guidance were originally effective for annual reporting periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018.

On August 12, 2015, FASB issued ASU No. 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*, to allow entities additional time to implement systems, gather data, and resolve implementation questions. This update allows for public business entities, certain NFPs, and certain employee benefit plans to apply the new requirements to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

All other entities will now apply the guidance in ASU No. 2014-09 to annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. Application is permitted earlier only as of an annual reporting period beginning after December 15, 2016, including interim reporting periods within that reporting period, or an annual reporting period beginning after December 15, 2016, and interim reporting periods within annual reporting periods beginning one year after the annual reporting period in which an entity first applies the guidance in ASU No. 2014-09.

Overview of the New Guidance

The core principle of the revised revenue recognition standard is that an entity should recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those good or services.

To apply the proposed revenue recognition standard, ASU No. 2014-09 states that an entity should follow these five steps:

1. Identify the contract(s) with a customer.
2. Identify the performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract.
5. Recognize revenue when (or as) the entity satisfies a performance obligation.

Under the new standard, revenue is recognized when a company satisfies a performance obligation by transferring a promised good or service to a customer (which is when the customer obtains control of that good or service). See the following discussion of the five steps involved when recognizing revenue under the new guidance.

Understanding the Five-Step Process

Step 1: Identify the Contract(s) With a Customer

ASU No. 2014-09 defines a contract as "an agreement between two or more parties that creates enforceable rights and obligations." The new standard affects contracts with a customer that meet the following criteria:

- Approval (in writing, orally, or in accordance with other customary business practices) and commitment of the parties
- Identification of the rights of the parties
- Identification of the payment terms
- Contract has commercial substance
- Probable that the entity will collect substantially all the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer

A contract does not exist if each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party (parties).

Step 2: Identify the Performance Obligations in the Contract

A *performance obligation* is a promise in a contract with a customer to transfer a good or service to the customer.

At contract inception, an entity should assess the goods or services promised in a contract with a customer and identify as a performance obligation (possibly multiple performance obligations) each promise to transfer to the customer either

- a good or service (or bundle of goods or services) that is distinct, or
- a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

A good or service that is not distinct should be combined with other promised goods or services until the entity identifies a bundle of goods or services that is distinct. In some cases, that would result in the entity accounting for all the goods or services promised in a contract as a single performance obligation.

Step 3: Determine the Transaction Price

The transaction price is the amount of consideration (fixed or variable) the entity expects to receive in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties. To determine the transaction price, an entity should consider the effects of

- variable consideration,
- constraining estimates of variable consideration,
- the existence of a significant financing component,
- noncash considerations, and
- consideration payable to the customer.

If the consideration promised in a contract includes a variable amount, then an entity should estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer. An entity would then include in the transaction price some or all of an amount of variable consideration only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

An entity should consider the terms of the contract and its customary business practices to determine the transaction price.

Step 4: Allocate the Transaction Price to the Performance Obligations in the Contract

The transaction price is allocated to separate performance obligations in proportion to the standalone selling price of the promised goods or services. If a standalone selling price is not directly observable, then an entity should estimate it. Reallocation of the transaction price for changes in the standalone selling price is not permitted. When estimating the standalone selling price, entities can use various methods, including the adjusted market assessment approach, expected cost plus a margin approach, and residual approach (only if the selling price is highly variable and uncertain).

Sometimes, the transaction price includes a discount or a variable amount of consideration that relates entirely to one of the performance obligations in a contract. Guidance under the new standard specifies when an entity should allocate the discount or variable consideration to one (or some) performance obligation(s), rather than to all the performance obligations in the contract.

Step 5: Recognize Revenue When (or as) the Entity Satisfies a Performance Obligation

The amount of revenue recognized when transferring the promised good or service to a customer is equal to the amount allocated to the satisfied performance obligation, which may be satisfied at a point in time or over time. Control of an asset refers to the ability to direct the use of, and obtain substantially all the remaining benefits from, the asset. Control also includes the ability to prevent *other entities* from directing the use of, and obtaining the benefits from, an asset.

When performance obligations are satisfied over time, the entity should select an appropriate method for measuring its progress toward complete satisfaction of that performance obligation. The standard discusses methods of measuring progress, including input and output methods, and how to determine which method is appropriate.

Additional Guidance Under the New Standard

In addition to the five-step process for recognizing revenue, ASU No. 2014-09 also addresses the following areas:

- Accounting for incremental costs of obtaining a contract, as well as costs incurred to fulfill a contract
- Licenses
- Warranties

Lastly, the new guidance enhances disclosure requirements to include more information about specific revenue contracts entered into by the entity, including performance obligations and the transaction price.

Transition Resource Group

Due to the potential for significant changes that may result from the issuance of the new standard, FASB and the IASB have received an abundance of implementation questions from interested parties. To address these questions, the boards have formed a joint Transition Resource Group (TRG) for revenue recognition to promote effective implementation and transition to the converged standard.

Since the issuance of the standard, the TRG has met several times to discuss implementation issues raised by concerned parties and actions to take to address these issues. Refer to FASB's TRG website for more information on this group and the status of their efforts, including meeting materials and meeting summaries.

Latest Developments

Based on discussions held thus far on individual areas affected by the new standard, the TRG informed the boards that technical corrections are needed to further articulate the guidance in the standard. As a result, FASB has issued updates to clarify guidance on performance obligations, licensing, principal versus agent considerations, and other narrow-scope improvements and practical expedients.

ASU No. 2016-08, *Revenue from Contracts with Customers (Topic 606): Principle versus Agent Considerations (Reporting Revenue Gross versus Net)*, was issued in March 2016 to clarify the guidance in FASB ASC 606 with respect to principal versus agent. There is little disagreement that an entity who is a principal recognizes revenue in the gross amount of consideration when a performance obligation is satisfied. An entity who is an agent (collecting revenue on behalf of the principal) recognizes revenue only to the extent of the commission or fee that the agent collects. This ASU hopes to eliminate the potential diversity in practice when determining whether an entity is a principal or an agent by clarifying the following:

- An entity determines whether it is a principal or an agent for each distinct good or service.
- An entity determines the nature of each specified good or service (including whether it is a right to a good or service)
- When an entity is a principal, it obtains control of
 - a good or another asset from the other party that it then transfers to the customer;
 - a right to a service that will be performed by another party, which gives the entity the ability to direct that party to provide the service to the customer on the entity's behalf; or

- a good or service from the other party that it combines with other goods or services to provide the specified good or service to the customer.
- Indicators in the assessment of control may be more or less relevant or persuasive, or both, to the control assessment, depending on the facts and circumstances.

Additional illustrative examples are also provided in ASU No. 2016-08 to further assist practitioners in applying this guidance. The effective date of this update is in line with the guidance in ASU No. 2014-09, as amended by ASU No. 2015-14.

ASU No. 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*, was issued in April 2016 to reduce potential for diversity in practice at initial application of FASB ASC 606, as well as the cost and complexity of applying FASB ASC 606 at transition and on an ongoing basis. When identifying promised goods and services in a contract, this ASU states that entities

- are not required to assess whether promised goods or services are performance obligations if they are immaterial to the contract.
- can elect to account for shipping and handling activities as an activity to fulfill promises within the contract, rather than as an additional promised service.

When assessing whether promised goods or services are distinct, this ASU emphasizes the need to determine whether the nature of the promise is to transfer

- each of the goods or services, or
- a combined item (or items) to which the promised goods or services are inputs.

With regards to licensing, ASU No. 2016-10 clarifies whether revenue should be recognized at a point in time or over time, based on whether the license provides a right to use an entity's intellectual property or a right to access the entity's intellectual property. Specifically,

- if the intellectual property has significant standalone functionality, the license does not include supporting or maintaining that intellectual property during the license period. Therefore, the performance obligation would be considered satisfied at a point in time. Examples of this type of intellectual property include software, biological compounds or drug formulas, and media.
- licenses for symbolic intellectual property include supporting or maintaining that intellectual property during the license period and, therefore, are considered to be satisfied over time. Examples of symbolic intellectual property include brands, team or trade names, logos, and franchise rights.

Lastly, ASU No. 2016-10 provides clarification on implementation guidance on recognizing revenue for sales-based or usage-based royalty promised in exchange for a license of intellectual property. The effective date of this ASU is in line with the guidance in ASU No. 2014-09, as amended by ASU No. 2015-14.

In addition to ASU Nos. 2016-08 and 2016-10, ASU No. 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*, was issued in May 2016. Topics covered in this ASU include

- clarification on contract modifications. This amendment permits an entity to determine and allocate the transaction price on the basis of all satisfied and unsatisfied performance obligations in a modified contract as of the beginning of the earliest period presented in accordance with the guidance in FASB ASC 606. An entity would not be required to separately evaluate the effects of each contract modification. An entity that chooses to apply this practical expedient would apply the expedient consistently to similar types of contracts.
- how to assess the collectibility criterion. The amendment introduces new criteria to meet the collectibility requirement. An entity should assess the collectibility of the consideration promised in a contract for the goods or services that will be transferred to the customer, rather than assessing the collectibility of the consideration promised in the contract for all the promised goods or services.
- how to report sales taxes and similar taxes. This amendment states that an entity may make an accounting policy election to exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction and collected by the entity from a customer (for example, sales, use, value added, and some excise taxes). Taxes assessed on an entity's total gross receipts or imposed during the inventory procurement process should be excluded from the scope of the election. An entity that makes this election should exclude from the transaction price all taxes in the scope of the election and should comply with the applicable accounting policy guidance, including disclosure requirements.
- when to measure noncash consideration. This amendment clarifies that the measurement date for noncash consideration is contract inception. If the fair value of the noncash consideration varies because of the form of the consideration and for reasons other than the form of the consideration, an entity should apply the guidance on variable consideration only to the variability resulting from reasons other than the form of the consideration.
- how to apply transition guidance. This amendment clarifies that a completed contract for purposes of transition is a contract for which all (or substantially all) the revenue was recognized under legacy GAAP before the date of initial application. Accounting for elements of a contract that do not affect revenue under legacy GAAP are irrelevant to the assessment of whether a contract is complete. In addition, the amendment permits an entity to apply the modified retrospective transition method either to all contracts or only to contracts that are not completed contracts.

The effective date of this ASU is in line with the guidance in ASU No. 2014-09, as amended by ASU No. 2015-14.

FASB also issued ASU No. 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers*, in December 2016. These amendments affect narrow aspects of guidance issued in ASU No. 2014-09, including but not limited to, guidance on

- impairment testing. When performing impairment testing, an entity should consider expected contract renewals and extensions. In addition, the assessment should include both the amount of consideration it already has received but has not yet recognized as revenue, and the amount it expects to receive in the future.
- additional scope exceptions. The term "insurance" is removed from the scope exceptions of FASB ASC 606 to clarify that all contracts within the scope of FASB ASC 944, *Financial Services—Insurance*, are excluded.
- provisions for losses on construction-type and production-type contracts. Such provisions should be determined at least at the contract level; however, an entity can make an accounting policy election to determine the provision for losses at the performance obligation level.
- disclosure of remaining performance obligations. Optional exemptions from the disclosure requirement are provided for remaining performance obligations when an entity is not required to estimate variable consideration to recognize revenue.

Consistent with the other ASUs, the effective date of ASU No. 2016-20 is in line with the guidance in ASU No. 2014-09, as amended by ASU No. 2015-14.

In February 2017, the FASB issued ASU No. 2017-05, *Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*. The amendments in this ASU include, but are not limited to

- a definition of the term in substance nonfinancial asset, to clarify the scope of FASB ASC 610-20. An in substance nonfinancial asset is, in part, a financial asset promised to a counterparty in a contract if substantially all of the fair value of the assets (recognized and unrecognized) that are promised to the counterparty in the contract is concentrated in nonfinancial assets. An in substance nonfinancial asset also includes a financial asset that is held in an individual consolidated subsidiary within a contract if substantially all the fair value of the assets (recognized and unrecognized) that are promised to the counterparty in that subsidiary is concentrated in nonfinancial assets.
- a clarification that nonfinancial assets within the scope of FASB ASC 610-20 may include nonfinancial assets transferred within a legal entity to a counterparty. For example, a parent may transfer control of nonfinancial assets by transferring ownership interests in a consolidated subsidiary. A contract that includes the transfer of ownership interests in one or more consolidated subsidiaries is within the scope of Subtopic 610-20 if substantially all of the fair value of the assets that are promised to the counterparty in a contract is concentrated in nonfinancial assets.

- removal of the scope exception for transfers of equity method investment that were considered in substance nonfinancial assets. All transfers of equity method investments will be accounted for in accordance with FASB ASC 860, *Transfers and Servicing*.
- derecognition of each distinct nonfinancial asset or in substance nonfinancial asset promised to a counterparty. Each asset will be derecognized when a counterparty obtains control of it. The amendments also clarify that an entity should allocate consideration to each distinct asset by applying the guidance in FASB ASC 606 on allocating the transaction price to performance obligations.
- partial sales transactions. An entity will derecognize a distinct nonfinancial asset or distinct in substance nonfinancial asset in a partial sale transaction when it (1) does not have (or ceases to have) a controlling financial interest in the legal entity that holds the asset in accordance with FASB ASC 810, *Consolidation*, and (2) transfers control of the asset in accordance with FASB ASC 606. Once an entity transfers control of a distinct nonfinancial asset or distinct in substance nonfinancial asset, it is required to measure any noncontrolling interest it receives (or retains) at fair value. If an entity transfers ownership interests in a consolidated subsidiary and continues to have a controlling financial interest in that subsidiary, it does not derecognize the assets and liabilities of the subsidiary and accounts for the transaction as an equity transaction. Therefore, no gain or loss is recognized.
- contributions of nonfinancial assets to a joint venture or other non-controlled investee. These contributions will be within the scope of FASB ASC 610-20, and an entity will recognize a full gain or loss on transfers of nonfinancial assets to equity method investees.

Consistent with the other ASUs, the effective date of ASU No. 2017-05 is in line with the guidance in ASU No. 2014-09, as amended by ASU No. 2015-14.

Conclusion

Upon implementation of the new standard, consistency of revenue recognition principles across geography and industry will be enhanced and financial statement users will be provided better insight through improved disclosure requirements. To provide CPAs with guidance during this time of transition, the AICPA's Financial Reporting Center (FRC) offers invaluable resources on the topic, including a roadmap to ensure that companies take the necessary steps to prepare themselves for the new standard. In addition, the FRC includes a list of conferences, webcasts, and other products to keep you informed on upcoming changes in revenue recognition. Refer to www.aicpa.org/interestareas/frc/accountingfinancialreporting/revenuerecognition/pages/revenuerecognition.aspx to stay updated on the latest information available on revenue recognition.

Appendix D

Accounting for Financial Instruments

This appendix is nonauthoritative and is included for informational purposes only.

Overall Project Objective

The objective of FASB's Accounting for Financial Instruments project is to significantly improve the decision usefulness of financial instrument reporting for users of financial statements. The project was initiated to reconsider recognition and measurement of financial instruments, address issues related to impairment of financial instruments and hedge accounting, and increase convergence in accounting for financial instruments. In replacing the existing financial instruments standards, an expected outcome is the simplification of the accounting requirements for financial instruments. The project was split into three phases including classification and measurement, impairment, and hedge accounting. This appendix focusses on the latest developments in each of these phases.

Classification and Measurement

Overview

On January 5, 2016, FASB issued Accounting Standards Update (ASU) No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, to enhance the reporting model for financial instruments and to provide users of financial statements with more decision-useful information. The amendments in the ASU are intended to improve certain aspects of recognition, measurement, presentation, and disclosure of financial instruments.

The new guidance will accomplish the following:

- Require equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income
- Replace the impairment model for equity investments without readily determinable fair values with a qualitative impairment assessment
- Eliminate the requirement to disclose the fair values of financial assets and financial liabilities measured at amortized cost for entities that are not public business entities
- Eliminate the requirement for public business entities to disclose the methods and significant assumptions used to estimate fair value that is required to be disclosed for financial assets and financial liabilities measured at amortized cost on the balance sheet

- Require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes
- Require an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments
- Require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements
- Clarify that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale debt securities in combination with an entity's other deferred tax assets
- Eliminate an entity's ability to estimate the disclosed fair values of financial assets and financial liabilities on the basis of entry prices

Applicability and Effective Date

ASU No. 2016-01 affects all entities that hold financial assets or have financial liabilities and is effective as follows:

	<i>Fiscal Years Beginning After</i>	<i>Interim Periods Within Fiscal Years Beginning After</i>
Public business entities	December 15, 2017	December 15, 2017
All other entities, including not-for-profit entities and employee benefit plans within the scope of FASB <i>Accounting Standards Codification</i> (ASC) 960–965 on plan accounting	December 15, 2018	December 15, 2019

All entities that are not public business entities may adopt the amendments in this ASU earlier as of the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.

Early application by public business entities to financial statements of fiscal years or interim periods that have not yet been issued or, by all other entities, that have not yet been made available for issuance of the following amendments in this ASU are permitted as of the beginning of the fiscal year of adoption:

- An entity should present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk if the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments.

- Entities that are not public business entities are not required to apply the fair value of financial instruments disclosure guidance in the "General" subsection of FASB ASC 825-10-50.

With the exception of this early application guidance, early adoption of the amendments in this ASU is not permitted.

Impairment

Overview

On June 16, 2016, FASB issued ASU No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. Upon the effective date of this ASU, the incurred loss impairment methodology in current general accepted accounting principles (GAAP) is replaced with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates.

Assets Measured at Amortized Cost

ASU No. 2016-13 eliminates the probable initial recognition threshold under current GAAP and requires entities that measure financial assets (or a group of financial assets) at amortized cost basis to present such assets at the net amount expected to be collected. The amendments in this ASU broaden the information that an entity must consider in developing its expected credit loss estimate for assets measured either collectively or individually. In addition to past events and current conditions, entities should also consider reasonable and supportable forecasts that affect the collectibility of the reported amount. However, an entity may revert to historical loss information that is reflective of the contractual term (considering the effect of prepayments) for periods that are beyond the time frame for which the entity is able to develop reasonable and supportable forecasts.

An entity may apply any method for measuring expected credit losses as long as their method reasonably reflects its expectations of the credit loss estimate.

Purchased Financial Assets With Credit Deterioration

ASU No. 2016-13 defines *purchased financial assets with credit deterioration* (PCD assets) as acquired individual financial assets (or acquired groups of financial assets with similar risk characteristics) that as of the date of acquisition have experienced a more-than-insignificant deterioration in credit quality since origination, as determined by the acquirer's assessment. The allowance for credit losses for PCD assets that are measured at amortized cost basis is determined in a similar manner to other financial assets measured at amortized cost basis. The initial allowance for credit losses is added to the purchase price, rather than being reported as a credit loss expense. Entities record only subsequent changes in the allowance for credit losses as a credit loss expense for PCD assets. Furthermore, an entity should recognize interest income for PCD assets based on the effective interest rate, excluding the discount embedded in

the purchase price that is attributable to the acquirer's assessment of credit losses at acquisition.

Disclosures

In an effort to increase users' understanding of underwriting standards and credit quality trends, ASU No. 2016-13 requires the current disclosure on credit quality indicators in relation to the amortized cost of financing receivables to be further disaggregated by year of origination (or vintage). Entities that are not public business entities are not required to disclose the disaggregation by year of origination.

Available for Sale Debt Securities

Entities will now be required to present credit losses on available-for-sale debt securities as an allowance, rather than as a permanent write-down.

An entity will now be able to record reversals of credit losses on debt securities (in situations in which the estimate of credit declines) in current period net income. Thus, aligning the income statement recognition of credit losses with the reporting period in which changes occur. However, an entity may not record an allowance for credit losses exceeding the amount by which fair value is below amortized cost.

Purchased Debt Securities With Credit Deterioration

The allowance for credit losses for purchased available-for-sale debt securities with a more-than-insignificant amount of credit deterioration since origination is also determined in a similar manner to other available-for-sale debt securities. However, ASU No. 2016-13 requires an entity to add the initial allowance for credit losses to the purchase price, rather than reporting it as a credit loss expense. Entities record only subsequent changes in the allowance for credit losses as a credit loss expense. Furthermore, an entity should recognize interest income based on the effective interest rate, excluding the discount embedded in the purchase price that is attributable to the acquirer's assessment of credit losses at acquisition.

Troubled Debt Restructurings

The ASU does not change the definition or derecognition guidelines for troubled debt restructurings (TDRs), but, rather, changes the impairment recognized on restructuring. Credit losses for TDRs now will be measured using the current expected credit loss model. The ASU eliminates the current GAAP requirement to use a discounted cash flow technique. Credit losses, including concessions given to a borrower under a TDR, will be recognized through an allowance account.

Applicability and Effective Date

ASU No. 2016-13 affects entities holding financial assets and net investment in leases that are not accounted for at fair value through net income. It also affects loans, debt securities, trade receivables, net investments in leases, off-balance sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash.

Because there is diversity in practice in applying the incurred loss methodology, ASU No. 2016-13 will affect entities to varying degrees depending on the credit quality of the assets held by the entities, their duration, and how the entity applies current GAAP.

ASU No. 2016-13 is effective as follows:

	<i>Fiscal Years Beginning After</i>	<i>Interim Periods Within Fiscal Years Beginning After</i>
Public business entities that are SEC filers	December 15, 2019	December 15, 2019
All other public entities	December 15, 2020	December 15, 2020
All other entities, including not-for-profit entities and employee benefit plans within the scope of FASB ASC 960–965 on plan accounting	December 15, 2020	December 15, 2021

All entities may adopt the amendments in this ASU earlier as of the fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

Transition Resource Group

Due to the potential for significant changes that may result from the issuance of the new standard, FASB has formed the Transition Resource Group (TRG) for Credit Losses to

- solicit, analyze, and discuss stakeholder issues arising from implementation of the new guidance.
- inform FASB about those implementation issues, which will help FASB determine what, if any, action will be needed to address those issues.
- provide a forum for stakeholders to learn about the new guidance from others involved with implementation.

The TRG will meet to discuss and share their views on potential implementation issues raised by concerned parties and, subsequent to each meeting, FASB will determine what actions, if any, will be taken on each issue. Refer to the page "Transition Resource Group for Credit Losses" on FASB's website for more information on this group and the status of their efforts, including meeting materials and meeting summaries.

Hedge Accounting

Overview

Hedge accounting is the third phase in FASB's overall project on accounting for financial instruments. The objective of this project is to make targeted improvements to the hedge accounting model based on the feedback received from preparers, auditors, users, and other stakeholders. FASB has also noted it will consider opportunities to align with IFRS 9, *Financial Instruments*.

Latest Developments

FASB staff are drafting a proposed ASU based on the tentative decisions reached by the board. Readers are encouraged to visit the "Technical Agenda" page under "Projects" at www.fasb.org for the latest developments regarding the hedge accounting phase.

Conclusion

The extent of the effect of the new financial instruments standards will depend upon the relative significance of financial instruments to an entity's operations and financial position as well as the entity's business strategy. To provide CPAs with guidance during this time of transition, the AICPA's Financial Reporting Center (FRC) offers invaluable resources on the topic. In addition, the FRC includes a list of conferences, webcasts, and products to keep you informed on the latest developments in accounting for financial instruments. Refer to www.aicpa.org/interestareas/frc/accountingfinancialreporting/financialinstruments/pages/default.aspx to stay updated on the latest information available on accounting for financial instruments.

Appendix E

Information Sources

This appendix is nonauthoritative and is included for informational purposes only.

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 listed telephone numbers are voice lines unless otherwise designated as fax (f) lines.

Information Sources

Organization	General Information	Fax Services	Available Publications
American Association of Homes and Services for the Aging	AAHSA Publications Dept. 5119 Washington, DC 20061-5119 202.783.2242 www.leadingage.org		<i>Continuing Care Retirement Communities: An Industry in Action</i>
American Hospital Association	<i>Order Department</i> P.O. Box 92683 Chicago, IL 60675-2683 800.AHA.2626	Fax-on-Demand 312.422.2020	<i>Hospital Statistics National Hospital Panel Survey Report</i>
American Medical Association	<i>Order Department</i> 515 N. State Street Chicago, IL 60610-4325 800.621.8335	Information-on-Request Fax Line 800.621.8335	"Socioeconomic Resources in Medicine: Review of the Literature"
Center for Health Care Industry Performance Studies	<i>Order Department</i> 1550 Old Henderson Road Suite S277 Columbus, OH 43220-3626 800.859.2447		<i>Almanac of Hospital Financial and Operating Indicators</i>

(continued)

Information Sources—continued

Organization	General Information	Fax Services	Available Publications
Healthcare Financial Management Association	<i>Order Department</i> 2 Westbrook Corporate Center Suite 700 Westchester, IL 60154 800.252.4362		<i>hfm</i> magazine Issue Analysis 98-1, <i>Compliance with Laws and Regulations for Healthcare Organizations</i>
Health Leaders-InterStudy	<i>Order Department</i> One Vantage Way B-300 Nashville, TN 37228 800.643.7600	Fax-on-Demand 615.385.4979	<i>Competitive Edge: The HMO Industry Report</i>
Medical Group Management Association	<i>Order Department</i> P.O. Box 17603 Denver, CO 80217-0603 877.275.6462	Fax-on-Demand 303.784.6110	<i>Cost Survey Practice Management: Academic Practice</i>

Organization	General Information	Fax Services	Website Address	Recorded Announcements
American Institute of Certified Public Accountants	<i>Order Department</i> 220 Leigh Farm Road Durham, NC 27707-8110 888.777.7077 If outside of the United States, call 919.402.2317	<i>24 Hour Fax Hotline</i> 800.362.5066	www.aicpa.org	
American Society of Actuaries	475 N Martingale Road # 600, Schaumburg, IL 60173 847.706.3500		https://www.soa.org	
Financial Accounting Standards Board	<i>Order Department</i> 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116 203.847.0700, ext. 10 800.748.0659		www.fasb.org	<i>Action Alert Telephone Line</i> 203.847.0700, ext. 444

Organization	General Information	Fax Services	Website Address	Recorded Announcements
Governmental Accounting Standards Board	<i>Order Department</i> 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116 203.847.0700, ext. 10 800.748.0659		www.gasb.org	
Government Accountability Office	441 G Street, NW Washington, DC 20548		www.gao.gov	
Government Printing Office	732 N. Capitol Street, NW Washington, DC 20401-0001		www.gpo.gov	
National Association of Insurance Commissioners	1100 Walnut Street, Suite 1500 Kansas City, MO 64106-2197		www.naic.org	
Office of Management and Budget	725 17th Street, NW Washington, DC 20503 202.395.3080		www.omb.gov	
Securities and Exchange Commission	100 F Street, NE Washington, DC 20549 <i>Publications Unit</i> 202.551.4040 <i>SEC Public Reference Information Line</i> 202.942.8088, ext. 4 TTY 202.551.6020		www.sec.gov	

Appendix F

Category B Guidance

This appendix is nonauthoritative and is included for informational purposes only.

As discussed in chapter 15, "Unique Considerations of State and Local Government Health Care Entities," of this guide, GASB Statement No. 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, establishes the hierarchy of generally accepted accounting principles (GAAP) for state and local governments. The GAAP hierarchy consists of sources of accounting principles used in the preparation of financial statements so that they are presented in accordance with GAAP and the framework for selecting those principles. Sources of category B guidance include AICPA literature specifically made applicable to state and local governmental entities and cleared by GASB, such as certain provisions in this guide. This appendix lists the category B guidance that is included in this guide. Category B guidance appears in orange font in this guide.

Location	Nature of Guidance	GASB Codification Reference 2016–2017
Paragraph 1.08c and footnote 1	Definition of <i>government</i>	1000.801; 1000 fn4
Paragraph 15.87	Reporting of proceeds from bonds issued by a financing authority	P80.801 Ho5.801
Paragraph 15.133	Exclusion of charity care from revenue	P80.802 Ho5.802
Paragraph 15.136	Disclosure information about charity care in the notes to the financial statements	P80.803 Ho5.803
Paragraph 15.145	Statement of Position 98-2, <i>Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising</i> (AICPA, <i>Professional Standards</i> , ACC sec. 10)	Ho5.804-.817

Appendix G

The New Leases Standard: FASB ASU No. 2016-02

This appendix is nonauthoritative and is included for informational purposes only.

Overview

Issuance and Objective

On February 25, 2016, FASB issued Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842)*. The objective of the ASU is to increase transparency and comparability in financial reporting by requiring balance sheet recognition of leases and note disclosure of certain information about lease arrangements. This ASU codifies the new FASB ASC topic 842, *Leases*, and makes conforming amendments to other FASB ASC topics.

The new FASB ASC topic on leases consists of these subtopics:

- a. Overall
- b. Lessee
- c. Lessor
- d. Sale and leaseback transactions
- e. Leveraged lease arrangements

Applicability and Effective Date

ASU No. 2016-02 is applicable to any entity that enters into a lease and is effective as follows:

	<i>Fiscal Years Beginning After</i>	<i>Interim Periods Within Fiscal Years Beginning After</i>
Public business entities, certain not-for-profit entities with conduit financing arrangements, and employee benefit plans	December 15, 2018	December 15, 2018
All other entities	December 15, 2019	December 15, 2020

FASB ASC 842 applies to all leases and subleases of property, plant, and equipment; it specifically does not apply to the following nondepreciable assets accounted for under other FASB ASC topics:

- a. Leases of intangible assets
- b. Leases to explore for or use nonregenerative resources such as minerals, oil, and natural gas
- c. Leases of biological assets, such as timber

- d. Leases of inventory
- e. Leases of assets under construction

Main Provisions

Overall

Identifying a Lease

Key changes in the guidance are illustrated by comparing the definition of a lease in FASB ASC 840 (extant GAAP) and FASB ASC 842.

<i>FASB ASC 840</i>	<i>FASB ASC 842</i>
An agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time.	A contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.

The identification of a lease under FASB ASC 842 should be based on the presence of key elements in the definition.

Separating Components of a Lease Contract

Under FASB ASC 842, a contract that contains a lease should be separated into lease and nonlease components. Separation should be based on the right to use; each underlying asset should be considered to be separate from other lease components when both of the following criteria are met:

- a. The lessee can benefit from the right-of-use of the asset (either alone or with other readily available resources)
- b. The right-of-use is neither highly dependent on or highly interrelated with other underlying assets in the contract

The consideration in the contract should be allocated to the separate lease and nonlease components in accordance with provisions of FASB ASC 842.

Lessees can make an accounting policy election to treat both lease and nonlease elements as a single lease component.

Lease Classification

When a lease meets any of the following specified criteria at commencement, the lease should be classified by the lessee and lessor as a finance lease and a sales-type lease, respectively. These criteria can be summarized as follows:

- a. Transfers ownership to lessee
- b. Purchase option reasonably certain to be exercised
- c. Lease term for major portion of asset's remaining economic life
- d. Present value of lease payments and residual value exceeds substantially all of the fair value of the underlying asset
- e. Specialized nature of underlying asset results in no expectation of alternative use after the lease term

If none of the above criteria are met, the lease should be classified as follows:

Lessee—classify as an operating lease

Lessor—classify as an operating lease unless (1) the present value of the lease payments and any residual value guarantee that equals or exceeds substantially all of the fair value of the underlying asset and (2) it is probable that the lessor will collect the lease payments plus any residual value guarantee. If both of these summarized criteria from FASB ASC 842-10-25-3 are met, the lessor should classify the lease as a direct financing lease.

Lease Term and Measurement

The lease term is the noncancellable period of the lease together with all of the following:

- a. Period covered by the option for the lessee to extend the lease if the option is reasonably certain to be exercised
- b. Period covered by option for lessee to terminate the lease if reasonably certain not to be exercised
- c. Period covered by option for lessor to extend or not terminate the lease if option is controlled by lessor.

Lease Payments

Lease payments relating to use of the underlying asset during the lease term include the following at the commencement date:

- a. Fixed payments less incentives payable to lessee
- b. Variable lease payments based on an index or other rate
- c. Exercise price of an option to purchase the underlying asset if it is reasonably certain to be exercised
- d. Payments for penalties for terminating a lease if the lease term reflects exercise of lessee option
- e. Fees paid by the lessee to the owners of a special purpose entity for structuring the lease
- f. For lessee only, amounts probable of being owed under residual value guarantees

Lease payments specifically exclude the following:

- a. Certain other variable lease payments
- b. Any guarantee by the lessee of the lessor's debt
- c. Certain amounts allocated to nonlease components

Reassessment of the lease term and purchase options, and subsequent remeasurement by either the lessee or lessor are limited to certain specified circumstances.

Lessee

Recognition and Measurement

Commencement Date

At the commencement date of the lease, a lessee should recognize a right-of-use asset and a lease liability; for short term leases, an alternative accounting policy election is available.

The lease liability should be measured at the present value of the unpaid lease payments. The right-of-use asset should consist of the following: the amount of the initial lease liability; any lease payments made to lessor at or before the commencement date minus any incentives received; and initial direct costs.

A short term lease is defined by the FASB ASC master glossary as a lease that, at the commencement date has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise. The accounting policy election for short term leases should be made by class of underlying asset. The election provides for recognition of the lease payments in profit or loss on a straight-line basis over the lease term and variable lease payments in the period in which the obligation for those payments is incurred.

After the Commencement Date

After the commencement date, the lessee should recognize in profit or loss (unless costs are included in the carrying amount of another asset) the following:

- Finance leases:
 - a. Amortization of the right-of-use asset and interest on the lease liability
 - b. Variable lease payments not included in the lease liability in the period obligation incurred
 - c. Any impairment
- Operating leases:
 - a. A single lease cost calculated such that the remaining cost is allocated on a straight line basis over the remaining lease term (unless another allocation is more representative of the benefit from use of the asset)
 - b. Variable lease payments not included in the lease liability in the period in which the obligation is incurred
 - c. Any impairment

Subsequent Measurement

FASB ASC 842-20-35 provides guidance for subsequent measurement.

Presentation and Disclosure

Key presentation matters include the following:

- Statement of financial position.
 - Separate presentation of right-of-use assets and lease liabilities from finance leases and operating leases.
- Statement of comprehensive income.
 - Finance leases—interest expense on the lease liability and amortization of right-of-use asset in a manner consistent with how the entity presents other interest expense and depreciation or amortization of similar assets.
 - Operating leases—expense to be included in the lessee's income from continuing operations.

- Statement of cash flows.
 - Presentation within financing activities—the repayment of the principal portion of the lease liability arising from finance leases.
 - Presentation within operating activities—payments arising from operating leases; interest payments on the lease liability; variable lease payments and short term lease payments not included in lease liability.

Disclosure requirements include qualitative and quantitative information for leases, significant judgements, and amounts recognized in the financial statements, including certain specified information and amounts.

Lessor

Recognition and Measurement

FASB ASC 842 provides recognition guidance for sales-type leases, direct financing leases, and operating leases. The following table summarizes the guidance:

<i>Sales-Type Leases</i>	
At the Commencement Date	After the Commencement Date
<p>Lessor should derecognize the underlying asset and recognize the following:</p> <ul style="list-style-type: none"> a. Net investment in the lease (lease receivable and unguaranteed residual asset) b. Selling profit or loss arising from the lease c. Initial direct costs as an expense 	<p>Lessor should recognize all of the following:</p> <ul style="list-style-type: none"> a. Interest income on the net investment in the lease b. Certain variable lease payments c. Impairment
<i>Direct Financing Leases</i>	
At the Commencement Date	After the Commencement Date
<p>Lessor should derecognize the underlying asset and recognize the following:</p> <ul style="list-style-type: none"> a. Net investment in the lease (lease receivable and unguaranteed residual asset reduced by selling profit) b. Selling loss arising from the lease, if applicable 	<p>Lessor should recognize all of the following:</p> <ul style="list-style-type: none"> a. Interest income on the net investment in the lease b. Certain variable lease payments c. Impairment

(continued)

<i>Operating Leases</i>	
At the Commencement Date	After the Commencement Date
Lessor should defer initial direct costs.	Lessor should recognize all of the following: <ol style="list-style-type: none"> a. The lease payments as income in profit or loss over the lease term on a straight line basis (unless another method is more representative of the benefit received) b. Certain variable lease payments as income in profit or loss c. Initial direct costs as an expense over the lease term on the same basis as lease income

FASB ASC 842-30-35 provides guidance for subsequent measurement.

Presentation and Disclosure

Key presentation matters include the following:

For sales-type and direct financing leases:

- Statement of financial position
 - Separate presentation of lease assets (that is, aggregate of lessor's net investment in sales-type leases and direct financing leases) from other assets.
 - Classified as current or noncurrent based on same considerations as other assets.
- Statement of comprehensive income
 - Presentation of income from leases in the statement of comprehensive income or disclosure of income from leases in the notes with a reference to the corresponding line in the statement of comprehensive income.
 - Presentation of profit or loss recognized at commencement date in a manner appropriate to lessor's business model.
- Statement of cash flows
 - Presentation within operating activities—cash receipts from leases.

For operating leases:

- Statement of financial position

- Presentation of an underlying asset subject to an operating leases in accordance with other FASB ASC topics.
- Statement of cash flows
 - Presentation within operating activities—cash receipts from leases.

Disclosure requirements include qualitative and quantitative information for leases, significant judgements, and amounts recognized in the financial statements, including certain specified information and amounts.

Sale and Leaseback Transactions

FASB ASC 842 provides guidance for both the transfer contract and the lease in a sale and leaseback transaction (a transaction in which a seller-lessee transfers an asset to a buyer-lessor and leases that asset back). Determination of whether the transfer is a sale should be based on provisions of FASB ASC 606, *Revenue from Contracts with Customers*. FASB ASC 842-40-25 provides measurement guidance for a transfer that is either determined to be a sale or determined not to be a sale.

FASB ASC 842-40 provides guidance for subsequent measurement, financial statement presentation, and disclosures.

Leveraged Lease Arrangements

The legacy accounting model for leveraged leases continues to apply to those leveraged leases that commenced before the effective date of FASB ASC 842. There is no separate accounting model for leveraged leases that commence after the effective date of FASB ASC 842.

Appendix H

The New Not-for-Profit Financial Reporting Model Standards: FASB ASU No. 2016-14

Overview

In August 2016, FASB issued Accounting Standards Update (ASU) No. 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities* (the ASU). The ASU, which is the first phase of a two-phase project, makes significant changes in seven areas:

- Net asset classes
- Liquidity and availability of resources
- Classification and disclosure of underwater endowment funds
- Expense reporting
- Statement of cash flows
- Investment return
- Release of restrictions on capital assets.

The amendments in FASB ASU No. 2016-14 are effective for annual financial statements issued for fiscal years beginning after December 15, 2017 (for example, years ending December 31, 2018 and years ending June 30, 2019), and for interim periods within fiscal years beginning after December 15, 2018. Application to interim financial statements is permitted but not required in the initial year of application. Early application of the amendments is permitted.

The amendments are to be applied on a retrospective basis in the year that they are first applied. However, if presenting comparative financial statements, a not-for-profit entity (NFP) has the option to omit the following information for any periods presented before the period of adoption:

1. Analysis of expenses by both natural classification and functional classification (the separate presentation of expenses by functional classification and expenses by natural classification is still required). NFPs that previously were required to present a statement of functional expenses do not have the option to omit this analysis; however, they may present the comparative period information in any of the formats permitted in the ASU, consistent with the presentation in the period of adoption.
2. Disclosures about liquidity and availability of resources.

In the period that the amendments are first applied, an NFP should disclose the nature of any reclassifications or restatements and their effects, if any, on changes in the net asset classes for each period presented.

Net Asset Classes

The three classes of net assets used in financial statements of not-for-profit organizations (unrestricted, temporarily restricted, and permanently restricted) will be replaced with two classes of net assets—net assets with donor restrictions and net assets without donor restrictions. Because the definition

of donor-imposed restriction is essentially unchanged, the effect of the change is that temporarily restricted net assets and permanently restricted net assets are combined in the statement of financial position and the statement of activities to become a single class—net assets with donor restrictions. Unrestricted net assets are now referred to as net assets without donor restrictions. (Changes in classification of underwater endowment funds and in the release of restrictions on capital assets are discussed later in this appendix.)

An NFP will be required to present, on the face of the statement of financial position, net assets with donor restrictions and net assets without donor restrictions, as well as the currently required amount for total net assets. On the statement of activities, an NFP will be required to present the change in each of the two net asset classes as well as the currently required amount of the change in total net assets.

The current requirement to provide relevant information about the nature and amounts of donor restrictions on net assets (either on the face of the statement of financial position or in the notes) has been retained. Information about how the restrictions affect the use of resources is also required. Note B in the "Pending Content" in *FASB Accounting Standards Codification (ASC) 958-205-55-21* provides the following example of such a disclosure:

Net assets with donor restrictions are restricted for the following purposes or periods.

Subject to expenditure for specified purpose:

Program A activities:	
Purchase of equipment	\$ 3,060
Research	950
Educational seminars and publications	240
Program B activities:	
Disaster relief	745
Educational seminars and publications	280
Program C activities: general	
Buildings and equipment	2,150
Annuity trust agreements for research	2,815
	10,450

Subject to the passage of time:

For periods after June 30, 20X1	3,140
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Subject to NFP spending policy and appropriation:

Investment in perpetuity (including amounts above original gift amount of \$122,337), which, once appropriated, is expendable to support:	
Program A activities	33,300
Program B activities	15,820
Program C activities	16,480
Any activities of the organization	109,100
	174,700

Subject to appropriation and expenditure when a specified event occurs:

Endowment requiring income to be added to original gift until fund's value is \$2,500	2,120
Paid-up life insurance policy that will provide proceeds upon death of insured for an endowment to support general activities	80
	<u>2,200</u>

Not subject to appropriation or expenditure:

Land required to be used as a recreation area	3,000
Total net assets with donor restrictions	<u>\$193,490</u>

In addition to information about net assets with donor restrictions, NFPs will also be required to disclose, as of the end of the reporting period, the amounts and purposes of governing board designations, appropriations, and similar actions that result in self-imposed limits on the use of resources that are free of donor-imposed restrictions. Note DD in the "Pending Content" in FASB ASC 958-205-55-21 provides the following example of such a disclosure:

Not-for-Profit Entity A's governing board has designated, from net assets without donor restrictions of \$92,600, net assets for the following purposes as of June 30, 20X1.

Quasi-endowment	\$36,600
Liquidity reserve	1,300
Total	<u>\$37,900</u>

Liquidity and Availability of Resources

Among the key objectives of FASB's NFP reporting project was the need to make it easier for readers of the financial statements to assess the organization's liquidity and to determine the availability of restricted resources to fund general expenditures. An organization will be required to disclose both qualitative and quantitative information about how it manages its liquid resources. The "Pending Content" in FASB ASC 958-210-50-1A requires an NFP to provide the following:

- a. Qualitative information useful in assessing an entity's liquidity that communicates how the NFP manages its liquid resources available to meet cash needs for general expenditures within one year of the balance sheet date.
- b. Quantitative information that communicates the availability of an NFP's financial assets at the balance sheet date to meet cash needs for general expenditures within one year of the balance sheet date. Availability of a financial asset may be affected by the following:
 - i. Its nature
 - ii. External limits imposed by donors, laws, and contracts with others
 - iii. Internal limits imposed by governing board decisions

ASU No. 2016-14 doesn't provide standards as to the types of qualitative or quantitative information to include. However, there are three examples of notes that meet the requirements (Note G in FASB ASC 958-205-55-21 and Example 2 in FASB ASC 958-210-55). Those examples include qualitative disclosures about the following:

- The organization's responsibility to maintain resources to meet donor restrictions, which may make those resources unavailable for general expenditures
- The organization's goals for maintaining financial assets
- The organization's policies for investing excess cash
- The organization's policies for spending from board designated quasi-endowment funds
- Contractual agreements that make certain financial assets unavailable to fund general expenditures
- Lines of credit that would be drawn down if the organization did not have any liquid, available financial assets

The ASU does not define general expenditures. Because the determination of which expenditures are general expenditures affects the determination of whether a financial asset is available to meet cash needs for general expenditures, the additional qualitative information required by FASB ASC 958-210-50-1(b) may need to include a description of how both general expenditures and availability of financial resources are determined by the NFP.

The "Pending Content" in FASB ASC 958-205-55-21 provides quantitative information in the form of a reconciliation, as of the financial statement date, of total financial assets to financial assets available to meet cash needs for general expenditures within one year. The reconciling items include amounts for financial assets that are not available for general expenditures, as shown in the following example, Note G:

The following reflects Not-for-Profit Entity A's financial assets as of the balance sheet date, reduced by amounts not available for general use because of contractual or donor-imposed restrictions within one year of the balance sheet date. Amounts not available include amounts set aside for long-term investing in the quasi-endowment that could be drawn upon if the governing board approves that action. However, amounts already appropriated from either the donor-restricted endowment or quasi-endowment for general expenditure within one year of the balance sheet date have not been subtracted as unavailable.

Financial assets, at year end	\$ 234,410
Less those unavailable for general expenditures within one year, due to:	
Contractual or donor-imposed restrictions:	
Restricted by donor with time or purpose restrictions	(11,940)
Subject to appropriation and satisfaction of donor restrictions	(174,700)
Investments held in annuity trust	(4,500)

Board designations:

Quasi-endowment fund, primarily for long-term investing	(36,600)
Amounts set aside for liquidity reserve	<u>(1,300)</u>
Financial assets available to meet cash needs for general expenditures within one year	<u>\$ 5,370</u>

Not-for-Profit Entity A is substantially supported by restricted contributions. Because a donor's restriction requires resources to be used in a particular manner or in a future period, Not-for-Profit Entity A must maintain sufficient resources to meet those responsibilities to its donors. Thus, financial assets may not be available for general expenditure within one year. As part of Not-for-Profit Entity A's liquidity management, it has a policy to structure its financial assets to be available as its general expenditures, liabilities, and other obligations come due. In addition, Not-for-Profit Entity A invests cash in excess of daily requirements in short-term investments. Occasionally, the board designates a portion of any operating surplus to its liquidity reserve, which was \$1,300 as of June 30, 20X1. There is a fund established by the governing board that may be drawn upon in the event of financial distress or an immediate liquidity need resulting from events outside the typical life cycle of converting financial assets to cash or settling financial liabilities. In the event of an unanticipated liquidity need, Not-for-Profit Entity A also could draw upon \$10,000 of available lines of credit (as further discussed in Note XX) or its quasi-endowment fund.

The "Pending Content" in FASB ASC 958-210-55-6 through 55-8 (Example 2) provides fact sets and example disclosures for two additional cases. They provide quantitative information in the form of a list of financial assets that are available to meet cash needs for general expenditures.

Based on the fact set in FASB ASC 958-210-55-6, the following disclosure is illustrated:

NFP A has \$395,000 of financial assets available within 1 year of the balance sheet date to meet cash needs for general expenditure consisting of cash of \$75,000, contributions receivable of \$20,000, and short-term investments of \$300,000. None of the financial assets are subject to donor or other contractual restrictions that make them unavailable for general expenditure within one year of the balance sheet date. The contributions receivable are subject to implied time restrictions but are expected to be collected within one year. NFP A has a goal to maintain financial assets, which consist of cash and short-term investments, on hand to meet 60 days of normal operating expenses, which are, on average, approximately \$275,000. NFP A has a policy to structure its financial assets to be available as its general expenditures, liabilities, and other obligations come due. In addition, as part of its liquidity management, NFP A invests cash in excess of daily requirements in various short-term investments including, certificate of deposits and short term treasury instruments. As more fully described in Note XX, NFP A also has committed lines of credit in the amount

of \$20,000, which it could draw upon in the event of an unanticipated liquidity need.

Based on the fact set FASB ASC 958-210-55-8, the following disclosure is illustrated to accompany a classified statement of financial position:

NFP A's financial assets available within one year of the balance sheet date for general expenditure are as follows:

Cash and cash equivalents	\$4,575
Accounts and interest receivable	2,130
Contributions receivable	1,825
Short-term investments	1,400
Other investments appropriated for current use	10,804
	<u>\$20,734</u>

NFP A's endowment funds consist of donor-restricted endowments and a quasi-endowment. Income from donor-restricted endowments is restricted for specific purposes and, therefore, is not available for general expenditure. As described in Note Y, the quasi-endowment has a spending rate of 5 percent. \$1.65 million of appropriations from the quasi-endowment will be available within the next 12 months.

As part of NFP A's liquidity management, it has a policy to structure its financial assets to be available as its general expenditures, liabilities, and other obligations come due. In addition, NFP A invests cash in excess of daily requirements in short-term investments. To help manage unanticipated liquidity needs, NFP A has committed lines of credit in the amount of \$20 million, which it could draw upon. Additionally, NFP A has a quasi-endowment of \$33 million. Although NFP A does not intend to spend from its quasi-endowment other than amounts appropriated for general expenditure as part of its annual budget approval and appropriation process, amounts from its quasi-endowment could be made available if necessary. However, both the quasi-endowment and donor-restricted endowments contain investments with lock-up provisions that would reduce the total investments that could be made available (see Note X for disclosures about investments).

Classification and Disclosure of Underwater Endowment Funds

In conjunction with the changes in the net asset classes and new required disclosures about liquidity and availability of financial assets, there are new accounting and disclosure requirements for underwater endowment funds. The ASU adds a definition of an underwater endowment fund to the FASB ASC Master Glossary as follows:

A donor-restricted endowment fund for which the fair value of the fund at the reporting date is less than either the original gift amount or the amount required to be maintained by the donor or by law that extends donor restrictions.

Current standards require the deficit of a donor-restricted endowment fund to be included in unrestricted net assets. The "Pending Content" in FASB ASC 958-205-45-13H states that "If a donor-restricted endowment fund is an underwater endowment fund, the accumulated losses shall be included together with that fund in net asset with donor restrictions." In other words, the endowment fund's balance is simply reduced. The fund balance of a donor-restricted endowment fund is entirely within net assets with donor restrictions, and the fund balance for a board-designated endowment fund is entirely within net assets without donor restrictions (unless the governing board designated resources that were purpose restricted by the donor to serve as an endowment). Changes were also made to an NFP health care entity's performance indicator to remove the requirement to separately report the increases and decreases in net assets without donor restrictions due to underwater endowment funds because those increases and decreases will no longer be reported in that net asset class.

In addition, the "Pending Content" in FASB ASC 958-205-50-2 requires that for each period for which a statement of financial position is presented, an NFP disclose each of the following, in the aggregate, for all underwater endowment funds:

- The fair value of the underwater endowment funds
- The original endowment gift amount or level required to be maintained by donor stipulations or by law that extends donor restrictions
- The amount of the deficiencies of the underwater endowment funds ((a) less (b))

To help readers of the financial statements understand the effects on availability of resources caused by an underwater condition, the pending content in FASB ASC 958-205-50-1B requires disclosures of the governing board's interpretation of laws affecting the ability to spend from underwater endowment funds, the organization's policies for spending from underwater endowment funds, and any actions taken during the period concerning appropriation from underwater endowment funds.

Analysis of Expenses by Function and Nature

ASU No. 2016-14 expands to all not-for-profit organizations the requirement to present an analysis of expenses by functional and natural classifications. That information, currently required only of voluntary health and welfare entities (paragraph 1.06), must be provided in one location—either on the face of the statement of activities, as a schedule in the notes to financial statements, or in a separate financial statement. The analysis must disaggregate the expense information by functional expense classifications, such as major classes of program services and supporting activities, and by natural expense classifications, such as salaries, rent, electricity, interest expense, supplies, depreciation, awards and grants to others, and professional fees. Expenses that are reported by other than their natural classification (such as salaries included in cost of goods sold or facility rental costs of special events reported as direct benefits to donors), must be reported by their natural classification in the analysis. Investment expenses that have been netted against investment return and items that are typically reported in other comprehensive income of for-profit entities (FASB ASC 220-10-45-10A) should not be included in the functional expense

analysis. The "Pending Content" in FASB ASC 958-205-55-21 provides an example of the analysis in Note F.

In addition to the analysis, NFPs will be required to provide a description of the methods used to allocate costs among program and support functions. To make those allocations more comparable between NFPs, the "Pending Content" in paragraphs 171–175 of FASB ASC 958-720-55 provide examples of activities that constitute direct conduct or direct supervision of program activities (and thus are program expenses) rather than management and general expenses. There are examples for the costs related to the chief executive officer, the chief financial officer, the human resource department, and for grant accounting and reporting. The "Pending Content" in FASB ASC 958-720-55-176 provides an example of the required disclosure.

Statement of Cash Flows

The new standards continue to permit an organization to choose whether to provide a statement of cash flows using the direct or indirect method of reporting operating cash flows. However, to encourage greater use of the direct method, if an NFP chooses to present cash flows from operations using the direct method, the indirect reconciliation will no longer be required. There are no changes to the classification of operating, investing and financing cash flows.

Investment Return

The ASU distinguishes between programmatic investing (the activity of making loans or other investments that are directed at carrying out a not-for-profit entity's purpose for existence) and total return investing (the activity of investing for the general production of income or appreciation of an asset). The new standards require that investment expenses related to total return investing be netted against investment return on the statement of activities and eliminate the requirement to disclose investment expenses that have been netted. That change was made to provide a more comparable measure of investment return across all not-for-profit organizations, regardless of whether the investment activities are managed internally or by outside investment managers, volunteers, or some combination. The new measure is also more comparable across organizations that invest in mutual funds, hedge funds, or other vehicles for which the management fees are embedded in the investment return of the vehicle. Because the disclosure of the netted expenses is eliminated, the difficulties and related costs in identifying embedded fees are eliminated, and the resultant inconsistencies in the reported amounts of investment expenses are avoided. Although no longer required to do so, an NFP may choose to continue to provide information about the netted investment expenses if it so desires. Netted investment expenses are limited to external investment expenses and direct internal investment expenses incurred during the period.

In addition, the ASU eliminates requirements for following disclosures about investment return. Although it may continue to do so, an NFP is no longer required to:

- Disclose investment income (for example, interest, dividends, rents) separately from the net appreciation or depreciation of investments

- Disclose the composition of investment return (investment income, net realized gains or losses on investments reported at other than fair value, and net gains or losses on investments reported at fair value)
- Provide a reconciliation of investment return to amounts reported in the statement of activities if investment return is separated into operating and nonoperating amounts.

Investment expenses that are netted against investment return are prohibited from inclusion in the analysis of expenses by functional and natural classifications.

Release Restrictions on Capital Assets

The ASU requires NFPs to use the placed-in-service approach to report expirations of restrictions on gifts of long-lived assets and cash or other assets to be used to acquire or construct long-lived assets (in the absence of specific donor restrictions stating otherwise). It eliminates the option of an NFP to adopt an accounting policy to imply a time restriction that expires over the useful life of the donated assets and recognize the release of the restriction ratably over the useful life of the asset.

In Conclusion

The AICPA encourages you to visit its website at aicpa.org and the Not-for-Profit Section at www.aicpa.org/interestareas/notforprofit/pages/default.aspx to assist in understanding the new standards and in implementing them. Certain content on the AICPA's website is restricted to AICPA members and the content in the Not-for-Profit Section is restricted to section members.

Although the changes seem numerous, implementing the majority of them should not be onerous. FASB staff members are encouraging early adoption of the standard. They point out that most of the new requirements are currently available as options within existing standards and can be used without formally adopting ASU No. 2016-14 early. Any of the following changes can be voluntarily included in financial statements now because they are not inconsistent with the existing standards:

- Use of the term net assets without donor restrictions rather than unrestricted net assets
- Disclosure of board-designated net assets and changes in them
- Increased detail in the disclosure of the restrictions on temporarily and permanently restricted net assets
- The qualitative liquidity and availability disclosures
- The quantitative liquidity and availability disclosure
- Presentation of an analysis of expenses by function and nature in one location
- Disclosure of cost allocation methods and bases
- Disclosure of the aggregate fair value and aggregate of original endowment gifts (or other level required by donor stipulation or by laws) for underwater endowment funds, in addition to the currently required aggregate deficit for underwater endowment funds

- Disclosure of policies for spending from underwater endowment funds

The following changes would be inconsistent with current standards and should only be incorporated in financial statements when ASU No. 2016-14 is fully adopted:

- Combining the temporarily restricted and permanently restricted net asset classes into one net asset class
 - Presenting a deficit in a donor-restricted endowment fund in a restricted net asset class rather than in unrestricted net assets
 - Eliminating the disclosure of investment expenses that are netted against investment return
 - Eliminating the three disclosures about investment return
 - Eliminating the indirect method reconciliation when using the direct method on the statement of cash flows
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Appendix I

Schedule of Changes Made to the Text From the Previous Edition

This appendix is nonauthoritative and is included for informational purposes only.

As of September 1, 2017

This schedule of changes identifies areas in the text and footnotes of this guide that have changed since the previous edition. Entries in the table of this appendix reflect current numbering, lettering (including that in appendix names), and character designations that resulted from the renumbering or reordering that occurred in the updating of this guide.

<i>Reference</i>	<i>Change</i>
General	Guide content included in shaded areas and "Guidance Update" boxes within the chapters have been updated to appropriately reflect guidance not yet effective as of the date of the guide. See the preface of this guide for more explanation to this "dual guidance" treatment.
General	Editorial changes, including rephrasing, may have been made in this guide to improve readability where necessary.
Preface	Updated.
Footnote 2 in paragraph 2.10	Deleted.
Paragraphs 2.15 and 2.28	Deleted PCAOB standards discussion of audits of internal control.
Paragraphs 2.78 and 2.85–.86	Revised to reflect the issuance of FASB Accounting Standards Update (ASU) No. 2014-15, <i>Presentation of Financial Statements—Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern</i> .
Paragraphs 2.78–.89	Revised to reflect this issuance of Statement on Auditing Standards (SAS) No. 132, <i>The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern</i> (AICPA, <i>Professional Standards</i> , AU-C sec. 570).

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<i>Reference</i>	<i>Change</i>
Paragraph 2.116	Added to reflect the issuance of Interpretation No. 3, "Providing Access to or Copies of Engagement Documentation to a Regulator" (AICPA, <i>Professional Standards</i> , AT-C sec. 9105 par. .15–.30), of AT-C section 105, <i>Concepts Common to All Attestation Engagements</i> .
Paragraph 3.16	Revised for the issuance of FASB ASU No. 2015-01, <i>Income Statement—Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items</i> , and FASB ASU No. 2016-19, <i>Technical Corrections and Improvements</i> .
Paragraphs 3.21–.22	Revised for the issuance of FASB ASU No. 2015-01.
Paragraph 4.37	Revised to reflect the issuance of FASB ASU No. 2015-07, <i>Fair Value Measurement (Topic 820): Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent) (a consensus of the Emerging Issues Task Force)</i> .
Paragraph 5.17	Revised to reflect the issuance of FASB ASU No. 2016-05, <i>Derivatives and Hedging (Topic 815): Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships (a consensus of the Emerging Issues Task Force)</i> .
Paragraph 6.31	Revised for the issuance of FASB ASU No. 2015-01.
Paragraph 6.35	Revised to reflect the issuance of FASB ASU No. 2015-05, <i>Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer's Accounting Fees Paid in a Cloud Computing Arrangement</i> .
Paragraphs 7.12–.13	Revised to correspond more completely with Chapter 18, "Auditor Involvement With Municipal Securities Filings," of the AICPA Audit and Accounting Guide <i>State and Local Governments</i> .

<i>Reference</i>	<i>Change</i>
Paragraph 7.45	Revised to reflect the issuance of FASB ASU No. 2015-03, <i>Interest—Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs</i> .
Paragraph 7.65	Revised to reflect the issuance of FASB ASU No. 2015-01.
Paragraph 7.69	Revised to reflect the issuance of FASB ASU No. 2016-01, <i>Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities</i> .
Paragraphs 7.86–.94	Revised to reflect the issuance of SAS No. 133, <i>Auditor Involvement With Exempt Offering Documents</i> (AICPA, <i>Professional Standards</i> , AU-C sec. 945).
Footnote 10 in paragraph 7.86	Revised to correspond more completely with Chapter 18 of the AICPA Audit and Accounting Guide <i>State and Local Governments</i> .
Former paragraph 7.88	Deleted, see paragraph 7.95.
Paragraphs 7.91–.92 and 7.98–.99	Revised to correspond more completely with Chapter 18 of the AICPA Audit and Accounting Guide <i>State and Local Governments</i> .
Paragraphs 7.101–.102	Added to correspond more completely with Chapter 18 of the AICPA Audit and Accounting Guide <i>State and Local Governments</i> .
Footnote 17 in paragraph 7.103	Deleted. Content moved into paragraph 7.103.
Paragraph 7.104	Revised to correspond more completely with Chapter 18 of the AICPA Audit and Accounting Guide <i>State and Local Governments</i> .
Paragraph 7.105	Added to reflect the issuance of Interpretation No. 1, "Responding to Requests for Reports on Matters Relating to Solvency" (AICPA, <i>Professional Standards</i> , AT-C sec. 9105 par. .01–.11), of AT-C section 105.

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<i>Reference</i>	<i>Change</i>
Appendix to chapter 7	Revised to correspond more completely with Chapter 18 of the AICPA Audit and Accounting Guide <i>State and Local Governments</i> .
Paragraph 8.77	Revised to reflect the issuance of FASB ASU No. 2016-19.
Paragraph 11.12	Revised to reflect the issuance of FASB ASU No. 2015-10, <i>Technical Corrections and Improvements</i> .
Exhibit 12-1, paragraph 12.05	Revised to reflect the issuance of FASB ASU Nos. 2015-02, <i>Consolidation (Topic 810): Amendments to the Consolidation Analysis</i> , and 2017-02, <i>Not-for-Profit Entities—Consolidation (Subtopic 958-810): Clarifying When a Not-for-Profit Entity That Is a General Partner or a Limited Partner Should Consolidate a For-Profit Limited Partnership or Similar Entity</i> .
Paragraph 12.12	Revised to reflect the issuance of FASB ASU No. 2015-10.
Paragraph 12.34	Revised to reflect the issuance of FASB ASU No. 2016-07, <i>Investments—Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting</i> .
Paragraphs 12.41–42	Revised to reflect the issuance of FASB ASU Nos. 2015-02 and 2017-02.
Paragraph 12.54	Deleted content moved to paragraph 12.62.
Former paragraph 12.55	Deleted, see paragraph 12.62.
Paragraph 12.60	Updated to eliminate repetitive guidance.
Paragraph 12.102	Deleted content moved to paragraph 12.114.
Former paragraph 12.103	Deleted, see paragraph 12.114.
Paragraph 15.08	Revised for clarity.
Paragraph 15.11	Revised for issuance of GASB Implementation Guide No. 2016-1, <i>Implementation Guidance Update—2016</i> . Revised for the passage of time.

<i>Reference</i>	<i>Change</i>
Footnote 7 in paragraph 15.11	Revised to provide cross-reference to related guidance.
Paragraphs 15.13–.14 and footnote 9	Revised to provide further understanding of deferred inflows of resources and deferred outflows of resources not related to issuance of new authoritative guidance.
Paragraph 15.23	Revised to provide further understanding of capital contributions from other fund within the primary government, not related to an issuance of new authoritative guidance.
Paragraph 15.25	Added to reflect the issuance of GASB Statement No. 69, <i>Government Combinations and Disposal of Government Operations</i> .
Former paragraph 15.32	Deleted, see paragraph 15.122.
Paragraphs 15.34–.35	Added to provide further understanding of measurement attributes, not related to and issuance of new authoritative guidance.
Paragraphs 15.39–.40	Revised to reflect the issuance of GASB Statement No. 72, <i>Reporting for Certain Investments and for External Investment Pools</i> , and to provide further understanding of measurement of certain investments not related to an issuance of new authoritative guidance.
Paragraph 15.41	Added to reflect the issuance of GASB Implementation Guide 2016-1.
Paragraph 15.42	Moved from paragraph 15.40.
Former paragraphs 15.39–.42	Deleted for passage of time. See paragraphs 15.44–.45, 15.47–.49, and 15.50.
Paragraph 15.43 and Exhibit 15-1	Revised to provide further understanding of measurement of investments that are measured at other than fair value, not related to the issuance of new authoritative guidance.
Paragraph 15.44	Added to reflect the issuance of GASB Statement No. 72, <i>Reporting for Certain Investments and for External Investment Pools</i> .

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<i>Reference</i>	<i>Change</i>
Paragraphs 15.45–.46	Revised to provide further understanding of use of the equity method, not related to the issuance of new authoritative guidance.
Paragraphs 15.47–.51	Added to reflect the issuance of GASB Statement No. 72, <i>Reporting for Certain Investments and for External Investment Pools</i> .
Former footnote 19, paragraph 15.53	Deleted, see paragraph 15.53.
Paragraph 15.54	Revised to further understanding of impairment of investments, not related to the issuance of new authoritative guidance.
Paragraph 15.58	Revised to simplify list.
Former paragraphs 15.65–.66	Deleted, see paragraphs 15.184–.185.
Paragraph 15.68–.70	Added to reflect the issuance of GASB Statement No. 72 and GASB Implementation Guide No. 2016-1.
Former paragraphs 15.72–.73	Deleted, see paragraphs 15.105–.106.
Paragraphs 15.74–.75	Revised to further understanding of intangible assets, not related to the issuance of new authoritative guidance.
Paragraphs 15.77–.79	Added to reflect the issuance of GASB Statement No. 69.
Paragraphs 15.81–.82	Revised for clarity.
Paragraph 15.85	Revised to further understanding of disclosures for service concession arrangements, not related to the issuance of new authoritative guidance.
Paragraph 15.86 and footnote 24	Revised to reflect the issuance of SAS No. 133.
Paragraphs 15.89–.91 and footnotes 25 and 27–29.	Revised to reflect the issuance of GASB Statement No. 86, <i>Certain Debt Extinguishment Issues</i> .
Paragraph 15.93	Revised to reflect the issuance of GASB Implementation Guide No. 2016-1 and FASB ASU No. 2015-03.
Paragraph 15.94	Revised to reflect the issuance of GASB Statement No. 86.
Paragraph 15.110, former footnote 27	Deleted for passage of time.

<i>Reference</i>	<i>Change</i>
Paragraph 15.111	Added to reflect the issuance of GASB Statement No. 78, <i>Pensions Provided Through Certain Multiple-Employer Defined Benefit Pension Plans</i> .
Paragraph 15.112	Moved from paragraph 15.109.
Paragraphs 15.113–.114 and footnote 33	Revised to reflect the issuance of GASB Statement No. 75, <i>Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions</i> , and GASB Statement No. 85, <i>Omnibus 2017</i> .
Paragraph 15.116	Added to further the understanding of postemployment benefits other than pensions, not related to the issuance of new authoritative guidance.
Paragraph 15.122	Revised to further the understanding of disclosures for postemployment benefits including pensions, not related to the issuance of new authoritative guidance.
Paragraph 15.143	Revised to reflect the issuance of GASB Statement No. 81, <i>Irrevocable Split-Interest Agreements</i> .
Paragraph 15.145	Revised for clarity.
Paragraph 15.149	Revised to further the understanding of component units, not related to the issuance of new authoritative guidance. Footnote 54 added.
Paragraph 15.150	Revised for clarity. See paragraph 15.152.
Paragraphs 15.151 and 15.153–.154	Revised to further the understanding of component units, not related to the issuance of new authoritative guidance. Footnote 54 added.
Paragraph 15.155	Revised to reflect the issuance of GASB Statement No. 80, <i>Blending Requirements for Certain Component Units—an amendment to GASB Statement No. 14</i> . Revised to reflect the issuance of GASB Implementation Guide No. 2017-1, <i>Implementation Guidance Update—2017</i> . Revised to further the understanding of component units, not related to the issuance of new authoritative guidance.

(continued)

<i>Reference</i>	<i>Change</i>
Paragraph 15.156 and footnote 56	Revised to reflect the issuance of GASB Statement No. 85.
Paragraph 15.157	Revised to reflect the issuance of GASB Statement No. 72. Revised to further the understanding of component units, not related to the issuance of new authoritative guidance.
Paragraph 15.158	Revised to further the understanding of component units, not related to the issuance of new authoritative guidance.
Paragraphs 15.163–.165	Revised to reflect the issuance of GASB Statement No. 72. Revised to further the understanding of component units, not related to the issuance of new authoritative guidance.
Paragraphs 15.166–.169	Added to further the understanding of joint ventures, not related to the issuance of new authoritative guidance.
Paragraph 15.172	Revised for clarity. See paragraph 15.155.
Paragraphs 15.173–.174	Revised to further the understanding of institutionally-related foundations, not related to the issuance of new authoritative guidance.
Paragraphs 15.176–.177	Revised to reflect the issuance of GASB Statement No. 69.
Paragraphs 15.178–.190	Added to reflect the issuance of GASB Statement No. 69.
Paragraph 15.185	Revised to reflect the issuance of GASB Statement No. 85.
Paragraphs 15.199–.201	Moved from former box preceding paragraph 15.01.
Paragraph 15.206, footnotes 71–72	Added to further the understanding of independent auditor reports, not related to the issuance of new authoritative guidance.
Appendix B	Updated.

<i>Reference</i>	<i>Change</i>
Appendix C	Updated to reflect this issuance of FASB ASU No. 2016-20, <i>Technical Corrections and Improvements to Topic 606 Update 2014-09</i> , Revenue from Contracts with Customers (Topic 606), and No. 2017-05, <i>Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets</i> .
Appendix H	Added to reflect the issuance of FASB ASU No. 2016-14, <i>Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities</i> .
Appendix I	Updated and relocated from former appendix H.
Index of Pronouncements and Other Technical Guidance	Updated.
Subject Index	Updated.

Glossary

The following terms can be found in the FASB *Accounting Standards Codification* (ASC) glossary:

acquiree. The business or businesses that the acquirer obtains control of in a business combination. This term also includes a nonprofit activity or business that a not-for-profit acquirer obtains control of in an acquisition by a not-for-profit entity.

acquirer. The entity that obtains control of the acquiree. However, in a business combination in which a variable interest entity is acquired, the primary beneficiary of that entity always is the acquirer.

acquisition by a not-for-profit entity. A transaction or other event in which a not-for-profit acquirer obtains control of one or more nonprofit activities or businesses and initially recognizes their assets and liabilities in the acquirer's financial statements. When applicable guidance in FASB ASC 805, *Business Combinations*, is applied by a not-for-profit entity (NFP), the term business combination has the same meaning as this term has for an NFP. Likewise, a reference to business combinations in guidance that links to FASB ASC 805 has the same meaning as a reference to acquisitions by NFPs.

acquisition date. The date on which the acquirer obtains control of the acquiree.

advance refunding. A transaction involving the issuance of new debt to replace existing debt with the proceeds from the new debt placed in trust or otherwise restricted to retire the existing debt at a determinable future date or dates.

affiliate. A party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an entity.

agent. An entity that acts for and on behalf of another. Although the term *agency* has a legal definition, the term is used broadly to encompass not only legal agency, but also the relationships described in FASB ASC 958, *Not-for-Profit Entities*. A recipient entity 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 entity 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 entity also acts as an agent if a beneficiary can compel the recipient entity to make distributions to it or on its behalf.

© Update Glossary *Accounting and Reporting: Definition of a Business*

FASB Accounting Standards Update (ASU) No. 2017-01, *Business Combinations (Topic 805): Clarifying the Definition of a Business*, issued in issued in January 2017, is effective for annual periods of public business entities beginning after December 15, 2017, including interim periods within those periods. For all other entities, the amendments in FASB ASU No. 2017-01 are

effective for annual periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019.

FASB ASU No. 2016-20 amends the definition of a *business* to include reference to requirements in FASB ASC 805-10-55 that must be met for an integrated set of activities and assets to be considered a business. This edition of the guide has not been updated to reflect changes as a result of this ASU; however, the definition that follows will be updated in a future edition.

Readers are encouraged to consult the full text of the ASU on FASB's website at www.fasb.org.

business. An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants. Additional guidance on what a business consists of is presented in paragraphs 4–9 of FASB ASC 805-10-55.

business combination. A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as true mergers or mergers of equals also are business combinations. See also [**business and**] **acquisition by a not-for-profit entity**.

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, hospitals, and other similar providers. Capitation fees may be determined actuarially or negotiated based on expected costs to be incurred.

cash flow hedge. A hedge of the exposure to variability in the cash flows of a recognized asset or liability, or of a forecasted transaction, that is attributable to a particular risk.

charity care. Charity care represents health care services that are provided but are never expected to result in cash flows. Charity care is provided to a patient with demonstrated inability to pay. Each entity establishes its own criteria for charity care consistent with its mission statement and financial ability.

claim adjustment expenses. Expenses incurred in the course of investigating and settling claims [(further industry-specific information is provided in the following list of terms)].

collaborative arrangement. A contractual arrangement that involves a joint operating activity (see FASB ASC 808-10-15-7). These arrangements involve two (or more) parties that meet both of the following requirements:

- a. They are active participants in the activity (see paragraphs 8–9 of FASB ASC 808-10-15).
- b. They are exposed to significant risks and rewards dependent on the commercial success of the activity (see paragraphs 10–13 of FASB ASC 808-10-15).

compensation. Reciprocal transfers of cash or other assets in exchange for services performed.

conditional promise to give. A promise to give that depends on the occurrence of a specified future and uncertain event to bind the promisor.

conduit debt securities. Certain limited-obligation revenue bonds, certificates of participation, or similar debt instruments issued by a state or local governmental entity for the express purpose of providing financing for a specific third party (the conduit bond obligor) that is not a part of the state or local government's financial reporting entity. Although conduit debt securities bear the name of the governmental entity that issues them, the governmental entity often has no obligation for such debt beyond the resources provided by a lease or loan agreement with the third party on whose behalf the securities are issued. Further, the conduit bond obligor is responsible for any future financial reporting requirements.

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. Those characteristics distinguish contributions from exchange transactions, which are reciprocal transfers in which each party receives and sacrifices approximately equal value; from investments by owners and distributions to owners, which are nonreciprocal transfers between an entity and its owners; and from other nonreciprocal transfers, such as impositions of taxes or legal judgments, fines, and thefts, which are not voluntary transfers. In a contribution transaction, the value, if any, returned to the resource provider is incidental to potential public benefits. In an exchange transaction, the potential public benefits are secondary to the potential proprietary benefits to the resource provider. The term *contribution revenue* is used to apply to transactions that are part of the entity's ongoing major or central activities (revenues), or are peripheral or incidental to the entity (gains). See also **inherent contribution**.

control. The direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise.

diagnosis-related group. A patient classification scheme that categorizes patients who are related medically with respect to primary and secondary diagnosis, age, or complications [(further industry-specific information is provided in the following list of terms)].

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 a use for a contributed asset that is more specific than broad limits resulting from the following:

- a. The nature of the not-for-profit entity (NFP)
- b. The environment in which it operates
- c. The purposes specified in its articles of incorporation or bylaws or comparable documents for an unincorporated association.

A donor-imposed restriction on an NFP's use of the asset contributed may be temporary or permanent. Some donor-imposed restrictions impose limits that are permanent, for example, stipulating that resources

be invested in perpetuity (not used up). Others are temporary, for example, stipulating that resources may be used only after a specified date, for particular programs or services, or to acquire buildings and equipment.

economic interest. A not-for-profit entity's (NFP's) interest in another entity that exists if any of the following criteria are met:

- a. The other entity holds or utilizes significant resources that must be used for the unrestricted or restricted purposes of the NFP, either directly or indirectly by producing income or providing services.
- b. The NFP is responsible for the liabilities of the other entity.

See FASB ASC 958-810-55-6 for examples of economic interests.

endowment fund. An established fund of cash, securities, or other assets used to provide income for the maintenance of a not-for-profit entity (NFP). 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 either of the following:

- a. A permanent endowment, which is to provide a permanent source of income
- b. A term endowment, which is to provide income for a specific period.

Alternatively, an NFP's governing board may earmark a portion of its unrestricted net assets as a board-designated endowment fund.

equity transfer. An equity transfer is nonreciprocal. An equity transfer is a transaction directly between a transferor and a transferee. Equity transfers are similar to ownership transactions between a for-profit parent and its owned subsidiary (for example, additional paid-in capital or dividends). However, equity transfers can occur only between related not-for-profit entities if 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).

fed funds effective swap rate (or overnight index swap rate). The fixed rate on a U.S. dollar, constant-notional interest rate swap that has its variable-rate leg referenced to the Fed Funds effective rate with no additional spread over the Fed Funds effective rate on that variable-rate leg. That fixed rate is the derived rate that would result in the swap having a zero fair value at inception because the present value of fixed cash flows, based on that rate, equates to the present value of the variable cash flows.

financially interrelated entities. A recipient entity and a specified beneficiary are financially interrelated entities if the relationship between them has both of the following characteristics:

- a. One of the entities has the ability to influence the operating and financial decisions of the other.
- b. One of the entities has an ongoing economic interest in the net assets of the other.

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.

fundraising activities. Activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets, or time.

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.

incurred but not reported claims. Claims relating to insured events that have incurred but have not yet been reported to the insurer or reinsurer as of the date of the financial statements [(further industry-specific information is provided in the following list of terms)].

inherent contribution. A contribution that results if an entity voluntarily transfers assets (or net assets) or performs services for another entity in exchange for either no assets or for assets of substantially lower value and unstated rights or privileges of a commensurate value are not involved.

in-substance defeasance. Placement by the debtor of amounts equal to the principal, interest, and prepayment penalties related to a debt instrument in an irrevocable trust established for the benefit of the creditor [(further industry-specific information is provided in the following list of terms)].

intermediary. Although in general usage the term intermediary encompasses a broad range of situations in which an entity acts between two or more other parties, in this usage, it refers to situations in which a recipient entity 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.

legal entity. Any legal structure used to conduct activities or to hold assets. Some examples of such structures are corporations, partnerships, limited liability companies, grantor trusts, and other trusts.

maintenance costs. Costs associated with maintaining records relating to insurance contracts and with the processing of premium collections and commissions [(further industry-specific information is provided in the following list of terms)].

management and general activities. Activities that are not identifiable with a single program, fundraising activity, or membership-development activity but that are indispensable to the conduct of those activities and to an entity's existence.

membership development activities. Membership development activities include soliciting for prospective members and membership dues, membership relations, and similar activities. However, if there are no significant benefits or duties connected with membership, the substance of membership development activities may, in fact, be fundraising.

merger date. The date on which the merger becomes effective.

merger of not-for-profit entities. A transaction or other event in which the governing bodies of two or more not-for-profit entities (NFPS) cede control of those entities to create a new NFP.

natural expense classification. A method of grouping expenses according to the kinds of economic benefits received in incurring those expenses. Examples of natural expense classifications include salaries and wages, employee benefits, supplies, rent, and utilities.

net assets. The excess or deficiency of assets over liabilities of a not-for-profit entity, which is classified into three mutually exclusive classes according to the existence or absence of donor-imposed restrictions. See also **unrestricted net assets**, **temporarily restricted net assets**, and **permanently restricted net assets**.

nonfinancial assets. An asset that is not a financial asset. Nonfinancial assets include land, buildings, use of facilities or utilities, materials and supplies, intangible assets, or services.

nonprofit activity. An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing benefits, other than goods or services at a profit or profit equivalent, as a fulfillment of an entity's purpose or mission (for example, goods or services to beneficiaries, customers, or members). As with a not-for-profit entity, a nonprofit activity possesses characteristics that distinguish it from a business or a for-profit business entity.

not-for-profit entity. An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:

- a. Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return
- b. Operating purposes other than to provide goods or services at a profit
- c. Absence of ownership interests like those of business entities

Entities that clearly fall outside this definition include the following:

- a. All investor-owned enterprises
- b. Entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans

performance indicator. A performance indicator reports results of operations. A performance indicator and the income from continuing operations reported by for-profit health care entities generally are consistent, except for transactions that clearly are not applicable to one kind of entity (for example, for-profit health care entities typically would not receive contributions, and not-for-profit health care entities would not award stock compensation). That is, a performance indicator is analogous to income from continuing operations of a for-profit entity.

permanently restricted net assets. The part of the net assets of a not-for-profit entity (NFP) resulting from the following:

- a. Contributions and other inflows of assets whose use by the NFP 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 NFP.
- b. Other asset enhancements and diminishments subject to the same kinds of stipulations.
- c. Reclassification from or to other classes of net assets as a consequence of donor-imposed stipulations.

permanent restriction. A donor-imposed restriction that stipulates that resources be maintained permanently but permits the not-for-profit entity to use up or expend part or all of the income or other economic benefits derived from the donated assets.

prepaid health care plan. A plan in which the provider is compensated in advance by the sponsoring entity. The sponsoring entity 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.

prepaid health care services providers. Entities 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.

private company. Entities that are not public business entities, not-for-profits, or employee benefit plans.

program services. The activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the not-for-profit entity (NFP) exists. Those services are the major purpose for and the major output of the NFP and often relate to several major programs.

prospective rate setting. 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.

public business entity. A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.

- a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
- b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
- c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
- d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
- e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

reinsurance. A transaction in which a reinsurer (assuming entity), for a consideration (premium), assumes all or part of a risk undertaken originally by another insurer (ceding entity). For indemnity reinsurance, the legal rights of the insured are not affected by the reinsurance transaction and the insurance entity issuing the insurance contract remains liable to the insured for payment of policy benefits. Assumption or novation reinsurance contracts that are legal replacements of one insurer by another extinguish the ceding entity's liability to the policyholder [(further industry-specific information is provided in the following list of terms)].

retrospective rate setting. Under retrospective rate setting, third parties usually determine an interim payment rate and, during the rate period (generally one year), pay the health care entity 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. 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.

stop-loss insurance. A contract in which an entity agrees to indemnify providers for certain health care costs incurred by members.

tail coverage. Insurance designed to cover malpractice claims incurred before, but reported after, cancellation or expiration of a claims-made insurance policy.

temporarily restricted net assets. The part of the net assets of a not-for-profit entity (NFP) resulting from the following:

- a. Contributions and other inflows of assets whose use by the NFP is limited by donor-imposed stipulations that either expire by passage of time or can be fulfilled and removed by actions of the NFP pursuant to those stipulations
- b. Other asset enhancements and diminishments subject to the same kinds of stipulations
- c. Reclassification from or to 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 NFP pursuant to those stipulations

trading securities. Securities that are bought and held principally for the purpose of selling them in the near term and therefore held for only a short period of time. Trading generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price.

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. In some states, not-for-profit entities (NFPs) are organized under trust law rather than as corporations. Those NFPs are not trustees as defined because, under those statutes, they hold assets in trust for the community or some other broadly described group, rather than for a specific beneficiary.

unrestricted net assets. The part of net assets of a not-for-profit entity (NFP) that is neither permanently restricted nor temporarily restricted by donor-imposed stipulations. The only limits on the use of unrestricted net assets are the broad limits resulting from the following:

- a. The nature of the NFP
- b. The environment in which the NFP operates
- c. The purposes specified in the NFP's articles of incorporation or bylaws
- d. Limits resulting from contractual agreements with suppliers, creditors, and others entered into by the NFP in the course of its business

Unrestricted net assets generally result from revenues from providing services, producing and delivering goods, receiving unrestricted contributions, and receiving dividends or interest from investing in

income-producing assets, less expenses incurred in providing services, producing and delivering goods, raising contributions, and performing administrative functions.

variable interest entity. A legal entity subject to consolidation according to the provisions of the "Variable Interest Entities" subsections of FASB ASC 810-10.

voluntary health and welfare entity. A not-for-profit entity (NFP) that is formed for the purpose of performing voluntary services for various segments of society and that is 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 entities 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 entities include those NFPs 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. For purposes of this definition, the general public excludes government entities when determining whether an NFP is a voluntary health and welfare entity.

The following is a list of additional terms that have been used in this guide and further information on select terms defined in the FASB ASC 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.

administrative services only (ASO). A contract between a third-party company and self-funded plan in which the third-party company performs administrative services only and does not assume any risks. The employer is at risk for the cost of provided health care services. Services normally include claims processing but may include other services, such as actuarial analysis, utilization review, data reporting, and stop-loss coverage. This is a common arrangement when an employer sponsors a self-funded health care program.

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.

allocated loss adjustment expense. Claim expense that can be assigned to individual claims (for example, attorney's fees, claim adjusting service fees, or court costs).

allowable costs. Costs that are allowable under the principles of reimbursement of Medicare and Medicaid or contractual agreements with their payors, such as Blue Cross and Blue Shield.

allowance. The difference between gross patient service revenues charged at established rates for services rendered and amounts received or to be

received from patients or third-party payors. Allowances are to be distinguished from uncollectible losses. The types of allowances are as follows:

- *Charity allowances.* The difference between charges at established rates and amounts received from indigent patients, voluntary agencies, or governmental units on behalf of specific indigent patients. Charity allowances are subtracted from gross charges to compute gross patient service revenue.
- *Contractual allowances.* The difference between charges at established rates and amounts received from third-party payors under contractual agreement. Contractual allowances are subtracted from gross patient service revenue to compute net patient service revenue.
- *Courtesy allowances.* The difference between charges at established rates and amounts received from doctors, clergymen, employees, and employees' dependents. Also called policy discounts. Courtesy allowances are subtracted from gross patient service revenue to compute net patient service revenue.

ambulatory care. Provision of health care services to outpatients and other patients who do not require admission to the hospital as inpatients. Any type of medical care provided to a patient who is not hospitalized.

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).

ambulatory payment classifications (APC). The Medicare reimbursement mechanism that sets the prospectively established rate for outpatient reimbursement, which is similar to the diagnosis-related group (DRG) system that is used for inpatient reimbursement. APCs are based upon procedure versus diagnosis (as is used for DRGs) or encounter.

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 and Blue Shield); 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 entity by or on behalf of a patient alleging improper professional service.

assets limited as to use. Assets that are segregated and limited regarding how the assets may be used 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).

associated entity. An individual practice association, hospital, medical group, or similar health care entity 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.

benchmark. The process of comparing an entity's operations and financial data with that of other entities, particularly comparing one entity with the entity considered the best in the industry. Quantitative benchmarks are used to establish performance objectives. Among physicians, it is often the standard for quality medical care and can be applied to any condition or procedure.

best-efforts remarketing agreement. A financing agreement in which the agent agrees to buy only those securities that it is able to sell to others; if the agent is unable to remarket the debt, the issuer is obligated to pay off the debt.

board-designated funds. Unrestricted resources set aside by the governing board for specific purposes or projects or for investment to produce income as if they were endowment funds.

capitation arrangement. An arrangement in which certain medical and other defined health care services are provided by third-party health care providers to a specified population under contractual arrangement with payors. In a capitation arrangement, the primary entity retains responsibility for the quality and performance of the provided services.

case mix. Grouping of patients possessing similar clinical attributes and output utilization patterns, primarily for purposes of cost accounting and reimbursement. The classifications or categories of patients treated by a hospital. Case mix directly influences the length of stays and intensity, cost, and scope of services provided by a hospital. Also defined as a weighting of a patient's acuity in which the average acuity is one.

census, average daily. The average number of inpatients, excluding newborns, in the hospital or facility each day for a given period of time. Average daily census for any classification is computed by taking the total number of patient days of care for that classification throughout the period and dividing those days by the total number of days in that period.

Centers for Medicare & Medicaid Services (CMS). The federal agency responsible for Medicare and Medicaid programs.

claim adjustment expenses. Claim adjustment expenses include any legal fees and the costs of paying claims and all related expenses (defined in the FASB ASC glossary, as presented in the first section of this glossary).

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 entity used for diagnosis and treatment of outpatients.

coinsurance. A percentage that the insured member pays after the plan's deductible is exceeded and until the policy's stop-loss provision is reached. Sometimes used synonymously with copayment, but a *copayment* is a flat fee. See also **copayment**.

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 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.

community rating. The rating methodology required of federally-qualified health maintenance organizations (HMOs); HMOs under the laws of many states; and, occasionally, indemnity plans under certain circumstances. The HMO must obtain the same amount of money per member for all members in the plan. Community rating does allow for variability by allowing the HMO to factor in differences for age, sex, mix (average contract size), and industry factors; however, not all factors are necessarily allowed under state laws.

component unit. Component units are legally separate organizations for which the elected officials of the primary government are financially accountable. In addition, component units can be other organizations for which the nature and significance of their relationship with a primary government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete. A component unit may be a governmental organization, except those that meet the definition of a *primary government, nonprofit corporation, or for-profit corporation*.

conduit financing. A financing arrangement involving a government or other qualified agency using its name in an issuance of fixed income securities, generally for financing a not-for-profit entity's capital project. See also **conduit debt securities** in the FASB ASC glossary, as presented in the first section of this glossary.

continuing-care contract. An agreement between a resident and continuing care retirement community (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 called a residential care facility or 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.

copayment. That portion of a claim or medical expense that a member must pay out of pocket. Typical copayments are fixed or variable flat amounts for

physician office visits, prescriptions, or hospital services. Sometimes used synonymously with coinsurance, but *coinsurance* is a percentage payment. See also **coinsurance**.

cost-plus. A third-party administrator contract in which the employer pays the administrator a fee based on paid claims, such as a percentage of paid claims. The administrator funds the payment of claims and, therefore, is liable for unpaid claims if the employer is unable to pay the claims.

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 following:

- 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. See also **allowance**.

covered charges. The charges incurred by a patient that are covered under the contractual agreements with third-party payors.

common procedural terminology (CPT) coding. A coding structure used to code surgical procedures for statistical analysis and billing purposes. CPT coding was copyrighted by the American Medical Association, and the Centers for Medicare & Medicaid Services mandates the use of these codes for Medicare billing.

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 that the issuer is unable to place large amounts of maturing commercial paper with investors.

crossover refunding. 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 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. Also called a delayed defeasance.

debt reserve funds. The amount of funds or cash that needs to be set aside to fund debt repayment.

deductible. The portion of a member's health care expenses that must be paid out of pocket before any insurance coverage applies. Deductibles are common in indemnity insurance plans and preferred provider organizations, or PPOs, but uncommon in health maintenance organizations, or (HMOs).

defeasance. Legal satisfaction of refunded debt without the debt necessarily being retired.

diagnosis-related group (DRG). A statistical system of classifying any inpatient stay into groups for purposes of payment. DRGs may be primary or secondary, and an outlier classification also exists. This is the form of reimbursement that the Centers for Medicare & Medicaid Services uses to pay hospitals for Medicare recipients. Also used by a few states for all payors and by some private health plans for contracting purposes (defined in the FASB ASC glossary, as presented in the first section of this glossary).

donated services. Services of personnel who receive no monetary compensation or partial compensation. The term is usually applied to services rendered by members of religious orders, societies, or similar groups to institutions operated by, or affiliated with, such institutions.

durable medical equipment (DME). Medical equipment that is not disposable (that is, used repeatedly) and is only related to care for a medical condition. Examples would include wheelchairs and home hospital beds. An area of increasing expense, particularly in conjunction with case management.

Emergency Medical Treatment and Labor Act (EMTALA). A federal law governing assessment and transfer of patients seeking emergency care. Sometimes called Emergency Medical Treatment and Active Labor Act.

enrollee. An individual who is a subscriber or an eligible dependent of a subscriber in a prepaid health care plan.

enterprise fund. In governmental accounting, an enterprise fund may be used to report any activity for which a fee is charged to external users for goods or services. An enterprise fund is a proprietary fund that is generally used to account for governmental activities that are similar to activities that may be performed by a commercial enterprise.

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.

excess levels. The level of insurance coverage that applies to that portion of a loss or damage that exceeds a specified amount.

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 the number of occupied beds, outpatient visits, emergency room visits, and the number of residents by specialty.

Federal Employee Health Benefits Program. The program that provides health benefits to federal employees.

fee-for-service system. The traditional health care payment system under which providers receive a fee for each delivered service. Under the fee-for-service system, the total bill will increase not only if the fees increase but also if more units of service are rendered.

fee schedule. A comprehensive listing of fee maximums used to reimburse a provider on a fee-for-service basis. May also be referred to as fee maximums or a fee allowance schedule. A listing of the maximum fee that a health plan will pay for a certain service based on common procedural terminology billing codes.

final settlement. The ultimate liability of the health care entity to the third-party payor or the amount due to the health care entity from the payor as a result of determining the final total allowable cost for the reporting period and comparing that number with the amount that has been received from the payor for the reporting period.

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 that 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.

full medical risk. The risk from uncertainties about the frequency, severity, and health care costs of rendered medical services.

fund. A self-contained accounting entity set up to account for a specific activity or project.

gross charges. The total charges at established rates for services rendered to a patient.

- gross service revenues.** Gross charges less charity allowances (charity care at established rates).
- health care costs.** For managed care services, health care costs include costs incurred to provide benefits to members under risk arrangements, such as costs of capitation, wellness, network management, utilization management, quality assurance, and other health care services. Health care costs generally exclude general and administrative, selling, maintenance, marketing, and interest costs.
- health care services.** Services provided to individuals related to the diagnosis or treatment of physical or mental illness.
- Health Insurance Portability and Accountability Act (HIPAA) of 1996.** Enacted by the federal government to improve patient security and confidentiality and also to standardize the formatting of electronic transactions.
- home care.** This level of care involves visits by health care workers to the home of the patient.
- 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.
- hospital.** A health care institution with an organized medical and professional staff and permanent facilities that include inpatient beds and provide medical, nursing, and other health-related services to patients (each state has its own definition of *hospital* for accreditation purposes).
- incremental costs.** Costs that vary with, and are directly attributable to, changes in business, such as an additional employer or health maintenance organization, 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 associated with health care services incurred during a financial reporting period but not reported to the health care entity until after the financial reporting date. IBNR is also defined as potential claims for incidents associated with professional service that have occurred but have not yet been reported to the health care entity (defined in the FASB ASC glossary, as presented in the first section of this glossary).
- 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 specified fee for rendered services.
- 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 debtor is not legally released from being the primary obligor (defined in the FASB ASC glossary, as presented in the first section of this glossary).

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 (for example, inpatient acute care; ambulatory care; outpatient surgery; and 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 outstanding debt, but they do affect the issuer's debt portfolio and risk profile.

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. See also **nursing center**.

lag analysis. A report that tells managers the age of the claims that are being processed and the amount paid out each month (both for that month and any earlier months) and that compares those numbers with the amount of money that was accrued for expenses each month. A powerful tool used to determine whether the plan's reserves are adequate to meet all expenses. Plans that fail to properly perform lag studies may find themselves staring into the abyss.

length of stay (LOS). Number of calendar days that elapse between an inpatient's admission and discharge.

length of stay (average). A statistical measure of patient turnover determined by dividing the total number of patient days of care in a given period of time by the total number of inpatients who were discharged during that period.

London Interbank Offered Rate (LIBOR). A daily reference rate based on the interest rates at which banks offer to lend unsecured funds to other banks in the London wholesale money market.

long-term care. Provision of health, social, or personal care services on a recurring or continuous basis to persons with chronic physical or mental conditions who live in environments ranging from institutions to their own homes. This level of care is also called custodial care.

maintenance costs. Costs associated with maintaining enrollment records and processing premium collections and payments (defined in the FASB ASC glossary, as presented in the first section of this glossary).

managed care. A system of providing health care services to enrolled members in a plan through a defined network of health care providers who are given the responsibility to provide quality medical care while controlling the utilization of resources, use of expensive technologies, and access to specialists. Managed care can include a spectrum of systems, ranging from managed indemnity to preferred provider organizations, or, point of service, and open- and closed-panel health maintenance organizations, or HMOs.

managed care entities. A generic term applied to a managed care plan. These plans usually integrate the financing and delivery of health care services to an enrolled population. Managed care organizations contract with an organized provider network that either shares financial risks or has some incentive to deliver quality, cost-effective services. Also called managed care organizations.

mandatory tender. The requirement that a holder of a security surrender the security to the issuer or its agent (for example, a tender agent) for purchase. The tender date may be established under the bond contract or specified by the issuer upon the occurrence of an event specified in the bond contract. The purchase price typically is at par. Also called a mandatory put.

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.

Medicaid. Federal program created by Title XIX, "Medical Assistance," of the 1965 amendment to the Social Security Act of 1935 that provides health care benefits to indigent and medically-indigent persons (called Medi-Cal in California). Funded by the federal and state governments and administered by the states.

medical group. An association of physicians and other licensed health care professionals organized on a group basis to practice medicine.

Medicare. Federal program created by Title XVIII, "Health Insurance for the Aged," of the 1965 amendment to the Social Security Act of 1935 that provides health insurance benefits primarily to persons over the age of 65 and others eligible for Social Security benefits.

Medicare Administrative Contractors (MAC). A term used to describe those entities that are agents of the government in the application and provision of Medicare services. Previously referred to as a Medicare fiscal intermediary.

Medicare Part A. The portion of the Medicare program applicable to the reimbursement of inpatient hospital stays, critical access hospital services, certain care in a skilled nursing facility, hospice care, and some home health care.

Medicare Part B. The portion of the Medicare program applicable to the reimbursement of physician services, outpatient hospital care, durable medical equipment, and some medical services that are not covered by Medicare Part A.

Medicare Part C. The portion of the Medicare program created under the Balanced Budget Act of 1997 that includes the Medicare Advantage plans

(formerly called Medicare+Choice) through which beneficiaries can enroll in additional types of health plans, including managed care plans.

Medicare Part D. The portion of the Medicare program created under the Medicare Modernization Act of 2003 featuring a voluntary outpatient prescription drug benefit, along with an interim prescription drug discount card and transitional assistance programs.

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 an eligible dependent of a subscriber in a prepaid health care plan.

minimum premium contract. A third-party administrator contract in which the administrator provides stop-loss insurance. A minimum fee is paid by an obligated entity, such as an employer, to a third-party administrator, such as an insurance company, in exchange for the third party administering the payment of claims up to a specified amount. Typically, the obligated entity is responsible for claims up to a certain limit, such as a percentage of total claims or specified amount, and uses the third party to pay the claims on its behalf, usually out of an employer-owned bank account. However, the third-party administrator is responsible for all payments above the predetermined limit.

multiprovider captive. An insurance entity owned by two or more health care entities that underwrites malpractice insurance for its owners.

Municipal Swap Index. The Securities Industry and Financial Markets Association Municipal Swap Index, which is a commonly used underlying for interest rate swaps that are used as hedges of interest rate risk associated with variable-rate tax-exempt debt. Also called the SIFMA Index.

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, courtesy and policy discounts, or other adjustments and deductions, excluding charity care.

nonexchange transaction. As used in governmental financial accounting standards, an external transaction in which a government gives or receives value without directly receiving or giving equal value in exchange.

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.

nursing home. Institution with an organized professional staff and permanent facilities, including inpatient beds, that provides continuous nursing

and other health-related, psycho-social, and personal services to patients who are not in an acute phase of illness but who primarily require continued care on an inpatient basis.

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.

official statement (OS). The common term used for the offering document or offering circular prepared in connection with a new issue of municipal securities. Although functionally equivalent to the prospectus used in connection with registered securities, an official statement for municipal securities is exempt from the prospectus requirements of the Securities Act of 1933.

outliers. In referring to the Medicare Prospective Payment System, additional payments that are made for cases that have either unusually long lengths of stay or charges in excess of the cost outlier threshold.

outpatient. A patient who is not confined overnight in a health care institution. An ambulatory patient who visits the hospital for services but is not admitted to a hospital bed.

patient day. A common statistical measurement of hospital and inpatient activity. It represents one patient in the hospital or other facility overnight when the official patient census is taken. Many hospitals and providers follow the procedure of charging patients for fractional parts of a day or the day of discharge if the patient leaves after a particular hour referred to as the check-out time.

per diem reimbursement. Reimbursement of a health care entity based on a set rate per day, rather than charges. Per diem reimbursement can be varied by service (for example, medical or surgical, obstetrics, mental health, and intensive care) or uniform regardless of intensity of services.

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.

preferred provider organization (PPO). A plan that contracts with independent providers at a discount for services. The panel is limited in size and usually has some type of utilization review system associated with it. A PPO may be risk bearing, such as an insurance company, or nonrisk bearing, such as a physician-sponsored PPO that markets itself to insurance companies or self-insured companies via an access fee.

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.

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, outpatient clinic, or other outpatient department.

primary government. The foundation of a primary government is a separately elected governing body that is elected by the citizens in a general, popular election. As the nucleus of the financial reporting entity, the primary government generally is the focal point for the users of the financial statements. A primary government is any state government or general-purpose local government, municipality, or county. A primary government is also a special-purpose government (for example, a hospital district) that meets all of the following criteria:

- a. It has a separately elected governing body.
- b. It is legally separate.
- c. It is fiscally independent of other state and local governments.

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. Prospective rate setting is used to set provider rates under a PPS. See also **diagnosis-related group**.

protected health information (PHI). As defined by the Health Insurance Portability and Accountability Act of 1996 regulations, health information that is created or received by a health care provider and relates to the past, present, or future physical or mental health or condition of an individual.

provider. A person or entity that undertakes to provide health care services.

rate setting. Process of establishing rates for providers of health care services by taking into account the financial needs of the provider. See also **prospective rate setting** and **retrospective rate setting** (defined in the FASB ASC glossary, as presented in the first section of this glossary).

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.

rehabilitation facility. Facility that provides medical, health-related, social, or vocational services to disabled persons to help them attain their maximum functional capacity.

reimbursement, cost-based. Payment by a third-party payor to a hospital of all allowable costs covered by the contract that are incurred by the hospital in the provision of services to patients.

reimbursement, prospective. Method of third-party payment by which costs to be incurred by an institution in providing services to patients are based not on actual costs but estimates made at the beginning of a fiscal period.

reimbursement, retroactive. Additional payment by a third-party payor to an institution for services not identified at the time of initial reimbursement.

reimbursement, retrospective. Method of third-party payment by which costs incurred by a hospital in providing services to covered patients are based on actual costs determined at the end of a fiscal period.

- reinsurance.** Reinsurance includes insurance purchased by a health plan to protect it against extremely high cost cases. It is a type of protection purchased by health maintenance organizations (HMOs) from insurance companies specializing in underwriting specific risks for a stipulated premium. Typical reinsurance risk coverages are individual stop-loss, aggregate stop-loss, out-of-area, and insolvency protection. As HMOs grow in membership, they usually reduce their reinsurance coverage and related direct costs as they reach a financial position to assume such risks themselves (defined in the FASB ASC glossary, as presented in the first section of this glossary).
- resource-based relative value scales (RBRVS).** A system to determine how much money medical providers should be paid. It is currently used by Medicare and many health maintenance organizations, or HMOs.
- Resource Utilization Group (RUG).** A system that categorizes skilled nursing facilities' patients into similar medical diagnoses for purposes of Medicare reimbursement.
- retrospectively-rated insurance policy.** An insurance policy with a premium that is adjustable based on the experience of the insured health care entity or group of health care entities 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.
- risk pool.** A risk pool accumulates all the monies received from the capitation agreement and all the costs associated with providing patient services. At the end of the period, the excess of capitation payments over claims payments is distributed to the risk pool participants based upon the risk-sharing arrangement. See also **capitation arrangement**.
- secondary care.** Care that is rendered to inpatients in hospitals that offer short-term, acute-care services of either a general or specialized nature.
- self-insurance.** That portion of risk or loss assumed by a health care entity when no external insurance coverage exists.
- self-insured obligation.** The obligation for that portion of risk or loss assumed by a health care entity when no external insurance coverage exists.
- self-insured plan or self-funded plan.** A health plan in which the risk for medical cost is assumed by the company, rather than an insurance company or a managed care plan. Under the Employee Income Retirement Security Act of 1974, self-funded plans are exempt from state laws and regulations, such as premium taxes and mandatory benefits. Self-funded plans often contract with insurance companies or third-party administrators to administer the benefits.
- sinking fund.** A sinking fund is a means of repaying debt whereby the issuer makes periodic payments to a trustee who retires part of the issue, often by purchasing bonds on the open market.
- 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.

- 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.
- tender option.** A provision in a bond contract under which the investor has the right to surrender the securities to the issuer or someone acting on the issuer's behalf, such as a tender agent, at the predetermined price (usually par) and on specified dates after the required notification. Also called an optional tender or put option.
- tertiary care.** Care that is rendered in hospitals that possess the personnel, equipment, and expertise to handle complex cases.
- third-party administrator (TPA).** A party unrelated to a plan who contracts to be responsible for plan administration.
- third-party payor.** Any entity, such as Blue Cross and Blue Shield, Medicare, or a commercial insurance entity, that contracts with health care entities and patients to pay for the care of covered patients.
- 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.
- ultimate cost.** Total claims payments, including costs associated with litigating or setting claims.
- unasserted claim.** A medical malpractice claim that has not been formally asserted against a health care provider by, or on behalf of, a patient alleging improper professional service. It may relate to either reported or unreported incidents.
- unrelated business.** An activity that is a trade or business, regularly carried on, and not substantially related to furthering the exempt purpose of the not-for-profit entity. An unrelated business is subject to unrelated business income tax.
- 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.
- utilization (third party).** The ratio of hospital services provided to third-party beneficiaries in relation to services provided to all patients of the hospital. This is usually based upon days, charges, or costs.
- variable-rate demand notes (VRDN).** 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.
- wholly-owned captive.** An insurance entity subsidiary of a health care entity that provides malpractice insurance primarily to its parent entity.
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