



Audit and Accounting Guide

Health Care Entities

September 1, 2021



A resource of the
**Enhancing Audit
Quality Initiative**



Audit and Accounting Guide

Health Care Entities

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Preface

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

(Updated as of September 1, 2021)

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 practitioners in performing and reporting on their audit engagements and to assist management in the preparation of their financial statements in conformity with U.S. generally accepted accounting principles (GAAP).

An AICPA Guide containing auditing guidance related to generally accepted auditing standards (GAAS) is recognized as an interpretive publication, as defined in AU-C section 200B, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*.¹ Interpretive publications are recommendations on the application of 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 200B 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 the ASB chair's designee) and the chief auditor 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 existing GAAS.

Throughout this guide, when appropriate, reference is made to Technical Questions and Answers (Q&A) sections, which are considered other auditing publications. AU-C section 200B indicates that in applying the auditing guidance

¹ All AU-C sections can be found in AICPA *Professional Standards*.

included in an other auditing publication, the auditor should, exercising professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. Other auditing publications have no authoritative status; however, they may help the auditor understand and apply GAAS. The auditor is not expected to be aware of the full body of other auditing publications. Although the auditor determines the relevance of these publications in accordance with paragraph .28 of AU-C section 200B, the auditor may presume that other auditing publications published by the AICPA that have been reviewed by the AICPA Audit and Attest Standards staff are appropriate. These other auditing publications are listed in AU-C appendix F, *Other Auditing Publications*.

Any auditing guidance in a guide appendix or exhibit (whether a chapter or back matter appendix or exhibit) is also considered an "other auditing publication." While other auditing publications have no authoritative status, when 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*.² 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 guide applicable to the practitioner's attestation engagement. If the practitioner does not apply the attestation guidance included in an applicable interpretive publication, the practitioner should document how the requirements of the SSAE were complied with in the circumstances addressed by such attestation guidance.

Any attestation guidance in a guide appendix or exhibit (whether a chapter or back matter appendix or exhibit) 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 and the Accounting and Review Services Committee are the designated senior committees of the AICPA authorized to speak for the AICPA on all matters related to attestation in their respective areas of responsibility. Conforming changes made to the attestation guidance contained in this guide are approved by the ASB chair (or the ASB chair's designee) and the chief auditor 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

² All AT-C sections can be found in AICPA *Professional Standards*.

all ASB members have been provided an opportunity to consider and comment on whether the guide is consistent with the SSAEs.

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 the FinREC chair's 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 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" (ET sec. 1.320.001 and 2.320.001).³

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

³ All ET sections can be found in AICPA *Professional Standards*.

applicable AICPA Guide. Both appendixes and exhibits are included for informational purposes and have no authoritative status.

Recognition

2021 Guide Edition

AICPA Senior Committees

Auditing Standards Board

Tracy Harding, *Chair*

Financial Reporting Executive Committee

Angela Newell, *Chair*

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Guidance Considered in This Edition

This edition of the guide has been revised by 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, 2021, 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, 2021, is incorporated directly in the text of this guide. Relevant guidance issued but not yet effective as of September 1, 2021, but becoming effective on or before June 30, 2022, 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, 2022, 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. 2021-05, *Leases (Topic 842): Lessors — Certain Leases with Variable Lease Payments*
- GASB Statements, Interpretations, Technical Bulletins, and Implementation Guides issued through September 1, 2021
- Statement on Auditing Standards (SAS) No. 144, *Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources*
- Statement of Position 21-1, *Performing Agreed-Upon Procedures Related to Rated Exchange Act Asset-Backed Securities Third-Party Due Diligence Services as Defined by SEC Release No. 34-72936* (AUD sec. 65)⁴
- Interpretations issued or reissued through September 1, 2021

Users of this guide should consider guidance issued subsequent to those items listed previously to determine their effect, if any, on entities and engagements 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 H, "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.

FASB standards quoted are from *FASB Accounting Standards Codification* ©2021, Financial Accounting Foundation. All rights reserved. Used by permission.

GASB standards quoted are from GASB Statements, Concepts Statements, Interpretations, Implementation Guides, and Technical Bulletins, ©2021, Financial Accounting Foundation. All rights reserved. Used by permission.

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), should also refer to AICPA Audit Guide *Government Auditing Standards and Single Audits*.

⁴ All AUD sections can be found in AICPA *Professional Standards*.

Updates for ASB Statements on Auditing Standards — The Auditor Reporting Suite

Between May 2019 and May 2020, the ASB issued the following seven SASs that affect the auditor's report, which are referred to collectively as "the auditor reporting suite":

- SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*
- SAS No. 136, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA* (AU-C sec. 703)
- SAS No. 137, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports* (AU-C sec. 720)
- SAS No. 138, *Amendments to the Description of the Concept of Materiality*
- SAS No. 139, *Amendments to AU-C Sections 800, 805, and 810 to Incorporate Auditor Reporting Changes From SAS No. 134*
- SAS No. 140, *Amendments to AU-C Sections 725, 730, 930, 935, and 940 to Incorporate Auditor Reporting Changes From SAS Nos. 134 and 137*
- SAS No. 141, *Amendment to the Effective Dates of SAS Nos. 134–140*

SAS Nos. 134 and 136–140 and the amendments to other SASs made by these SASs are effective for audits of financial statements for periods ending after December 15, 2021. Early implementation is permitted. The effective dates were aligned so that these SASs would be implemented together, primarily to accommodate the amendments to the auditor reporting model. Accordingly, the ASB recommends they be implemented concurrently.

This guide has been updated for those recently issued SASs and for SAS No. 135, *Omnibus Statement on Auditing Standards — 2019*, in the following manner:

- If the text of the guide would change as a result of the amended AU-C section, the affected guide paragraph is repeated, updated, and shaded in gray. The distinct presentation of this content is intended to aid the reader in identifying the content that will be deleted upon the effective date of the SASs, as well as the text that will replace it (the guide's "dual guidance" treatment of applicable new guidance). Each gray-shaded paragraph includes a footnote showing the effective date of the SASs.
- If the text of the guide would not change, but the AU-C paragraph number referenced by the guide would change, a gray-shaded footnote has been added to the guide that indicates the new paragraph number and the effective date of the SASs.
- A "B" suffix has been added to references in the guide (for example, "AU-C section 300B") to denote content that does not reflect the codification of SAS Nos. 134–140 or the amendments to other SASs made by SAS Nos. 134–140. Unless otherwise noted by a gray-shaded footnote, the reader can assume that the codified or

amended content (that is, the new standards) can be found in the corresponding AU-C section (for example, AU-C section 300, or in the case of content that was further amended by SAS Nos. 142–144, can be found in the corresponding AU-C sections 500A, 501A, 540A, and 620A). Dual guidance (that is, repeating the paragraph with gray shading) is not used if the only change to the paragraph would be the deletion of the "B" suffix, so that the reader can focus on the significant changes to the guide content caused by the SASs. For example, paragraph 2.15 of this guide reads, "Auditors of health care entities should refer to auditing standards, including AU-C section 300B, *Planning an Audit*, which addresses the auditor's responsibilities to plan an audit of financial statements. AU-C section 300B 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." Paragraph 2.15 will not have a corresponding gray-shaded paragraph, because if it did, the only change would be the deletion of the letter "B" in the reference.

- Readers should assume that all AU-C sections with a "B" suffix have been amended by SAS Nos. 134–140, even if, as illustrated in the previous bullet, there is no need for a gray-shaded paragraph. For example, SAS No. 134 amends content within AU-C section 300B.

In the rare case that an AU-C section was not amended by SAS Nos. 134–140, a gray-shaded footnote will indicate that fact.

Appendix E, "Auditor Reporting Standards," provides additional information about the new SASs. In addition, readers are encouraged to consult the full text of the SASs at <https://www.aicpa.org/interestareas/frc/auditattest/auditing-standards-information-and-resources.html>.

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, 2021, 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 in which 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" (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. This guide does not provide information about audits conducted in accordance with PCAOB standards.

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 nonissuers⁵ — are to be conducted in accordance with

⁵ See the definition of the term *nonissuer* in the AU-C Glossary.

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.

In rare situations, an auditor may be engaged to also follow PCAOB auditing standards in the audit of a nonissuer. When the audit is not under the jurisdiction of the PCAOB but the entity desires, or is required by an agency, by a regulator, or by contractual agreement, to obtain an audit conducted under PCAOB standards, the AICPA requires the auditor to also conduct the audit in accordance with GAAS. Paragraph .44 and paragraphs .A43–.A47 of AU-C section 700B, *Forming an Opinion and Reporting on Financial Statements*, clarify the format of the auditor's report that should be issued when the auditor conducts an audit in accordance with the standards of the PCAOB, but the audit is not under the jurisdiction of the PCAOB. Interpretation No. 4, "Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and the Standards of the PCAOB" (AU-C sec. 9700B par. .14–.21), provides guidance on how an auditor would evaluate the circumstances of the engagement and possibly modify the PCAOB form of the report to comply with AU-C section 700B.

The auditing content in this guide 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 <https://pcaobus.org/oversight/standards/auditing-standards/analogous-standards>.

Applicability of Quality Control Standards

QC section 10, *A Firm's System of Quality Control*,⁶ 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 provide the firm with reasonable assurance that 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" (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*.

⁶ The QC sections can be found in *AICPA Professional Standards*.

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 220B, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*
- AT-C section 105
- AR-C section 60A, *General Principles for Engagements Performed in Accordance With Statements on Standards for Accounting and Review Services*⁷

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

⁷ All AR-C sections can be found in AICPA *Professional Standards*.

- 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: *Alternatives Available to Private Companies*.

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, all authoritative guidance of FASB and GASB, and AICPA *Professional Standards*, 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. 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, "Category B Guidance") 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 activities or only in business-type activities and fiduciary

activities⁸ 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, 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.⁹

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, as amended, 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 or only in business-type activities and fiduciary activities, such as certain governmental health care entities. Governmental health care entities that are special-purpose governments engaged only in business-type activities should present only the financial statements required for enterprise funds. Many governmental health care entities have fiduciary activities; if so, they present only the financial statements required by enterprise funds and the financial statements required for fiduciary 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.¹⁰ 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 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.

⁸ 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. Nonauthoritative reporting guidance on separate reporting by individual enterprise funds of a government is provided in AICPA Audit and Accounting Guide *State and Local Governments*.

⁹ See chapter 1, "Overview and Introduction," and chapter 12, "Special-Purpose and State Governments," of AICPA Audit and Accounting Guide *State and Local Governments*.

¹⁰ 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.

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.

AICPA Enhancing Audit Quality (EAQ) Areas of Focus

Audits play a vital role in society, providing valuable information to business owners, investors, and the public. As today's business environment continues to evolve and become more complex, upholding audit quality becomes more crucial than ever.

The AICPA promotes this goal through its Enhancing Audit Quality initiative (EAQ). The initiative, which started in 2014, aligns all AICPA assurance-related activities to support auditors in their quality improvement.

EAQ takes a data-driven approach to audit quality. First, data is gathered from the AICPA Peer Review Program and other sources. Then, the AICPA analyzes that data, actions of standard setters, and other prevailing environmental trends to identify areas where quality challenges may arise. Each year, it uses that analysis to determine areas of focus for EAQ. The AICPA then helps auditors improve in those areas by revising standards and guides to improve clarity, developing free education and resources, and emphasizing the areas of focus in Peer Review. In 2021, those areas of focus were COVID-19 audit implications (including those relevant to single audits), auditing revenue recognition, risk assessment and response, engagement acceptance and continuance, and emerging attestation engagements.

Through EAQ, the AICPA has developed toolkits to help auditors avoid the most common quality issues. Those toolkits can be found at <https://us.aicpa.org/eqq>.

Select Recent Developments Significant to This Guide

Government Intervention to Curtail the Economic Effects of COVID-19

The COVID-19 pandemic is adversely affecting the global economy and causing significant business disruptions. Therefore, the U.S. government passed several laws to prevent economic downturn in various ways.

The Coronavirus Aid, Relief and Economic Security (CARES) Act, passed at the end of March 2020, was an over \$2 trillion relief package. This act provided prompt economic assistance for American workers and families, small businesses, not-for-profit entities, and state and local governments. The CARES Act attempted to alleviate some of the financial strain on hospitals, physicians,

and other health care entities through a series of new policies that temporarily boosted Medicare and Medicaid payments, allowed for added flexibility in treatment modalities, and expanded the availability of advance or accelerated payments from Medicare. In addition to Paycheck Protection Plan (PPP) loans, an employee retention tax credit, Social Security tax payment and pension funding deferrals, the CARES Act established a Provider Relief Fund to be used for economic support of health care entities in connection with health care-related expenses or lost revenues attributable to COVID-19 and treatment of uninsured COVID-19 patients. Initially, \$50 billion of the Provider Relief Fund was allocated for general distribution to a wide range of entities across the U.S. health system. Subsequently, amounts were allocated for additional general distributions and targeted distributions to health care entities with specific characteristics, and an unspecified amount was allocated to pay health care entities for treating uninsured COVID-19 patients.

The Consolidated Appropriations Act, signed into law on December 27, 2020, continued many of the programs in the CARES Act by adding new phases, new allocations, and new guidance to address issues related to the continuation of the COVID-19 pandemic.

The American Rescue Plan, signed into law on March 11, 2021, provides additional economic assistance for American workers, families, small businesses, and industries. The American Rescue Plan continues many of the programs started by the CARES Act and Consolidated Appropriations Act by adding new phases, new allocations, and new guidance to address issues related to the continuation of the COVID-19 pandemic. The American Rescue Plan also creates a variety of new programs to address continuing pandemic-related crises, and fund recovery efforts as the United States begins to emerge from the pandemic.

The spread of the pandemic has greatly affected both auditors and their clients. As the pandemic continues, auditors are facing challenges they have not seen before. These challenges include potential scope limitations due to the pandemic to be considered in audit planning, the need to leverage technologies to be able to perform certain audit procedures, and alternatives or supplements to other audit procedures typically performed. Additionally, some not-for-profit and governmental clients will require a Single Audit or a program-specific audit for the first time, and they may be unfamiliar with the federal funding rules. Similarly, investor-owned health care entities that have received Provider Relief Fund funding or other awards from the U.S. Department of Health and Human Services will be required to have either a single audit, a program-specific audit, or a financial-related audit under *Government Auditing Standards*. These entities will likely be even less familiar with federal funding rules. Auditors should ensure that they have the appropriate skills and expertise necessary to undertake these audits.

The federal stimulus legislation continues to evolve, creating difficulties in keeping up with the most current regulations and their impact on financial reporting, especially on revenue recognition. The Small Business Administration, Department of the Treasury, IRS, Department of Health and Human Services, and Health Resources and Services Administration all have resources available. The following resources are among those available from FASB, GASB, and AICPA:

- GASB Technical Bulletin 2020-1, *Accounting and Financial Reporting Issues Related to the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) and Coronavirus Diseases*, which

clarifies the application of certain GASB Statements to resources received from certain programs established by the CARES Act and clarifies the presentation of certain inflows of CARES Act resources and the additional unplanned outflows of resources incurred in response to COVID-19.

- FASB Response to COVID, which is available at <https://fasb.org/jsp/FASB/Page/SectionPage&cid=1176174418336>.
- GASB Response to COVID-19, which is available at <https://gasb.org/jsp/GASB/Page/GASBSectionPage&cid=1176174419678>.
- COVID-19 Audit and Assurance Resources at <https://www.aicpa.org/topic/audit-assurance/covid-19-audit-assurance>
- COVID-19 Tax Policy and Advocacy Resources at <https://us.aicpa.org/advocacy/tax/covid-19>
- Employee Retention Credit Guidance and Resources at <https://www.aicpa.org/resources/toolkit/employee-retention-credit-guidance-and-resources>
- SBA Paycheck Protection Program (PPP) Resources at <https://www.aicpa.org/resources/toolkit/paycheck-protection-program-resources-for-cpas>
- For the latest single audit implications relevant to pandemic funding refer the newest edition of AICPA Audit Guide Government Auditing Standards *and Single Audits*, and the AICPA Governmental Audit Quality Center (www.aicpa.org/gaqc) for COVID-19 information tools, and resources.
- The discussion under the heading "Auditing in a COVID-19 Environment" in AICPA Audit Risk Alert *Not-for-Profit Entities Industry Developments — 2021*.
- Frequently asked questions about the Paycheck Protection Program, which are available at <https://future.aicpa.org/resources/article/sba-paycheck-protection-program-ppp-faqs>.
- AICPA GAQC nonauthoritative guidance, "FAQs — State and Local Government Financial Statement Accounting and Auditing Matters and Auditor Reporting Issues Relating to COVID-19," at <https://www.aicpa.org/content/dam/aicpa/interestareas/governmentalauditquality/resources/auditeeresourcecenter/downloadabledocuments/state-and-local-gov-accounting-and-auditing-faq-related-to-coronavirus.pdf>.
- Q&A section 6400.63, "Background to Sections 6400.64–.70 — CARES Act Provisions Specific to Health Care Entities."¹¹
- Q&A section 6400.64, "Accounting for Provider Relief Fund General and Targeted Distribution Payments," which discusses how nongovernmental health care entities should account for distribution payments from the Provider Relief Fund.
- Q&A section 6400.66, "Period of Accounting for Provider Relief Fund General Distribution Payments," which discusses the reporting of the passage of the CARES Act as a subsequent event

¹¹ All Q&A sections can be found in *Technical Questions and Answers*. *Technical Questions and Answers* can be downloaded at <https://www.aicpa.org/resources/download/aicpa-technical-questions-and-answers-at-your-fingertips>.

in quarterly or annual financial statements issued by nongovernmental health care entities for the period ended March 31, 2020.

- Q&A section 6400.67, "Accounting for Uninsured Pool Portion of Provider Relief Funds," which discusses how nongovernmental health care entities account for the payments for services provided to uninsured COVID-19 patients that are billed to the federal government under the HRSA COVID-19 Uninsured Program.
- Q&A section 6400.68, "Accounting for Payments Received Under the Medicare Accelerated and Advance Payment Program," which discusses how nongovernmental health care entities account for payments received under the Medicare Accelerated and Advance Payment Program.
- Q&A section 6400.69, "Accounting for Temporary Increases in Medicare and Medicaid Payments," which discusses how CARES Act changes to Medicare and Medicaid payment rules affect recognition by nongovernmental health care entities of patient service revenue.
- Q&A section 6400.70, "FEMA Public Assistance Payments to NFP Health Care Entities for Emergency Protective Measures During the COVID-19 Pandemic," which discusses how non-governmental health care entities account for reimbursements received from FEMA for costs associated with eligible emergency medical care activities.
- Q&A section 3200.18, "Borrower Accounting for a Forgivable Loan Received Under the Small Business Administration Paycheck Protection Program," which discusses the accounting for receipts from the Paycheck Protection Program (PPP) as either a loan (FASB ASC 470, *Debt*) or a grant that is a conditional contribution (FASB ASC 958-605).

Reference Rate Reform

Reference rates, including the London Interbank Offered Rate (LIBOR), are widely used in debt agreements and derivative instruments. Regulators and market participants in various jurisdictions have undertaken efforts, generally referred to as reference rate reform, to eliminate certain reference rates and introduce new reference rates that are based on a larger and more liquid population of observable transactions. Both FASB and GASB have issued standards to provide guidance for the accounting implications of the transition.

FASB ASC 848, *Reference Rate Reform*, provides guidance if modifications of debt agreements are made due to reference rate reform. FASB ASC 848 also provides optional expedients for allowing hedging relationships to continue when one or more of the critical terms of the hedging relationship change because of reference rate reform. FASB ASC 848 discusses changes in the interest rates used for margining, discounting, or contract price alignment for derivative instruments that are occurring as part of the market-wide transition to new reference rates (commonly referred to as the "discounting transition"). FASB ASC 848 is effective from March 12, 2020, through December 31, 2022.

GASB Statement No. 93, *Replacement of Interbank Offered Rates*, issued in March 2020, provides exceptions for certain hedging derivative instruments

to the hedge accounting termination provisions and for lease modifications when an interbank offered rate is replaced as the reference rate. In addition, it clarifies certain standards for hedge accounting terminations, reference rates and appropriate benchmark interest rates. As amended by GASB Statement No. 95, *Postponement of the Effective Dates of Certain Authoritative Guidance*, the requirements of GASB Statement No. 93, except for paragraphs 11b, 13, and 14 are effective for reporting periods beginning after June 15, 2020. The requirement in paragraph 11b is effective for reporting periods ending after December 31, 2021. The requirements in paragraphs 13 and 14 are effective for fiscal years periods beginning after June 15, 2021, and all reporting periods thereafter. Earlier application is encouraged.

FASB's Leases

FASB ASU No. 2016-02, *Leases (Topic 842)*, 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). 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. Appendix G, "The New Leases Standard: FASB ASC 842," of this guide provides additional information about FASB ASC 842.

In June 2020, FASB issued FASB ASU No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, which deferred the effective date of the new lease standards for entities that as of June 3, 2020, had not issued financial statements or made financial statements available for issuance that reflected adoption of the new lease standards. Public business entities did not receive a deferral. As a result, for other entities that had not issued financial statements or made financial statements available for issuance reflecting their adoption of the new leases standards before June 3, 2020, ASU No. 2016-02 is effective as follows:

- If not-for-profit entities have issued, or are conduit bond obligors for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, ASU No. 2016-02 is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.
- For all other entities, the amendments in ASU No. 2016-02 are effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022.
- Early adoption is permitted.

Chapter 6, "Property and Equipment and Other Assets," contains gray-shaded text to show the effects of the new lease guidance on the discussion in that

chapter of a prospective lessee's involvement in the construction or design of an underlying asset prior to lease commencement (commonly referred to as a "build-to-suit" lease). The distinct presentation of this content is intended to aid the reader in identifying the content that will be deleted upon the effective date of FASB ASC 842 as well as the text that will replace it (the guide's "dual guidance" treatment of applicable new guidance).

Statement on Auditing Standards No. 142, *Audit Evidence*

SAS No. 142, *Audit Evidence* (AU-C sec. 500), issued in July 2020, is effective for audits of financial statements for periods ending on or after December 15, 2022. SAS No. 142 supersedes SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*, as amended, section 500, *Audit Evidence*, and amends various other AU-C sections. The SAS explains what constitutes audit evidence in an audit of financial statements and sets out attributes of information that are taken into account by the auditor when evaluating information to be used as audit evidence. Taking these attributes into account assists the auditor in maintaining professional skepticism. The SAS addresses such issues as the use of emerging technologies and techniques by both preparers and auditors, the application of professional skepticism, the expanding use of external information sources to provide audit evidence, and more broadly, the relevance and reliability of audit evidence.

Extant AU-C section 500 is designated with an "A" suffix (for example, "AU-C section 500A") to denote content that does not reflect the codification of SAS No. 142. Upon implementation of SAS No. 142, auditors and firms should no longer utilize content from AU-C section 500A and should follow the standard as codified. This edition of the guide has not been updated to reflect changes that result from this SAS; however affected sections will be updated in a future edition. Readers are encouraged to consult the full text of the SAS on AICPA's website at aicpa.org.

Statement on Auditing Standards No. 143, *Auditing Accounting Estimates and Related Disclosures*

SAS No. 143, *Auditing Accounting Estimates and Related Disclosures* (AU-C sec. 540), issued in July 2020, is effective for audits of financial statements for periods ending on or after December 15, 2023.

SAS No. 143 supersedes SAS No. 122, as amended, section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, and amends various other AU-C sections. The SAS addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. This standard enables auditors to appropriately address the increasingly complex scenarios that arise from new accounting standards that include estimates and related disclosures, and to enhance the auditor's focus on factors driving estimation uncertainty and potential management bias.

Extant AU-C section 540 is designated with an "A" suffix (for example, "AU-C section 540A") to denote content that does not reflect the codification of SAS No. 143. Upon implementation of SAS No. 143, auditors and firms should no longer utilize content from AU-C section 540A and should follow the standard as codified. This edition of the guide has not been updated to reflect changes that result from this SAS; however affected sections will be updated in a future

edition. Readers are encouraged to consult the full text of the SAS on AICPA's website at aicpa.org.

Statement on Auditing Standards No. 144, Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources

SAS No. 144, issued in June 2021, is effective for audits of financial statements for periods ending on or after December 15, 2023.

The amendments include the following:

AU-C section 501, <i>Audit Evidence — Specific Considerations for Selected Items</i>	Various application material paragraphs are amended to provide guidance on applying AU-C section 540 when management has used the work of a specialist in developing accounting estimates.
AU-C section 540, <i>Auditing Accounting Estimates and Related Disclosures</i>	A new appendix, "Use of Pricing Information From Third Parties as Audit Evidence," is added to provide guidance on using such information as audit evidence for estimates related to the fair value of financial instruments.
AU-C section 620, <i>Using the Work of an Auditor's Specialist</i>	Various application paragraphs are amended to enhance the guidance related to using the work of an auditor's specialist.

Extant AU-C sections 501, 540, and 620 are designated with an "A" suffix (for example, AU-C sections 501A, 540A and 620A) to denote content that does not reflect the codification of SAS No. 144. Upon implementation of SAS No. 144, auditors and firms should no longer utilize content from these AU-C sections designated with an "A" suffix and should follow the standards as codified. This edition of the guide has not been updated to reflect changes that result from this SAS; however affected sections will be updated in a future edition. Readers are encouraged to consult the full text of the SAS on AICPA's website at aicpa.org.

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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 entities¹ 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," 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 AICPA Audit and Accounting Guide *Not-for-Profit Entities*, rather than this guide.

¹ Technical Questions and Answers (Q&A) section 7100, "Definition of a Public Business Entity," can assist in applying the definition of a public business entity. Although not intended to serve as guidance to not-for-profit entities (NFPs), it may assist NFPs in understanding the key terms used in the various definitions of public entity, including the definitions of security, over-the-counter market, and conduit debt obligor.

All Q&A sections can be found in *Technical Questions and Answers*. *Technical Questions and Answers* can be downloaded at <https://www.aicpa.org/resources/download/aicpa-technical-questions-and-answers-at-your-fingertips>.

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
- Assisted living facilities and 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 corporations² 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

² *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.

of FASB ASC 958, *Not-for-Profit Entities*. Additional accounting guidance may be obtained in 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 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, each state's Medicaid offices, the IRS, the Drug Enforcement Administration, the Occupational Safety and Health 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.
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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, 2021, but becoming effective on or prior to June 30, 2022, 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 2-1 **Auditing: Audit Evidence, Auditing Accounting Estimates, Use of Specialists, and Pricing Information**

This edition of the guide has not been updated to reflect changes as a result of the issuance of the following Statements on Auditing Standards (SAS):

- SAS No. 142, *Audit Evidence* (AU-C sec. 500)
- SAS No. 143, *Auditing Accounting Estimates and Related Disclosures* (AU-C sec. 540)
- SAS No. 144, *Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources*

SAS No. 142 is effective for audits of financial statements for periods ending on or after December 15, 2022. SAS Nos. 143 and 144 are effective for audits of financial statements for periods ending on or after December 15, 2023. Early implementation is permitted.

Affected sections of this chapter will be updated in a future edition. Readers should refer to the preface for further details regarding these SASs. Readers are encouraged to consult the full text of the SASs at aicpa.org.

Overview

2.01 AU-C section 200B, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*,¹ 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 engagements conducted in accordance with GAAS, including the obligation to comply with GAAS.

2.02 Paragraph .12 of AU-C section 200B 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

¹ All AU-C sections can be found in AICPA *Professional Standards*.

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 200B, 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 200B 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 200B 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.²
- 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.

² In May 2013, the Committee of Sponsoring Organizations of the Treadway Commission issued its updated *Internal Control — Integrated Framework* and related illustrative documents.

Audit Risk

2.05 Paragraph .A36 of AU-C section 200B 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 200B 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 315B, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, 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 .A44 of AU-C section 200B 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 200B 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 210B, *Terms of Engagement*, 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 210B provides a listing of agreed-upon terms that should be included. As explained in paragraph .A22 of AU-C section 210B,³ 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 940B, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements*, establishes requirements for and includes special considerations for performing an integrated audit.

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

³ Paragraph renumbered as .A23 by Statement on Auditing Standards (SAS) No. 137, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*. SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the Auditing Standards Board (ASB) recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

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;⁴ (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 800B, *Special Considerations — Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*; AU-C section 805B, *Special Considerations — Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*; AU-C section 806B, *Reporting on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements*; AU-C section 945B, *Auditor Involvement With Exempt Offering Documents*; 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

⁴ See Technical Questions and Answers (Q&A) section 9110.15, "Reporting on Medicaid/Medicare Cost Reports," for additional guidance regarding auditor association with cost reports in certain jurisdictions. Q&As are an "other auditing publication." In applying the auditing guidance included in an other auditing publication, the auditor should, exercising professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. Other auditing publications have no authoritative status; however, they may help the auditor understand and apply generally accepted auditing standards. The auditor is not expected to be aware of the full body of other auditing publications.

All Q&A sections can be found in *Technical Questions and Answers*. *Technical Questions and Answers* can be downloaded at <https://www.aicpa.org/resources/download/aicpa-technical-questions-and-answers-at-your-fingertips>.

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 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 300B, *Planning an Audit*, which addresses the auditor's responsibilities to plan an audit of financial statements. AU-C section 300B 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."
- 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 adjustments, 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 300B, 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 315B; the nature, timing and extent of planned further audit procedures at the relevant assertion level as determined under AU-C section 330B, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*; 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 300B 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 600B, *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)*, 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 600B 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 600B addresses special considerations that apply to group audits, in particular those that involve component auditors. Accordingly, a critical aspect of AU-C section 600B is the identification of the components that are included in group financial statements. The requirements in paragraphs .51–.65 of AU-C section 600B 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 600B 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 600B 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 600B 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 600B addresses considerations related to group audits.

Complex Transactions

© Update 2-2 *Auditing: Use of Specialists and Use of Pricing Information*

This edition of the guide has not been updated to reflect changes as a result of the issuance of SAS No. 144, *Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources*.

SAS No. 144 is effective for audits of financial statements for periods ending on or after December 15, 2023. Early implementation is permitted.

The following paragraph will be updated in a future edition. Readers should refer to the preface for further details regarding this SAS. Readers are encouraged to consult the full text of the SAS at aicpa.org.

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 620B, *Using the Work of an Auditor's Specialist*,⁵ legal inquiry, and detailed reviews of contracts.

Materiality

2.25 AU-C section 320B, *Materiality in Planning and Performing an Audit*, addresses the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements. AU-C section 450B, *Evaluation of Misstatements Identified During the Audit*, 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 600B 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 320B state that the auditor's determination of materiality is a matter of professional judgment and is affected 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.

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 affected by the auditor's perception of the financial information needs of users of financial statements. In planning the audit, the auditor makes judgments about misstatements that will be considered material.⁶

⁵ AU-C section 620, *Using the Work of an Auditor's Specialist*, was not amended by SAS Nos. 134–140. Auditors that have implemented SAS Nos. 134–140 and the amendments to other SASs made by SAS Nos. 134–140 will use AU-C section 620A until they implement SAS No. 143, *Auditing Accounting Estimates and Related Disclosures*.

⁶ SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the ASB recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

2.27 In accordance with paragraphs .10 and .A5 of AU-C section 320B, 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 320B 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 940B states that the auditor should use the same materiality for planning and performing the audit of ICFR and the financial statement audit.

In accordance with paragraphs .10 and .A6 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 there is a substantial likelihood that misstatements of lesser amounts than materiality for the financial statements as a whole would influence the judgment made by a reasonable user based on 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 .A13–.A14 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), paragraph .20 of 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.⁷

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

⁷ SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the ASB recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

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 320B⁸ 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 320B, 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 320B 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 530B, *Audit Sampling*, defines tolerable misstatement and provides further application guidance about the concept.

2.30 Paragraph .A14 of AU-C section 320B⁹ 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)

⁸ Paragraph renumbered as .A15 by SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*. SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the Auditing Standards Board (ASB) recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

⁹ Paragraph renumbered as .A15 by SAS No. 134. SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the ASB recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

- 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 450B 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 320B.

Qualitative considerations also influence the auditor in reaching a conclusion about whether misstatements are material. Paragraph .A28 of AU-C section 450 provides qualitative factors that the auditor may consider relevant in determining whether misstatements are material. It is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature (that is, qualitative considerations). However, consideration of the nature of potential misstatements in disclosures is relevant to the design of audit procedures to address risks of material misstatement. In addition, when evaluating the effect on the financial statements of all uncorrected misstatements, 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 320.¹⁰

Use of Assertions in Assessment of Risks of Material Misstatement

2.33 In accordance with paragraph .26b of AU-C section 315B, to provide a basis for designing and performing further audit procedures, the auditor should identify and assess the risks of material misstatement at the relevant assertion level for classes of transactions, account balances, and disclosures. Paragraphs .A126–.A133 of AU-C section 315B discuss the use of assertions in assessment of risks of material misstatement. In representing that the financial statements are 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

¹⁰ SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the ASB recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

auditor to consider the different types of potential misstatements fall into the following categories and may take the following forms:

Categories of Assertions

	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>
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.
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.	—	—

(continued)

Categories of Assertions — continued

	<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>
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.

In accordance with paragraph .26b of AU-C section 315A, to provide a basis for designing and performing further audit procedures, the auditor should identify and assess the risks of material misstatement at the relevant assertion level for classes of transactions, account balances, and disclosures. Paragraphs .A130–.A138 of AU-C section 315A discuss the use of assertions in assessment of risks of material misstatement. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding recognition, measurement, and presentation of the classes of transactions and events, account balances, and disclosures. Assertions used by the auditor in considering the different types of potential misstatements that may occur 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 and Related Disclosures During the Period</i>	<i>Account Balances and Related Disclosures at the End of the Period</i>
Occurrence/existence	Transactions and events that have been recorded or disclosed have occurred, and such transactions and events pertain to the entity.	Assets and liabilities exist. For investor-owned health care entities, equity interests exist.
Rights and obligations	—	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

Categories of Assertions — *continued*

	<i>Description of Assertions</i>	
	<i>Classes of Transactions and Events and Related Disclosures During the Period</i>	<i>Account Balances and Related Disclosures at the End of the Period</i>
Completeness	All transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.	All assets, liabilities, equity interests, and restrictions on net assets that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
Accuracy, valuation and allocation	Amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.	Assets, liabilities, equity interests, and restricted net assets have been included in the financial statements at appropriate amounts, any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.
Cutoff	Transactions and events have been recorded in the correct accounting period.	—
Classification	Transactions and events have been recorded in the proper accounts.	Assets, liabilities, equity interests, and net assets have been recorded in the proper accounts.
Presentation	Transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.	Assets, liabilities, equity interests, and net assets are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

The assertions described in the preceding chart, adapted as appropriate, may also be used by the auditor in considering the different types of potential misstatements that may occur in disclosures not directly related to recorded classes of transactions, events, or account balances. As an example of such a disclosure, a health care entity may be required to describe its exposure to risks arising from financial instruments, including how the risks arise; the objectives, policies, and processes for managing the risks; and the methods used to measure the risks.¹¹

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 315B addresses the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding 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 315B, 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 320B;
- 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.

¹¹ SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the ASB recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

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 315A, 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 relating to amounts or disclosures in the financial statements for which special audit consideration may be necessary (for example, related party transactions or management's evaluation of the entity's ability to continue as a going concern, or when considering the business purpose of 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 representations¹²

Risk Assessment Procedures and Related Activities

2.37 As described in paragraph .05 of AU-C section 315B, 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 315B 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 315B 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 315B. The depth of the overall understanding that is

¹² SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the ASB recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

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

2.39 Paragraph .06 of AU-C section 315B 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 who, in the auditor's professional judgment, may have information that is likely to assist in identifying risks of material misstatement due to fraud or error
- Analytical procedures
- Observation and inspection

Analytical Procedures

2.40 Paragraphs .A14–.A17 of AU-C section 315B 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 also may help to identify the existence of unusual transactions or events and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

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 315B, 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 315B¹³ states this discussion may be held concurrently with the discussion among the engagement team that is required by AU-C section 240B, *Consideration of Fraud in a Financial Statement Audit*, 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 315B states that the auditor should obtain an understanding of the following:

- Relevant industry, regulatory, and other external factors, including the applicable financial reporting framework.
- The nature of the entity, including
 - its operations;
 - its ownership and governance structures;
 - the types of investments that the entity is making and plans to make, including investments in entities formed to accomplish specific objectives; and
 - 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.
- 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.
- The entity's objectives and strategies and those related business risks that may result in risks of material misstatement.
- The measurement and review of the entity's financial performance.

2.45 Appendix A, "Understanding the Entity and Its Environment," of AU-C section 315B 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

¹³ Paragraph renumbered as .A22 by SAS No. 134. SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the ASB recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

of the entity's financial performance. Appendix B, "Internal Control Components," of AU-C section 315B 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 315B, 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	• Regulatory requirements unique to entities receiving Medicare; Medicaid; or other federal or state payments, including federal financial assistance. • Health care reform initiatives brought on by government efforts, 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).

<i>Aspects of the Auditor's Understanding of the Entity and Its Environment</i>	<i>Considerations for Health Care Entities</i>
Nature of the entity	• 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.
Objectives and strategies and related business risks	• Changing strategies to create more viable health care 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.

(continued)

<i>Aspects of the Auditor's Understanding of the Entity and Its Environment</i>	<i>Considerations for Health Care Entities</i>
Measurement and review of the entity's financial performance	• 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."

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."

Revenue Recognition

2.48 Chapter 2, "General Auditing Considerations," of AICPA Audit and Accounting Guide *Revenue Recognition* (Revenue Recognition Guide) aids an auditor in identifying the significant auditing considerations relevant to FASB *Accounting Standards Codification* (ASC) 606, *Revenue from Contracts with Customers*, and subsequent updates to FASB ASC 606 so that sufficient appropriate evidence is available to auditors. It describes audit issues that may arise under the five-step model for recognizing revenue under FASB ASC 606, risk assessment and fraud risk under FASB ASC 606, auditing considerations in the adoption and transition to FASB ASC 606, and general and specific audit considerations for revenue recognition. In contrast, this chapter and chapter 7, "Health Care Entities," of the Revenue Recognition Guide describe certain inherent complexities and uncertainties unique to revenue recognition by health care entities.

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.

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.¹⁴ Nor does an audit under GAAS include providing

¹⁴ 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*, 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 entered into with the Office of Inspector General of the U.S. Department of Health and Human Services.

All AT-C sections can be found in *AICPA Professional Standards*.

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 250B, *Consideration of Laws and Regulations in an Audit of Financial Statements*,¹⁵ 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 250B, 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 250B 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 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,

¹⁵ AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, was not amended by SAS Nos. 134–140.

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 315B 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 520B, *Analytical Procedures*,¹⁶ 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. Nonauthoritative guidance about the use of analytical procedures in all three stages of the audit (planning, substantive testing, and review) can be found in AICPA Audit Guide *Analytical Procedures*.

2.59 According to paragraph .05 of AU-C section 520B,¹⁷ when designing and performing analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with AU-C section 330B, 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 520B¹⁸ and compare the

¹⁶ AU-C section 520, *Analytical Procedures*, was not amended by SAS Nos. 134–140.

¹⁷ AU-C section 520 was not amended by SAS Nos. 134–140.

¹⁸ AU-C section 520 was not amended by SAS Nos. 134–140.

recorded amounts, or ratios developed from recorded amounts, with the expectations.

Accounting Estimates

Ⓒ Update 2-3 *Auditing: Accounting Estimates, Use of Specialists, and Use of Pricing Information*

This edition of the guide has not been updated to reflect changes as a result of the issuance of the following SASs:

- SAS No. 143
- SAS No. 144

SAS Nos. 143 and 144 are effective for audits of financial statements for periods ending on or after December 15, 2023. Early implementation is permitted.

The following section will be updated in a future edition. Readers should refer to the preface for further details regarding these SASs. Readers are encouraged to consult the full text of the SASs at aicpa.org.

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 540B, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*,¹⁹ 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 315B and 330B, 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.

2.61 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. That fact 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

¹⁹ AU-C section 540A, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, reflects amendments made by SAS No. 134 to AU-C section 540B. Auditors that have implemented SAS Nos. 134–140 and the amendments to other SASs made by SAS Nos. 134–140 will use AU-C section 540A until they implement SAS No. 143, *Auditing Accounting Estimates and Related Disclosures*.

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.

In the current health care environment, the outcome of future program audits, administrative reviews, billing reviews, regulatory investigations, or other actions affecting revenues will not be known because the uncertainties will not be resolved until a future date. As stated in paragraph .A14 of AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*, absence of the existence of information related to the outcome of an uncertainty does not necessarily lead to a conclusion that the audit evidence supporting management's assertion is not sufficient. 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 its presentation or disclosure in the financial statements, an unmodified opinion ordinarily is appropriate.²⁰

2.62 If the auditor is unable to obtain sufficient appropriate audit evidence that the auditor needs to conclude that the financial statements are free from material misstatement, the auditor would express a qualified opinion or disclaim an opinion because of a scope limitation. For example, assume a health care 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. If 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.

2.63 The accuracy of management's assumptions will not be known until future events occur. In evaluating the accuracy of those assumptions, the health care 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. Paragraphs 2.95–.101 discuss management representations.

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

- The variable consideration for third-party payor contractual adjustments (explicit price concessions) and self-pay patients (implicit price concessions), as well as the estimated receivables and

²⁰ SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the ASB recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

payables for final settlements with those payors, as discussed further in chapter 10, "Health Care Service Revenue and Related Receivables."

- 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

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

2.66 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

2.67 Paragraphs .13–.14 of AU-C section 315B 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.

2.68 AU-C section 402B, *Audit Considerations Relating to an Entity Using a Service Organization*,²¹ addresses the user auditor's responsibility for obtaining sufficient appropriate audit evidence in an audit of the financial statements

²¹ AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization*, was not amended by SAS Nos. 134–140.

of a user entity that uses one or more service organizations. Specifically, it expands on how the user auditor applies AU-C sections 315B and 330B, 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.

Compliance With Laws and Regulations

2.69 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

2.70 The requirements of AU-C section 250B²² 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

2.71 In accordance with paragraph .03 of AU-C section 250B,²³ 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

2.72 As stated in paragraph .05 of AU-C section 250B,²⁴ 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:

²² AU-C section 250 was not amended by SAS Nos. 134–140.

²³ AU-C section 250 was not amended by SAS Nos. 134–140.

²⁴ AU-C section 250 was not amended by SAS Nos. 134–140.

- 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.

2.73 Paragraph .06 of AU-C section 250B²⁵ 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.

2.74 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 250B.²⁶ For the category referred to in paragraph 2.73a, 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 2.73b, 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.

2.75 The auditor is required by paragraph .08 of AU-C section 250B²⁷ 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

²⁵ AU-C section 250 was not amended by SAS Nos. 134–140.

²⁶ AU-C section 250 was not amended by SAS Nos. 134–140.

²⁷ AU-C section 250 was not amended by SAS Nos. 134–140.

required by AU-C section 200B, is important in this context, given the extent of laws and regulations that affect the entity.

2.76 Examples of laws and regulations, described in paragraph 2.73*a*, 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.

2.77 Health care entities also may be affected by many other laws and regulations as described in paragraph 2.73*b*, 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.

2.78 As required in paragraph .14 of AU-C section 250B,²⁸ the auditor should perform the following audit procedures that may identify instances of noncompliance with other laws and regulations described in paragraph 2.73*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

2.79 Paragraph .A5 of AU-C section 250B²⁹ 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

²⁸ AU-C section 250 was not amended by SAS Nos. 134–140.

²⁹ AU-C section 250 was not amended by SAS Nos. 134–140.

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

2.80 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 570B, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, 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 700B, *Forming an Opinion and Reporting on Financial Statements*, and AU-C section 800B, was used to prepare the financial statements.

The Auditor's Responsibility

2.81 In accordance with paragraph .10 of AU-C section 570B, 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 570B.

2.82 AU-C section 570B does not define *substantial doubt*. However, 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."

2.83 Paragraph .11 of AU-C section 570B 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 570B, 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 Master 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*).

Auditor's Consideration of Conditions and Events

2.84 Pursuant to paragraph .12 of AU-C section 570B, when performing risk assessment procedures as required by AU-C section 315B, 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.

2.85 Pursuant to paragraph .13 of AU-C section 570B, 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. Paragraph .14 of AU-C section 570B describes the auditor's evaluation, which should

- a. address management's evaluation of 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,
- b. cover the same period as that used by management in its evaluation as required by the applicable financial reporting framework, and
- c. include consideration of whether management's evaluation includes all relevant information of which the auditor is aware as a result of the audit.

2.86 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
- Inability to refinance debt or to obtain new 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

2.87 Pursuant to paragraph .16 of AU-C section 570B, 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.

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

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

2.89 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 570B 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

2.90 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 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), as well as additional information. The auditor's assessment of the financial statement effects under AU-C section 570B 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 using terms consistent with those included in the financial reporting framework used in the preparation of the financial statements. When FASB ASC or the GASB statements are the applicable financial reporting framework, the auditor's conclusion about the entity's ability to continue as a going concern is expressed through the use of the phrase "substantial doubt about its (the entity's) ability to continue as a 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.

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 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), 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 a separate section in the auditor's report with the heading "Substantial Doubt About the Entity's Ability to Continue as a Going Concern." The auditor should include the information in paragraph .24 of AU-C section 570. The description in the "Going Concern" section about the entity's ability to continue as a going concern for a reasonable period of time should use terms consistent with those included in the applicable financial reporting framework and should not use conditional language concerning the existence of substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. When FASB ASC or the GASB statements are the applicable financial reporting framework, the auditor's conclusion about the entity's ability to continue as a going concern is expressed through the use of the phrase "substantial doubt about its (the entity's) ability to continue as a 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.³⁰

2.91 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. Whether the 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 constitute substantial doubt
- b. The auditor's consideration of management's plans
- c. Whether management's use of the going concern basis of accounting, when relevant, is appropriate in the preparation of the financial statements
- d. The adequacy of related disclosures in the financial statements
- e. The implications for the auditor's report

Documentation

2.92 Paragraph .32 of AU-C section 570B 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.

³⁰ SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the ASB recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

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

2.93 In addition, paragraph .18 of AU-C section 570B 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 570B 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.

Considerations if Liquidation Is Imminent

2.94 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" (AU-C sec. 9700B par. .01–.05), of AU-C section 700B, contains applicable guidance regarding the auditor's reporting responsibilities when using the liquidation basis of accounting.

Written Representations

2.95 AU-C section 580B, *Written Representations*, 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

2.96 According to paragraphs .03–.04 of AU-C section 580B, 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

2.97 As explained in paragraph .A2 of AU-C section 580B, 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 580B, the auditor should request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned.

2.98 Paragraph .A2 of AU-C section 580B 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

2.99 Paragraphs .10–.18 of AU-C section 580B 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 580B states that the auditor should request such other written representations.

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

- For receivables, consider the following:
 - Recorded valuation allowances for impairments of receivables are necessary, appropriate, and properly supported.
 - Implicit and explicit price concessions are not reported as valuation allowances, but instead reduce the initial

amount reported as revenue and receivable; and re-assessments of the estimates of implicit and explicit price concessions are reported as increases or decreases of revenue with a corresponding change in the amount of the receivable.

- 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 revenue recognition issues, auditors may consider written representations for the following:
 - Terms and conditions of unusual or complex criteria included in contracts with customers.
 - Terms and conditions of unusual or complex situations that qualify promised goods and services as distinct and therefore as separate performance obligations.
 - Significant estimates and assumptions used in determining amounts of variable consideration, including the constraint
 - Adequate consideration has been given to, and appropriate provision made for, explicit and implicit price concessions, denied claims, and changes to home health

resource group, resource utilization group, ambulatory payment classification, and DRG assignments

- For contingencies related to health care third-party revenue recognition, 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.

2.101 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 net assets with donor restrictions or without donor restrictions 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 net assets with donor restrictions are subject to either (1) donor-imposed purpose or time restrictions that precluded the health care entity from expending such amounts or recognizing such amounts as net assets without donor restrictions as of the balance sheet date, or (2) 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 net assets with donor restrictions. Reclassifications between net asset classes are proper.
- 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

2.102 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.

2.103 The auditor's standard report is described in paragraphs .22–.41 of AU-C section 700B.³¹ 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. Examples 15-1 (paragraph 15.234) and 15-2 (paragraph 15.235) provide illustrative independent auditor's reports under AICPA standards for governmental health care entities.

³¹ Paragraphs renumbered to .21–.43 by SAS No. 134. New paragraph .38 added by SAS No. 137, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*. SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the ASB recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

2.104 Auditors of governmental health care entities do not express an opinion on results of operations. Chapter 15, "Unique Considerations of State and Local Government Health Care Entities," 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.³² 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.

³² 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]

Independent Auditor's Report

[Appropriate Addressee]

Report on the Audit of the Financial Statements³³**Opinion**

We have audited the 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.

In our opinion, the accompanying consolidated financial statements 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 its net assets and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Basis for Opinion

We conducted our audits in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of XYZ Health Care Entity and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Key Audit Matters

[This section of the auditor's report is included only if the auditor is engaged to communicate key audit matters.]

Key audit matters are those matters that were communicated with those charged with governance and, in our professional judgment, were of most significance in our audit of the consolidated financial statements of the current period. These matters were addressed in the context of our audit of the consolidated financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

³³ 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.

[Description of each key audit matter in accordance with AU-C section 701, Communicating Key Audit Matters in the Independent Auditor's Report]

Responsibilities of Management for the Financial Statements

Management is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with accounting principles generally accepted in the United States of America, and for 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.

In preparing the consolidated financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about XYZ Health Care Entity's ability to continue as a going concern for *[insert the time period set by the applicable financial reporting framework]*.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the consolidated financial statements.

In performing an audit in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to the audit 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 XYZ Health Care Entity's internal control. Accordingly, no such opinion is expressed.³⁴
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the consolidated financial statements.

³⁴ In circumstances in which the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, omit the following: "but not for the purpose of expressing an opinion on the effectiveness of XYZ Health Care Entity's internal control. Accordingly, no such opinion is expressed."

- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about XYZ Health Care Entity's ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control-related matters that we identified during the audit.

Other Information [or another title, if appropriate, such as "Information Other Than the Financial Statements and Auditor's Report Thereon"]

*[Reporting in accordance with the reporting requirements in AU-C section 720, The Auditor's Responsibilities Relating to Other Information Included in Annual Reports (Refer to illustrations in the exhibit of AU-C section 720.)]*³⁵

Report on Other Legal and Regulatory Requirements

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

[Signature of the auditor's firm]

[City and state where the auditor's report is issued]

*[Date of the auditor's report]*³⁶

Single Audit Act and Related Audit Considerations

2.105 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, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (the Uniform Guidance), as amended.³⁷ 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.

³⁵ Paragraph .24 of AU-C section 720 describes the separate section of the auditor's report that is required if other information, whether financial or nonfinancial, is included in an entity's annual report, as defined.

³⁶ SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the ASB recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

³⁷ In August 2020, the Office of Management and Budget (OMB) issued a revision to the Uniform Guidance. The revisions were generally effective on November 12, 2020, although two sections were effective August 13, 2020 (those relate to Title 2 U.S. *Code of Federal Regulations* [CFR] 200.340 termination of federal awards and 2 CFR 200.216 concerning new prohibitions on certain telecommunication and video surveillance services or equipment). The revised Uniform Guidance will apply to new awards issued on or after the effective date. Federal agencies may also have to take action to adopt the updated regulation in their individual agency regulations. The most current version of the Uniform Guidance in its entirety can be found on www.econf.gov.

2.106 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.)

2.107 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 investor-owned health care entities 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*,³⁸ or an audit that meets the requirements of the Uniform Guidance.

2.108 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 75.³⁹

2.109 AU-C section 935B, *Compliance Audits* 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 935B, 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

³⁸ *Government Auditing Standards* (2018 revision), issued by the U.S. Government Accountability Office (GAO), 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.

³⁹ Cost principles applicable to hospitals are not superseded with the issuance of Title 2 U.S. 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.

listed in paragraph .A41 of AU-C section 935B.⁴⁰ Furthermore, paragraph .14 of AU-C section 935B 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.

2.110 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.

2.111 AICPA 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 and a single audit or program-specific audit in 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.⁴¹

Statutory Reporting Considerations for Health Plans

2.112 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).

2.113 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

⁴⁰ Paragraph amended and renumbered as .A43 by SAS No. 140, *Amendments to AU-C Sections 725, 730, 930, 935, and 940 to Incorporate Auditor Reporting Changes From SAS Nos. 134 and 137*. SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the ASB recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

⁴¹ The 2021 edition of AICPA Audit Guide *Government Auditing Standards and Single Audits* (as of April 1, 2021) has been updated to reflect changes as a result of SAS Nos. 134–141. If auditors have not implemented SAS Nos. 134–140, it will be necessary to look back to the 2020 AICPA Audit Guide *Government Auditing Standards and Single Audits* (as of April 1, 2020) for the auditing guidance and illustrative auditor reporting in effect prior to SAS Nos. 134–140. The 2020 edition of the guide remains available in all formats in the AICPA store through <https://www.aicpa.org/cpe-learning>.

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.

2.114 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 800B. Appendix B of AU-C section 800B 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 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.

2.115 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

2.116 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.

2.117 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

2.118 AU-C section 265B, *Communicating Internal Control Related Matters in an Audit*, defines the following terms: deficiency in internal control, material weakness, and significant deficiency.

- *Deficiency in internal control.* A deficiency in internal control over financial reporting 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 over financial reporting, 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 over financial reporting 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

2.119 Audits performed pursuant to AU-C section 265B 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 265B 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.

The auditor's written communication of significant deficiencies and material weaknesses should include the elements described in paragraph .14 of AU-C section 265B.

Communications With Regulators

2.120 The NAIC Annual Financial Reporting Model Regulation, commonly referred to as the Model Audit Rule (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.

2.121 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" (AT-C sec. 9105 par. .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

Gray shaded text in this chapter reflects guidance issued but not yet effective as of the date of this guide, September 1, 2021, but becoming effective on or prior to June 30, 2022, 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.

3.01 Not-for-profit (NFP) business-oriented health care entities must apply the NFP financial reporting model described in FASB *Accounting Standards Codification* (ASC) 958, *Not-for-Profit Entities*, 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 should include, either in the body of financial statements or in the accompanying notes, information required by generally accepted accounting principles (GAAP) or by applicable specialized accounting and reporting principles and practices unless NFPs are specifically exempt from providing that information.

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.

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

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.

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."

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; total net assets without donor restrictions and total net assets with donor restrictions. FASB ASC 958-810-45-1 describes how to report noncontrolling 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 958-220 describes the unique standards relating to the income statement (statement of activities) of an NFP. FASB ASC 954-220 modifies the requirements of FASB ASC 958-220 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, which reports all changes in net assets without donor restrictions for the period, and a statement of changes in net assets. Alternatively, in accordance with FASB ASC 954-220-45-1, 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 958-220-45, as briefly discussed subsequently. Reclassifications, equity transfers, and equity transactions should be reported as separate items. The FASB ASC Master Glossary defines a *reclassification of net assets* as the simultaneous increase of one class of net assets and decrease of another. A reclassification of net assets usually results from a donor-imposed restriction (donors include other types of contributors, including makers of certain grants) being satisfied or

otherwise lapsing. Paragraphs 12.76–.79 describe equity transfers, and paragraphs 12.80–.83 describe equity transactions.

Performance Indicator

3.12 FASB ASC 954-220-45-5 requires that the statement of operations for an NFP business-oriented health care entity include a performance indicator. The FASB ASC Master 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 954-220-45-5 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 net assets without donor restrictions.

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 Net Assets without Donor Restrictions") generally is regarded as the functional equivalent of other comprehensive income of an investor-owned entity.

3.15 FASB ASC 954-220-50-1 requires that the notes to the financial statements include a description of the nature and composition of the performance indicator.

3.16 FASB ASC 954-220-45-8, combined with FASB ASC 958-715-45 states that the following items are excluded from the performance indicator:

- a. Transactions with owners acting in that capacity.
- b. Equity transfers involving other entities that control the reporting entity, are controlled by the reporting entity, or are under common control with the reporting entity.
- c. Receipt of donor-restricted restricted contributions.
- 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*

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.

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.

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; the portion of the gain or loss on derivative instruments designated and qualifying as cash flow hedging instruments included in the assessment of effectiveness, and for all qualifying hedging relationships amounts excluded from the assessment of effectiveness and recognized in earnings through an amortization approach in accordance with the "Pending Content" in FASB ASC 815-20-25-83A.⁴

- f. Items that are required to be reported separately under specialized NFP standards.
- g. Unrealized gains and losses on investments other than trading debt securities, in accordance with FASB ASC 954-220-45-9.
- h. Investment returns restricted by donors or law. See also FASB ASC 954-220-45-10.
- i. An inherent contribution (see FASB ASC 958-805-25-31) received in an NFP acquisition transaction that increases net assets with donor restrictions, as described in FASB ASC 954-805-45-2.
- j. The portion of the total change in the fair value of the liability resulting from a change in the instrument-specific credit risk, in accordance with FASB ASC 825-10-45-5.
- k. The net gain or loss, the prior service costs or credits, and the transition asset or obligation that would be recognized in other comprehensive income pursuant to FASB ASC 715-30-35 and 715-60-35 (as described in FASB ASC 958-715-45-1), and the contra adjustment or adjustments to the initially recognized net gain or loss, the prior service costs or credits, and the transition asset or obligation (as described in FASB ASC 958-715-45-2), in the same line item(s) within changes in net assets without donor restrictions, and apart from expenses.

3.17 The preceding items that reflect increases or decreases in net assets without donor restrictions are reported below the performance indicator in the statement of operations. Items that reflect increases or decreases in net assets with donor restrictions are reported in the statement of changes in net assets.

⁴ FASB Accounting Standards Update (ASU) No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, is effective for public business entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. As amended by FASB ASU No. 2019-10, *Financial Instruments — Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*, for all other entities (including NFP conduit bond obligors with publicly traded debt), the amendments in ASU No. 2017-12 are effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Early application is permitted in any interim period after issuance of the ASU.

Other Intermediate Subtotals

3.18 As noted in paragraphs 6–7 of FASB ASC 954-220-45, 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 9–10 of FASB ASC 958-220-45, NFPs have the flexibility to choose whether to report an operating measure.

3.19 FASB ASC 958-220-45-11 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 that qualifies for discontinued operations treatment, as defined in FASB ASC 205-20, and pursuant to FASB ASC 360-10-45-5

In addition, the subtotal such as income from operations should exclude the components of net periodic pension cost and net periodic postretirement benefit cost other than the service cost component, pursuant to FASB ASC 958-715-45-3.

3.20 As required by FASB ASC 958-220-50-1, 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 FASB ASC 958-220-55-6, 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 Accounting Standards Update (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 be displayed similar to discontinued operations, unless the transition requirements provided otherwise.

Revenues

3.23 FASB ASC 958-220-45-5 requires that revenues be reported as increases in net assets without donor restrictions, 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," and display of managed care revenue is discussed in chapter 13, "Financial Accounting and Reporting for Managed Care Services."

3.25 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 958-220-45-7 requires an NFP to report all expenses as decreases in net assets without donor restrictions with the exception of investment expenses, which should be netted against investment return and reported in the net asset class in which the net investment return is reported. FASB ASC 958-720-45 provides standards for the presentation of expenses in the financial statements of an NFP.

3.27 Pursuant to FASB ASC 958-205-55-11, expenses may be reported on the face of the statement of operations using either a natural classification or functional presentation or by both.

3.28 FASB ASC 958-720-45-15 requires an NFP business-oriented health care entity to report information about all expenses in one location — on the face of the statement of operations, as a schedule in the notes to financial statements, or in a separate financial statement — presenting the relationship between functional classification and natural classification for all expenses in an analysis that disaggregates functional expense classifications, such as major classes of program services and supporting activities, by their natural expense classifications, such as salaries, rent, electricity, supplies, interest expense, depreciation, awards and grants to others, and professional fees.

3.29 FASB ASC 958-720-45-15 also requires that to the extent that expenses 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), they should be reported by their natural

classification in the analysis of expenses by nature and function. For example, salaries, wages, and fringe benefits that are included as part of the cost of goods sold on the statement of operations should be included with other salaries, wages, and fringe benefits in the analysis of expenses by nature and function.

3.30 External and direct internal investment expenses that have been netted against investment return should not be included in the analysis of expenses by nature and function. Certain items that are typically excluded from net income and that are included in other comprehensive income of business entities, such as those items listed in FASB ASC 220-10-45-10A, are considered gains or losses and, like other gains and losses, should not be included in the analysis of expenses by nature and function. Note F in FASB ASC 958-205-55-21 provides an example of how to report expenses by nature and function.

3.31 According to FASB ASC 954-220-45-4, the primary functional expense 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. FASB ASC 958-720-50-1(d) requires an NFP to describe the methods used to allocate costs among program and support functions. FASB ASC 958-720-55-176 and Note F in FASB ASC 958-205-55-21 provide examples of note disclosures on the cost allocation methods used.

Statement of Changes in Net Assets (or Equity)

3.32 The statement of changes in net assets (or equity) reports all changes that have occurred during the reporting period in each of the two classes of net assets (net assets without donor restrictions and net assets with donor restrictions). As discussed in paragraph 3.10, this statement may be combined with the statement of operations or presented separately.

3.33 The statement of changes in net assets displays the three measures required by FASB ASC 958-220-45-1: the change in net assets without donor restrictions, the change in net assets with donor restrictions, 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 class net assets without donor restrictions in the statement of changes in net assets is highly aggregated.

3.34 Restricted contributions and restricted investment returns, which are excluded from the performance indicator, are reported as increases or decreases in net assets with donor restrictions in the statement of changes in net assets. Restricted contributions are discussed in chapter 11, "Contributions Received and Made," and restricted investment returns are discussed in paragraphs 4.35–37.

3.35 Because all expenses must be reported as decreases in net assets without donor restrictions, as discussed in paragraph 3.26, no expenses should be reported in the class net assets with donor restrictions. However,

certain losses may be reported within that class, as discussed in FASB ASC 958-220-45-8.

Statement of Cash Flows

3.36 The general standards for reporting cash flows are provided in FASB ASC 230, *Statement of Cash Flows*. FASB ASC 958-230-55 provides incremental guidance related to reporting NFP-specific transactions within this statement. Paragraphs 22–22A of FASB ASC 230-10-45 requires that the classification of cash receipts and payments be determined first by applying specific guidance in FASB ASC 230 and other topics. In the absence of specific guidance, a reporting entity should determine each separately identifiable source or each separately identifiable use within the cash receipts and cash payments on the basis of the nature of the underlying cash flows, including when judgment is necessary to estimate the amount of each separately identifiable source or use. A reporting entity should then classify each separately identifiable source or use within the cash receipts and payments on the basis of their nature in financing, investing, or operating activities. In situations in which cash receipts and payments have aspects of more than one class of cash flows and cannot be separated by source or use, the appropriate classification should depend on the activity that is likely to be the predominant source or use of cash flows for the item. 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.

3.37 FASB ASC 230-10-45-29 states that NFPs that use the direct method of reporting net cash flows from operations are not required to provide a reconciliation of change in net assets to net cash flow from operating activities. An investor-owned health care entity should provide a reconciliation of net income to net cash flow from operating activities described in FASB ASC 230-10-45-28 regardless of whether the direct or indirect method of reporting net cash flow from operating activities is used.

3.38 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.

3.39 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 available for current use and without donor restrictions. Therefore, as discussed in FASB ASC 230-10-45-4 and further discussed in paragraph 4.11, certain disclosures are required when cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents are presented in more than one line item within the statement of financial position. FASB ASC 958-230-55-3 states that when an NFP reports cash received (or cash receipts from the sale of donated financial assets that upon receipt were directed without any NFP-imposed limitations for sale and were converted nearly immediately into cash as discussed in FASB ASC

230-10-45-21A) with a donor-imposed restriction that limits its use to long-term purposes in conformity with FASB ASC 958-210-45-6, an adjustment to the change in net assets to reconcile to net cash flows from operating activities is necessary when using the indirect method of reporting cash flows in order to present those cash receipts as cash inflows from financing activities as required by FASB ASC 230-10-45-14(c).

3.40 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 FASB ASC 230-10-45-14(c), then those cash receipts meeting all the conditions in FASB ASC 230-10-45-21A should be classified as a financing activity.

Notes to the Financial Statements

3.41 FASB ASC 958-210-45-7 requires quantitative information, and additional qualitative information in the notes as necessary, about the availability of an NFP health care entity's financial assets at the balance sheet date to meet cash needs for general expenditures within one year of the balance sheet date be displayed on the face of the statement of financial position or in notes to the financial statements. FASB ASC 958-210-45-8 requires that additional information about the NFP health care entity's liquidity be provided by any of the following:

- a. Sequencing assets according to their nearness of conversion to cash and sequencing liabilities according to the nearness of their maturity and resulting use of cash
- b. Classifying assets and liabilities as current and noncurrent, as defined by FASB ASC 210-10 (required by FASB ASC 954-210-45-1 for statements of financial position prepared by not-for-profit, business-oriented health care entities)
- c. Disclosing in notes to financial statements any additional relevant information about the liquidity or maturity of assets and liabilities, including restrictions on the use of particular assets

3.42 Per FASB ASC 958-210-50-1, relevant information about the liquidity or maturity of assets and liabilities, including restrictions and self-imposed limits on the use of particular items, should be disclosed in notes to financial statements in addition to information provided on the face of the statement of financial position. FASB ASC 958-210-45-5A explains that when an NFP health care entity presents a statement of financial position that sequences assets and liabilities based on their relative liquidity, cash and cash equivalents of permanent endowment funds held temporarily until suitable long-term investment opportunities are identified may be included in the classification long-term investments. Likewise, cash held temporarily by a custodian for investment purposes may be included as part of investments in a statement of financial position rather than as cash. FASB ASC 958-205-55-7 states that similarly, cash and contributions receivable restricted by donors to investment in land, buildings, and equipment are not included with the line items cash and cash equivalents or contributions receivable. Rather, those items are reported

as assets restricted to investment in land, buildings, and equipment and are sequenced closer to land, buildings, and equipment. Similarly, FASB ASC 210-10-45-4 states that the concept of the nature of current assets contemplates the exclusion from that classification of such resources as cash that is designated for expenditure in the acquisition or construction of noncurrent assets or is 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 for similar purposes should also, under this concept, be excluded from current assets. However, if such funds are considered to pay off maturing debt that has been set up properly as a current liability, they may be included within the current asset classification.

3.43 Application of the guidance discussed in paragraphs 3.41–.42 results in certain (a) donor restrictions, (b) governing board designations, and (c) legal limitations affecting the classification of or disclosures about assets, or both. In meeting the requirements of FASB ASC 958-210 and FASB ASC 210-10-45 to provide information about liquidity, NFP business-oriented health care entities should consider not only maturity (nearness to conversion to cash or use of cash), but the effects on liquidity of donor-imposed restrictions, management's intent to meet those restrictions, and management's intent to use assets for long-term purposes (such as liquidation of long-term debts, payments to sinking funds, establishment of quasi endowment funds, and so forth). Chapter 3, "Financial Statements, the Reporting Entity, and General Financial Reporting Matters," of AICPA Audit and Accounting Guide *Not-for-Profit Entities*, provides additional information about the effects on liquidity of donor-imposed restrictions, governing board designations, and other limitations.

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

Subsequent Events

3.45 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.

3.46 As discussed in paragraphs 7.06–.08, 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.

3.47 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 Master 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

3.48 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.

3.49 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* (<https://www.aicpa.org/cpe-learning>), provide useful disclosure examples, even though they do not contain example financial statements of health care entities.

Chapter 4

Cash, Cash Equivalents, and Investments

Gray shaded text in this chapter reflects guidance issued but not yet effective as of the date of this guide, September 1, 2021, but becoming effective on or prior to June 30, 2022, 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.

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) Master 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 Master 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 Changes in the subsidiary's receivable relating to a centralized cash management program are presented as investing activities in the subsidiary's financial statements, 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 954-210-45-6 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 954-210-45-5, 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 954-210-45-5 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.

¹ Per the "Pending Content" in FASB *Accounting Standards Codification* (ASC) 954-210-45-6, a columnar presentation that highlights the two classes of net assets (that is, without donor restrictions and with donor restrictions) is not precluded if the totals for the reporting entity as a whole are displayed.

- 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).

Further, according to FASB ASC 954-210-45-4, internally designated funds should be reported separately from externally restricted funds either on the face of the balance sheet or in the notes to the financial statements.

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 either by a donor-imposed restriction or by governing board designations should be described in the notes to the financial statements if the nature of the restriction or designation (that is, amount and purpose) is not clear from the description on the face of the balance sheet.

4.11 Per FASB ASC 230-10-45-4, a statement of cash flows should explain the change during the period in the total of cash, cash and cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. When cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents are presented in more than one line item within the statement of financial position, an entity should provide the disclosures required in FASB ASC 230-10-50-8. The entity should, for each period that a statement of financial position is presented, present on the face of the statement of cash flows or disclose in the notes to the financial statements, the line items and amounts of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents reported within the statement of financial position. The amounts, disaggregated by the line item in which they appear within the statement of financial position, should sum to the total amount of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents at the end of the corresponding period shown in the statement of cash flows. This disclosure may be provided in either a narrative or a tabular format. Example 1 in paragraphs 2–21 of FASB ASC 958-205-55 illustrates the requirements. NFP business-oriented health care entities may find paragraphs 3.53–.58 of AICPA Audit and Accounting Guide *Not-for-Profit Entities* useful for identifying restricted cash.

Investments

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–.38)
- 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 4.39–.41)
- Investment pools (see paragraphs 4.42–.50)
- Fair value measurement (see paragraph 4.51)
- Impairment of investments (see paragraphs 4.52–.60)
- Securities lending arrangements (see paragraph 4.61)
- Transfers of assets to an NFP or charitable trust for investment (see paragraphs 4.62–.64)
- Regulation (see paragraph 4.65)
- Other financial statement presentation matters (see paragraphs 4.66–.74)

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.

4.16 NFP business-oriented health care entities can use exhibit 12-1, and investor-owned health care entities can use paragraph 12.60 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.

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.

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 954-220-45-6, 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, 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

4.24 Investor-owned health care entities are subject to the accounting and reporting requirements of FASB ASC 320, *Investments — Debt Securities*, and FASB ASC 321, *Investments — Equity Securities*. FASB ASC 320 applies to all investments in debt securities, including loans that meet the definition of a security and debt securities resulting from the securitization of other financial instruments. FASB ASC 321 applies to all investments in equity securities and other ownership interests in an entity, including investments in partnerships, unincorporated joint ventures, and limited liability companies as if those other ownership interests were equity securities,³ except for equity securities that are accounted for under the equity method. Neither FASB ASC 320 nor FASB ASC 321 applies to (a) investments in consolidated subsidiaries or (b) 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. (However, if an investment that would otherwise be within the scope of FASB ASC 320 or FASB ASC 321 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 or FASB ASC 321). FASB ASC 320-10-15 provides a more complete description of the debt instruments within the scope of FASB ASC 320. FASB ASC 321-10-15 provides a more complete description of the equity instruments within the scope of FASB ASC 321.

4.25 FASB ASC 320-10-25-1 states that at acquisition, an entity should classify its debt 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 that 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. Per FASB ASC 310-20-35-33, to the extent that the amortized cost basis of an individual callable debt security exceeds the amount repayable by the issuer at the earliest call date, the excess (that is, the premium) should be amortized to the earliest call date, unless the guidance in FASB ASC 310-20-35-26 is applied to consider estimated prepayments. After

³ Note that FASB ASC 321, *Investments — Equity Securities*, uses the term *equity securities* to include equity instruments that do not meet the definition of a security. Thus, ownership interests in all entities, including general partnerships, limited liability companies, limited liability partnerships, joint ventures, and so forth, are within the scope of FASB ASC 321, unless they are consolidated subsidiaries or accounted for using the equity method.

the earliest call date, if the call option is not exercised, the entity should reset the effective yield using the payment terms of the debt security. Investments in debt securities 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 in debt securities 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.

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. Per the "Pending Content" in FASB ASC 310-20-35-33, for each reporting period, to the extent that the amortized cost basis of an individual callable debt security exceeds the amount repayable by the issuer at the next call date, the excess (that is, the premium) should be amortized to the next call date, unless the guidance in FASB ASC 310-20-35-26 is applied to consider estimated prepayments. For purposes of this guidance, the next call date is the first date when a call option at a specified price becomes exercisable. Once that date has passed, the next call date is when the next call option at a specified price becomes exercisable, if applicable. If there is no remaining premium or if there are no further call dates, the entity should reset the effective yield using the payment terms of the debt security. Investments in debt securities 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 in debt securities 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

4.27 Per FASB ASC 321-10-35-1, investments in equity securities should be measured subsequently at fair value in the statement of financial position and unrealized holding gains and losses for equity securities should be included in earnings, except as indicated in the next sentence. Per the "Pending Content"

⁴ FASB Accounting Standards Update (ASU) No. 2020-08, *Codification Improvements to Subtopic 310-20, Receivables — Nonrefundable Fees and Other Costs*, is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2020. Early application is not permitted. For all other entities, FASB ASU No. 2020-08 is effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Early application is permitted for all other entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2020.

in FASB ASC 321-10-35-2, if an equity security does not have a readily determinable fair value and does not qualify for the practical expedient to estimate fair value [using net asset value] in accordance with FASB ASC 820-10-35-59, an entity may elect to measure that equity security at its cost minus impairment, if any. If an entity identifies observable price changes in orderly transactions for the identical or a similar investment of the same issuer, it should measure the equity security at fair value as of the date that the observable transaction occurred. An election to measure an equity security using the guidance in FASB ASC 321-10-35-2 should be made for each investment separately. Once an entity elects to measure an equity security in accordance with that paragraph, the entity should continue to apply that measurement until the investment does not qualify to be measured in accordance with that paragraph (for example, if the investment has a readily determinable fair value or becomes eligible for the practical expedient to estimate fair value [using net asset value] in accordance with FASB ASC 820-10-35-59). The entity should reassess at each reporting period whether the equity investment qualifies to be measured in accordance with FASB ASC 321-10-35-2.

4.28 For debt securities within the scope of FASB ASC 320, investor-owned health care entities should follow the disclosure requirements of FASB ASC 320-10-50. For equity investments within the scope of FASB ASC 321, investor-owned health care entities should follow the disclosure requirements of FASB ASC 321-10-50.

Not-for-Profit Entities

4.29 NFP business-oriented health care entities are subject to the accounting and reporting requirements of FASB ASC 958-320 and 958-321. FASB ASC 958-320 applies to all investments in debt securities, including mortgage-backed securities. FASB ASC 958-321 applies to all investments in equity securities and other ownership interests in an entity, including investments in partnerships, unincorporated joint ventures, and limited liability companies as if those other ownership interests are equity securities,⁵ except for equity investments accounted for under the equity method. FASB ASC 958-320-15 provides a more complete description of the scope of FASB ASC 958-320. Neither FASB ASC 958-320 nor FASB ASC 958-321 applies to (a) investments in consolidated subsidiaries, (b) investments held by a financially interrelated entity, as discussed in paragraph 12.81, (c) short sales of securities, or (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. (However, if an investment that would otherwise be within the scope of FASB ASC 958-320 or FASB ASC 958-321 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 958-320 or FASB ASC 958-321.)

4.30 NFP health care entities can designate debt securities as trading. Investment returns from investments, inclusive of debt securities designated as

⁵ Note that FASB ASC 321 uses the term *equity securities* to include equity instruments that do not meet the definition of a security. Thus, ownership interests in all entities, including general partnerships, limited liability companies, limited liability partnerships, joint ventures, and so forth, are within the scope of FASB ASC 321, unless they are consolidated subsidiaries or accounted for using the equity method.

trading, accounted for under FASB ASC 958-320 or FASB ASC 958-321 should be included as changes in net assets, consistent with paragraphs 4.31–.37.

4.31 FASB ASC 958-320 requires all investments in debt securities to be measured at fair value in the statement of financial position.

4.32 FASB ASC 958-321-35 requires investments in equity securities to be measured in accordance with FASB ASC 321-10-35. Therefore, investments in equity securities are measured at fair value in the statement of financial position, except as indicated in the next sentence. Per FASB ASC 321-10-35-2, if an equity security does not have a readily determinable fair value and does not qualify for the practical expedient to estimate fair value [using net asset value] in accordance with FASB ASC 820-10-35-59, an entity may elect to measure that equity security at its cost minus impairment, if any. If an entity identifies observable price changes in orderly transactions for the identical or a similar investment of the same issuer, it should measure the equity security at fair value as of the date that the observable transaction occurred. An election to measure an equity security using the guidance in FASB ASC 321-10-35-2 should be made for each equity investment separately. Once an entity elects to measure an equity investment in accordance with that paragraph, the entity should continue to apply that measurement until the investment does not qualify to be measured in accordance with that paragraph (for example, if the investment has a readily determinable fair value or becomes eligible for the practical expedient to estimate fair value [using net asset value] in accordance with FASB ASC 820-10-35-59). The entity should reassess at each reporting period whether the equity investment qualifies to be measured in accordance with FASB ASC 321-10-35-2.

4.33 According to FASB ASC 954-220-45-9, investment returns, including realized and unrealized gains and losses, not restricted by donors or law should be classified as changes in net assets without donor restrictions, as follows:

- a. Included in the performance indicator (see paragraphs 3.12–.17) are:
 - i. Dividend, interest, and other similar investment income
 - ii. Realized gains and losses
 - iii. Unrealized gains and losses on trading debt securities
 - iv. Other-than-temporary impairment losses
 - v. Unrealized gains and losses and impairments on equity investments accounted for under FASB ASC 321
- b. Excluded from the performance indicator are unrealized gains and losses on debt securities, unless the debt security is a trading debt security.

4.34 Because the performance indicator is analogous to income from continuing operations of an investor-owned health care entity, as discussed in paragraph 3.12, 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 4.57.

4.35 Pursuant to FASB ASC 958-220-45-19, except as described in paragraphs 4.36–.37, gains and losses on investments and dividend, interest, and other investment income should be reported as increases or decreases in net assets without donor restrictions, unless their use is limited by donor-imposed restrictions or by law that extends donor restrictions, in which case those amounts should be reported as increases or decreases in net assets with donor restrictions.

4.36 FASB ASC 958-220-45-24 states that gains and investment income that are limited to specific uses by donor-imposed restrictions may be reported as increases in net assets without donor restrictions 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 contributions received, 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 net assets without donor restrictions should be consistent with paragraph 4.33.

4.37 Paragraphs 13–13J of FASB ASC 958-205-45 describes the accounting for income, gains and losses on investments of donor-restricted endowment funds. FASB ASC 958-205-45-13H states that if a donor-restricted endowment fund is an underwater endowment fund, the accumulated losses should be included together with that fund in net assets with donor restrictions.

4.38 NFP health care entities should follow the disclosure requirements included in FASB ASC 958-320-50, FASB ASC 958-321-50, and FASB ASC 321-10-50, except for FASB ASC 321-10-50-4.

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

4.39 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 similar equity instruments. These types of investments are commonly referred to as alternative investments. As noted in FASB ASC 320-10-55-9 and FASB ASC 958-320-15-6, if an entity invests in a limited partnership interest (or a venture capital entity) that meets the definition of an equity security but substantially all of the partnership's assets consist of investments in debt securities, the investment would be considered an equity security because an entity should not look through the form of its investment to the nature of the securities held by the investee. An alternative investment may have a formal notification period that requires the investor to provide the investee 60, 90, or 360 days' 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. Because the accounting for these types of equity investments can vary depending upon the legal structure of the investment as well as the investment's terms and features, each alternative investment must be carefully considered before concluding on the appropriate method of accounting. For example:

- a.* Alternative investments with readily determinable fair values are reported at fair value.

- b. Alternative investments that qualify for the practical expedient to estimate fair value in accordance with FASB ASC 820-10-35-59 are reported using their net asset value, as described in paragraph 4.40.
- c. Alternative investments other than those described in (a) and (b) are reported in accordance with FASB ASC 321-10-35; that is, the investment is measured at fair value unless the entity elects to measure it at its cost minus impairment, if any. If an entity identifies observable price changes in orderly transactions for the identical or a similar investment of the same issuer, it should measure the equity security at fair value as of the date that the observable transaction occurred, as described in FASB ASC 321-10-35-2.

Exhibit 12-1 and paragraph 12.60 provide further guidance for determining the appropriate method of accounting for NFP health care entities and investor-owned health care entities, respectively. Paragraphs 4.42–.50 provide additional discussion for investment pools.

4.40 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 consistent with the measurement principles of FASB ASC 946 as of the reporting entity's measurement date. 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. FASB ASC 820-10-35-54B states that the disclosure requirements in FASB ASC 820-10-50-2 do not apply to those investments and that they should not be classified in the fair value hierarchy.

4.41 Technical Questions and Answers (Q&A) sections 2220.18–.26 and 2220.28⁶ are intended to assist reporting entities in applying the provisions of FASB ASC 820 that 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," 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

4.42 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

⁶ All Q&A sections can be found in *Technical Questions and Answers*. *Technical Questions and Answers* can be downloaded at <https://www.aicpa.org/resources/download/aicpa-technical-questions-and-answers-at-your-fingertips>.

paragraph 12.81. 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 958-320-20, is created. Paragraphs 4.43–.50 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.

4.43 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 12.81), the investor (participant) should recognize its beneficial-type interest as described in paragraphs 4.44–.45.
- 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 4.46–.48.

4.44 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.

4.45 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 an increase or decrease in net assets without donor restrictions. 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.

4.46 If the investor (participant) and sponsor are financially-interrelated entities, as discussed in FASB ASC 958-20-15-2 and paragraph 12.81, 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.

4.47 Q&A sections 6400.36–.42 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.

4.48 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," 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 equity investments accounted for under FASB ASC 958-321 and trading securities, as defined in FASB ASC 320, that are not restricted by donors or law and should exclude from the performance indicator the portion of the change attributable to unrealized gains and losses on other-than-trading debt securities. 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.

4.49 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.

4.50 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% 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, 958-321, 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

4.51 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

4.52 The following guidance should be considered when evaluating whether an investment is impaired and determining whether an impairment loss should be recognized:

- For debt securities: paragraphs 20–24, 30, and 33A–35A of FASB ASC 320-10-35
- For equity instruments other than those consolidated or reported using the equity method: paragraphs 3–4 of FASB ASC 321-10-35

- For equity instruments reported using the equity method: paragraphs 23–26 of FASB ASC 323-10-35

As noted in paragraph 4.39, entities should not look through the form of their investment to the nature of the securities held by an investee. Paragraphs 4.53–.59 summarize some of the more significant matters included in those paragraphs, but are not a substitute for reading the referenced paragraphs.

4.53 According to FASB ASC 320-10-35-20, impairment of a debt security 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 securities. FASB ASC 320-10-35-21 states that an investment [in a debt security] is impaired if the fair value of the investment is less than its cost.

4.54 According to FASB ASC 321-10-35-3, an equity investment that is measured in accordance with FASB ASC 321-10-35-2 should be written down to its fair value if a qualitative assessment indicates that the investment is impaired and the fair value of the investment is less than its carrying value. The impairment indicators that an entity considers in its qualitative assessment include, but are not limited to, the following:

- a. A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee.
- b. A significant adverse change in the regulatory, economic, or technological environment of the investee.
- c. A significant adverse change in the general market condition of either the geographical area or the industry in which the investee operates.
- d. A bona fide offer to purchase, an offer by the investee to sell, or a completed auction process for the same or similar investment for an amount less than the carrying amount of that investment.
- e. Factors that raise significant concerns about the investee's ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.

4.55 Per FASB ASC 321-10-35-4, if an equity security without a readily determinable fair value is impaired, an entity should include an impairment loss in net income equal to the difference between the fair value of the investment and its carrying amount. That is, if the investment is deemed to be impaired after conducting the qualitative evaluation required by FASB ASC 321-10-35-3, the entity should estimate the fair value of the equity investment to determine the amount of the impairment loss.

4.56 Per FASB ASC 320-10-35-30, if the fair value of an investment [in a debt security] 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. 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.

4.57 Per FASB ASC 320-10-35-34B, if an entity intends to sell the [impaired debt] security or more likely than not will be required to sell the [impaired debt] security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment should be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. In assessing whether the entity more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit losses, the entity should consider the factors in FASB ASC 320-10-35-33F. 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, which is recognized in earnings [or the performance indicator] in accordance with FASB ASC 320-10-35-34D.
- b. Amounts related to all other factors, which is recognized in other comprehensive income [or outside the performance indicator] in accordance with FASB ASC 320-10-35-34D.

4.58 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 (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 on the face of the statement, 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.

4.59 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.

4.60 FinREC believes that, 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 investment 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

4.61 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

4.62 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.

4.63 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 12.81 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).

4.64 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 12.80–.83. 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

4.65 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

4.66 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 Master 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 donor-restricted endowment funds held temporarily until suitable long-term investment opportunities are identified are included in the long-term investments classification.

4.67 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.

4.68 Paragraphs 4.29–.37 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. FASB ASC 230-10-45-21D discusses the classification in the statement of cash flows of distributions received from equity method investees.

Disclosure

4.69 All health care entities with investments that meet the definition of *financial instruments* as set forth in the FASB ASC Master Glossary are subject to the disclosure requirements of FASB ASC 825-10-50. Investor-owned health care entities with investments in equity and debt securities should refer to the disclosure requirements of FASB ASC 320-10-50, FASB ASC 321-10-50, and FASB ASC 323-10-50. NFP health care entities should refer to the disclosure requirements of FASB ASC 958-320-50, FASB ASC 321-10-50 (except for FASB ASC 321-10-50-4), and FASB ASC 958-325-50.⁷

4.70 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

⁷ The disclosure guidance in FASB ASC 825-10-50 applies only to public business entities, except for the disclosure guidance in paragraphs 20–23 of FASB ASC 825-10-50, which applies to all entities. For interim reporting periods, the disclosure guidance in paragraphs 20–23 of FASB ASC 825-10-50 is optional for those entities that do not meet the definition of a public business entity.

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.

4.71 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.

4.72 FASB ASC 860-30-50⁸ 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.

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

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

Auditing

© Update 4-1 *Auditing: Audit Evidence, Auditing Accounting Estimates, Use of Specialists, and Use of Pricing Information*

This edition of the guide has not been updated to reflect changes as a result of the issuance of the following Statements on Auditing Standards (SASs):

- SAS No. 142, *Audit Evidence* (AU-C sec. 500)⁹
- SAS No. 143, *Auditing Accounting Estimates and Related Disclosures* (AU-C sec. 540)
- SAS No. 144, *Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources*

SAS No. 142 is effective for audits of financial statements for periods ending on or after December 15, 2022. SAS Nos. 143 and 144 are effective for audits of financial statements for periods ending on or after December 15, 2023. Early implementation is permitted.

⁸ 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 paragraphs 4A–4D of FASB ASC 860-20-50.

⁹ All AU-C sections can be found in AICPA *Professional Standards*.

The following section will be updated in a future edition. Readers should refer to the preface for further details regarding these SASs. Readers are encouraged to consult the full text of the SASs at aicpa.org.

4.75 Auditing objectives and procedures for investments of health care entities generally are similar to those of other entities. AU-C section 501B, *Audit Evidence — Specific Considerations for Selected Items*, among other matters, addresses specific considerations by the auditor in obtaining sufficient appropriate audit evidence regarding certain aspects of investments in securities. The guidance in AU-C section 501B applies to debt and equity securities. AU-C section 540B, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*,¹⁰ 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 600B, *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)*, addresses auditing investments accounted for using the equity method of accounting. 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.

4.76 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.

¹⁰ AU-C section 540A, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, reflects amendments made by Statement on Auditing Standards (SAS) No. 134 to AU-C section 540B. Auditors that have implemented SAS Nos. 134–140 and the amendments to other SASs made by SAS Nos. 134–140 will use AU-C section 540A until they implement SAS No. 143, *Auditing Accounting Estimates and Related Disclosures* (AU-C sec. 540).

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 330B, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, 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 315B, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. Various audit procedures and the purposes for which they may be performed are described in paragraphs .A10–.A26 of AU-C section 500B, *Audit Evidence*.

Audit Considerations

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives¹¹</i>	<i>Substantive Audit Procedures¹²</i>
<i>Account Balances</i>			
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 620B, <i>Using the Work of an Auditor's Specialist</i> ; AU-C section 402B, <i>Audit Considerations Relating to an Entity Using a Service Organization</i> . ¹
Valuation and allocation, rights and obligations	Endowment funds are identified and classified in accordance with the source of their funding (that is, donor restricted or board designated) and related gains and losses on endowment investments are properly classified.	Values of individual endowment funds are reviewed periodically to determine whether the fund equals or exceeds its required level. Management reviews any individual underwater endowment funds to determine whether to temporarily discontinue spending.	Compare the fair value of the investments of an individual endowment fund to the level required by the donor, and determine whether any deficiencies have been disclosed. Review treatment of gains and losses on endowment funds to ensure that they are properly classified.

(continued)

¹¹ The auditor should consider a combination of preventive and detective controls responsive to the control objectives.

¹² 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 debt 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).
¹ Paragraphs .06 and .A11–.A19 of AU-C section 501B, <i>Audit Evidence — Specific Considerations for Selected Items</i> , establish requirements and provide guidance to auditors on audit evidence that may be used to support assertions about the fair value of securities. 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 540B, <i>Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures</i> , provides guidance on auditing fair value measurements and disclosures contained in financial statements. AU-C section 540B does not address specific types of assets, liabilities, components of equity, transactions, or industry-specific practices.			

Exhibit 4-1¹³

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 330B, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, 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 315A, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. Various audit procedures and the purposes for which they may be performed are described in paragraphs .A10–.A26 of AU-C section 500A, *Audit Evidence*.

¹³ SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the Auditing Standards Board (ASB) recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

Audit Considerations

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i> ¹⁴	<i>Substantive Audit Procedures</i> ¹⁵
Account Balances			
Existence, completeness, rights and obligations, and accuracy/valuation and allocation	Marketable securities are fairly stated, properly classified, and described, and all related disclosures are included.	An independent trustee manages the investments. The trustee's reports are reviewed by a responsible employee. Controls ensure that all appropriate disclosures have been made.	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 620A, <i>Using the Work of an Auditor's Specialist</i> ; AU-C section 402, <i>Audit Considerations Relating to an Entity Using a Service Organization</i> . ¹ Verify that all required disclosures have been included in the financial statements.
Classification	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 debt 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).

¹⁴ The auditor should consider a combination of preventive and detective controls responsive to the control objectives.

¹⁵ 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>
Accuracy/valuation and allocation, rights and obligations	Endowment funds are identified and classified in accordance with the source of their funding (that is, donor restricted or board designated) and related gains and losses on endowment investments are properly classified.	Values of individual endowment funds are reviewed periodically to determine whether the fund equals or exceeds its required level. Management reviews any individual underwater endowment funds to determine whether to temporarily discontinue spending.	Compare the fair value of the investments of an individual endowment fund to the level required by the donor, and determine whether any deficiencies have been disclosed. Review treatment of gains and losses on endowment funds to ensure that they are properly classified.
<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.
¹ Paragraphs .06 and .A11–.A19 of AU-C section 501A, <i>Audit Evidence — Specific Considerations for Selected Items</i> , establish requirements and provide guidance to auditors on audit evidence that may be used to support assertions about the fair value of securities. 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 540A, <i>Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures</i> , provides guidance on auditing fair value measurements and disclosures contained in financial statements. AU-C section 540A does not address specific types of assets, liabilities, components of equity, transactions, or industry-specific practices.			

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, 2021, but becoming effective on or prior to June 30, 2022, 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.

¹ Chapter 18, "Derivative Instruments: Futures, Forwards, Options, Swaps, and Other Derivative Instruments," of 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.

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 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. Contracts that provide for the purchase or sale of a commodity that will be delivered in quantities expected to be used by the health care entity over a reasonable period in the normal course of business may qualify for the normal purchase exception in FASB ASC 815-10-15. A derivative instrument that is used to fix the price of anticipated future purchases could be designated in a cash flow hedge if the contract 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 815-10-15 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 5.42, 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.

FASB ASC 954-815-25-2 states that except as provided in FASB ASC 954-815-50-1 and as discussed in paragraph 5.42, 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 the

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.

"Pending Content" 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 and fair value hedges. For a fair value hedge, amounts may be recorded in other comprehensive income if amounts are excluded from the assessment of effectiveness and are recognized in earnings through an amortization approach in accordance with the "Pending Content" in FASB ASC 815-20-25-83A. 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.³

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 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.

The "Pending Content" in 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 the "Pending Content" in paragraphs 1–6 of FASB ASC 815-25-35. If an entity excludes a portion of the hedging instrument from the assessment of hedge effectiveness in accordance with the "Pending Content" in FASB ASC 815-20-25-82, the initial value of the excluded component should be recognized in earnings (for NFP health care

³ FASB Accounting Standards Update (ASU) No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, is effective for public business entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. As amended by FASB ASU No. 2019-10, *Financial Instruments — Credit Losses (Topic 326) Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*, for all other entities (including not-for-profit [NFP] conduit bond obligors with publicly traded debt), the amendments in ASU No. 2017-12 are effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Early application is permitted in any interim period after issuance of the ASU.

entities, the performance indicator) using a systematic and rational method over the life of the hedging instrument with any difference between the change in fair value of the excluded component and amounts recognized in earnings under that systematic and rational method recognized in other comprehensive income in accordance with the "Pending Content" in FASB ASC 815-20-25-83A. Alternatively, an entity may elect to recognize the excluded component of the gain or loss currently in earnings (the performance indicator) in accordance with the "Pending Content" in FASB ASC 815-20-25-83B. Thus, investor-owned health care entities recognize the gain or loss on the derivative in earnings in the period of change, together with the offsetting loss or gain on the hedged item attributable to the risk being hedged, except for the excluded component, if any. Similarly, NFP health care entities report the derivative gains and losses, together with the offsetting loss or gain on the hedged item (except for the excluded component, if any), in the performance indicator in the period of change. In accordance with the "Pending Content" in FASB ASC 815-20-45-1A, the change in the value of the hedging instrument should be presented in the same line item in the income statement or statement of operations as the change in the value of the hedged item. For all qualifying hedging relationships, amounts excluded from the assessment of effectiveness and recognized in earnings through an amortization approach in accordance with FASB ASC 815-20-25-83A are reported in other comprehensive income by investor-owned health care entities or excluded from the performance indicator by business-oriented NFP health care entities.⁴

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 815-30-35-3.⁵

The "Pending Content" in FASB ASC 815-20-35-1(c) states that 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)

⁴ FASB ASU No. 2017-12 is effective for public business entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. As amended by FASB ASU No. 2019-10, for all other entities (including NFP conduit bond obligors with publicly traded debt), the amendments in FASB ASU No. 2017-12 are effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Early application is permitted in any interim period after issuance of the ASU.

⁵ 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.

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 the "Pending Content" in FASB ASC 815-30-35-3 and the "Pending Content" in paragraphs 38–41 of FASB ASC 815-30-35. If an entity excludes a portion of the hedging instrument from the assessment of hedge effectiveness in accordance with the "Pending Content" in FASB ASC 815-20-25-82, the initial value of the excluded component should be recognized in earnings using a systematic and rational method over the life of the hedging instrument with any difference between the change in fair value of the excluded component and amounts recognized in earnings under that systematic and rational method recognized in other comprehensive income in accordance with the "Pending Content" in FASB ASC 815-20-25-83A. An entity also may elect to recognize the excluded component of the gain or loss currently in earnings in accordance with paragraph 815-20-25-83B. In accordance with the "Pending Content" in FASB ASC 815-30-35-3(b) and the "Pending Content" in FASB ASC 815-20-45-1A, amounts in accumulated other comprehensive income that are reclassified to earnings should be presented in the same line item in the statement of operations or income statement as the earnings effect of the hedged item, in accordance with paragraph 815-20-45-1A.⁶

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.

Thus, unless an investor-owned health care entity elects to recognize the excluded component of the gain or loss currently in earnings, 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 that does not elect to recognize the excluded component of the gain or loss currently in the performance indicator, the 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

⁶ FASB ASU No. 2017-12 is effective for public business entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. As amended by FASB ASU No. 2019-10, for all other entities (including NFP conduit bond obligors with publicly traded debt), the amendments in FASB ASU No. 2017-12 are effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Early application is permitted in any interim period after issuance of the ASU.

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.⁷

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 Requirements

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 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.

To qualify for hedge accounting, at inception of the hedge, there must be formal documentation of all the information identified in the "Pending Content" 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, and the method(s) that will be used to retrospectively and prospectively assess hedge effectiveness, among others. The "Pending Content" in FASB ASC 815-20-25-3(b)(2)(iv) states that the entity must perform an initial prospective assessment of hedge effectiveness on a quantitative basis for all hedging relationships unless the hedging relationship meets one of the exceptions (that is, the hedge is assumed to be perfectly effective at hedge inception). At hedge inception, an entity also should document whether it elects to perform subsequent retrospective and

⁷ FASB ASU No. 2017-12 is effective for public business entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. As amended by FASB ASU No. 2019-10, for all other entities (including NFP conduit bond obligors with publicly traded debt), the amendments in FASB ASU No. 2017-12 are effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Early application is permitted in any interim period after issuance of the ASU.

prospective hedge effectiveness assessments on a qualitative basis and, if so, how it intends to carry out that qualitative assessment, as well as which quantitative method it will use if facts and circumstances of the hedging relationship change such that the entity no longer can assert qualitatively that the hedging relationship was and continues to be highly effective in achieving offsetting changes in fair values or cash flows and the entity must quantitatively assess hedge effectiveness in accordance with the "Pending Content" in FASB ASC 815-20-35-2D. An entity may elect to perform qualitative assessments on a hedge-by-hedge basis. Many not-for-profit and private company health care entities are permitted by the "Pending Content" in paragraphs 139–142 of FASB ASC 815-20-25 to delay documentation of the method of assessing hedge effectiveness at inception and on an ongoing basis, and performance of the initial hedge effectiveness assessment, as long as they are completed before the date on which the next interim (if applicable) or annual financial statements are available to be issued. The delay is not available to not-for-profit health care entities that are conduit borrowers with publicly-traded debt.⁸

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. (The shortcut method for hedges of interest rate risk, described in paragraphs 5.20–.28, assumes no hedge ineffectiveness.) 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.⁹

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. (The shortcut method for hedges of interest rate risk, described in paragraphs 5.20–.28, assumes no hedge ineffectiveness.) Many not-for-profit and private company health care entities are permitted by the "Pending Content" in FASB ASC 815-20-25-142 to delay performance of the ongoing hedge effectiveness assessments, as long as they

⁸ FASB ASU No. 2017-12 is effective for public business entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. As amended by FASB ASU No. 2019-10, for all other entities (including NFP conduit bond obligors with publicly traded debt), the amendments in FASB ASU No. 2017-12 are effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Early application is permitted in any interim period after issuance of the ASU.

⁹ 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.

are completed before the date on which the next interim (if applicable) or annual financial statements are available to be issued. The delay is not available to not-for-profit health care entities that are conduit borrowers with publicly-traded debt. 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.^{10,11}

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. 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 14–18 of FASB ASC 815-20-35) continue to be met.

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 documentation of both the election and periodic assessment of effectiveness has been executed in conformity with FASB ASC 815.

5.19 *Alternatives Available to Private Companies*

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. As noted in FASB ASC 815-20-25-131C, when applying the simplified hedge accounting approach, the documentation required by FASB ASC 815-20-25-3 to qualify for hedge accounting must be completed by the date on which

¹⁰ 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.

¹¹ FASB ASU No. 2017-12 is effective for public business entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. As amended by FASB ASU No. 2019-10, for all other entities (including NFP conduit bond obligors with publicly traded debt), the amendments in FASB ASU No. 2017-12 are effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Early application is permitted in any interim period after issuance of the ASU.

the first annual financial statements are available to be issued after hedge inception, rather than concurrently at hedge inception.

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 all of the conditions in the "Pending Content" in FASB ASC 815-20-25-135 and FASB ASC 815-20-25-137 are met, an entity may assume perfect effectiveness in a cash flow hedging relationship involving a variable-rate borrowing and a receive-variable, pay-fixed interest rate swap. 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. As noted in the "Pending Content" in FASB ASC 815-20-25-136, when applying the simplified hedge accounting approach, the documentation required by FASB ASC 815-20-25-3 to qualify for hedge accounting must be completed by the date on which the first annual financial statements are available to be issued after hedge inception, rather than concurrently at hedge inception.¹²

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, an entity can assume that there is no hedge ineffectiveness.

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

¹² FASB ASU No. 2017-12 is effective for public business entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. As amended by FASB ASU No. 2019-10, for all other entities (including NFP conduit bond obligors with publicly traded debt), the amendments in FASB ASU No. 2017-12 are effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Early application is permitted in any interim period after issuance of the ASU.

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 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.

The "Pending Content" in paragraphs 102–117 of FASB ASC 815-20-25 describes a set of conditions that determine which hedging relationships qualify for a shortcut version of hedge accounting, which assumes perfect hedge effectiveness. If all of the applicable conditions in the list in the "Pending Content" in FASB ASC 815-20-25-104 are met, an entity may assume perfect effectiveness in a hedging relationship of interest rate risk involving a recognized interest-bearing asset or liability and an interest rate swap. In addition, the "Pending Content" in FASB ASC 815-20-25-105 provides incremental conditions that apply to fair value hedges only, and the "Pending Content" in 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 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.¹³

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.

The "Pending Content" in FASB ASC 815-20-25-102 states that the shortcut method's 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 perfect effectiveness justified by applying other criteria. The verb *match* is used in the

¹³ FASB ASU No. 2017-12 is effective for public business entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. As amended by FASB ASU No. 2019-10, for all other entities (including NFP conduit bond obligors with publicly traded debt), the amendments in FASB ASU No. 2017-12 are effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Early application is permitted in any interim period after issuance of the ASU.

specified conditions in the list [of conditions in FASB ASC 815-20-25-104] to mean *be exactly the same or correspond exactly*.¹⁴

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 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.

As a condition for using the shortcut method for cash flow hedges, the pending content in ASC 815-20-25-106(g) requires that the index on which the variable leg of the interest rate swap is based match the contractually specified interest rate designated as the interest rate being hedged for that hedging relationship. As a condition for using the shortcut method for fair value hedges, the "Pending Content" in FASB ASC 815-20-25-105(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. The "Pending Content" in FASB ASC 815-20-25-6A states that, currently, in the United States, the interest rates on direct Treasury obligations of the U.S. government, the London Interbank Offered Rate (LIBOR) swap rate, the Fed Funds Effective Rate Overnight Index Swap Rate, the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate, and the Secured Overnight Financing Rate (SOFR) Overnight Index Swap Rate are considered to be benchmark interest rates. In each financial market, generally only the most widely used and quoted rates may be considered benchmark interest rates.¹⁵

¹⁴ FASB ASU No. 2017-12 is effective for public business entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. As amended by FASB ASU No. 2019-10, for all other entities (including NFP conduit bond obligors with publicly traded debt), the amendments in FASB ASU No. 2017-12 are effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Early application is permitted in any interim period after issuance of the ASU.

¹⁵ FASB ASU No. 2017-12 is effective for public business entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. As amended by FASB ASU No. 2019-10, for all other entities (including NFP conduit bond obligors with publicly traded debt), the

(continued)

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.

The preceding paragraph will be deleted upon the effective date of FASB Accounting Standards Update (ASU) No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*.¹⁶

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.

Implementation guidance and examples for use of the shortcut method are found in

- the "Pending Content" in FASB ASC 815-20-55-71;
- the "Pending Content" in FASB ASC 815-20-55-75;
- paragraphs 72–74 and 76–79 of FASB ASC 815-20-55;
- the "Pending Content" in paragraphs 42–43 of FASB ASC 815-25-55;
- the "Pending Content" in FASB ASC 815-25-55-46;
- the "Pending Content" in FASB ASC 815-25-55-49;
- the "Pending Content" in paragraphs 51–52 of FASB ASC 815-25-55;
- paragraphs 40–41, 44–45, 47–48, and 50 of FASB ASC 815-25-55;
- the "Pending Content" in paragraphs 24–25 of FASB 815-30-55;
- the "Pending Content" in paragraphs 28–29 of FASB ASC 815-30-55;

(footnote continued)

amendments in FASB ASU No. 2017-12 are effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Early application is permitted in any interim period after issuance of the ASU. FASB ASU No. 2018-16, *Derivatives and Hedging (Topic 815): Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting Purposes*, should be adopted at the same time as FASB ASU No. 2017-12 by entities that have not adopted FASB ASU No. 2017-12. A public business entity that has adopted FASB ASU No. 2017-12 should adopt FASB ASU No. 2018-16 for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. For all other entities that have adopted FASB ASU No. 2017-12, FASB ASU No. 2018-16 is effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years.

¹⁶ FASB ASU No. 2017-12 is effective for public business entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. As amended by FASB ASU No. 2019-10, for all other entities (including NFP conduit bond obligors with publicly traded debt), the amendments in FASB ASU No. 2017-12 are effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Early application is permitted in any interim period after issuance of the ASU.

- the "Pending Content" in FASB ASC 815-30-55-32; and
- paragraphs 26–27, 30–31 and 33 of FASB ASC 815-30-55.¹⁷

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.¹⁸

The preceding paragraph will be deleted upon the effective date of FASB ASU No. 2017-12.¹⁹

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.

The preceding paragraph will be deleted upon the effective date of FASB ASU No. 2017-12.²⁰

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

¹⁷ FASB ASU No. 2017-12 is effective for public business entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. As amended by FASB ASU No. 2019-10, for all other entities (including NFP conduit bond obligors with publicly traded debt), the amendments in FASB ASU No. 2017-12 are effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Early application is permitted in any interim period after issuance of the ASU.

¹⁸ In a Dutch auction, investors bid for the bonds, which are sold at the lowest yield necessary to sell the entire issue.

¹⁹ FASB ASU No. 2017-12 is effective for public business entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. As amended by FASB ASU No. 2019-10, for all other entities (including NFP conduit bond obligors with publicly traded debt), the amendments in FASB ASU No. 2017-12 are effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Early application is permitted in any interim period after issuance of the ASU.

²⁰ FASB ASU No. 2017-12 is effective for public business entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. As amended by FASB ASU No. 2019-10, for all other entities (including NFP conduit bond obligors with publicly traded debt), the amendments in FASB ASU No. 2017-12 are effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Early application is permitted in any interim period after issuance of the ASU.

policies, and leases, may contain embedded derivatives. *Embedded derivatives*, as defined in the FASB ASC Master 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 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 paragraphs 41–43 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 Master 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."²¹ 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 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

²¹ See FASB ASC 958-30 and chapter 6, "Split-Interest Agreements and Beneficial Interests in Trusts," of AICPA Audit and Accounting Guide *Not-for-Profit Entities* for a detailed discussion of split-interest agreements.

the hedged item ceases to be adjusted for changes in its fair value that are attributable to the risk being hedged.

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. An entity amortizes the adjustment to the carrying amount of the hedged item during an outstanding partial-term hedge of an interest-bearing financial instrument. The "Pending Content" in FASB ASC 815-25-35-9A provides guidance for an entity that amortizes the adjustment to the carrying amount of the hedged item during an outstanding partial-term hedge of an interest-bearing financial instrument.²²

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 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

²² FASB ASU No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments — Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments*, is effective as of the date the entity adopts FASB ASU No. 2017-12 if the entity has not yet adopted the amendments in FASB ASU No. 2017-12. For an entity that adopted FASB ASU No. 2017-12 before the issuance date of FASB ASU No. 2019-04, the amendments are effective as of the beginning of the first annual reporting period beginning after the issuance of FASB ASU No. 2019-04. Early adoption is permitted on any date on or after the issuance of FASB ASU No. 2019-04.

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 958-220-45-8, the changes in fair value of derivative instruments or hedged items are classified as increases or decreases in net assets without donor restrictions, unless their use is restricted by explicit donor stipulations or law that extends donor restrictions.

Auditing

© Update 5-1 *Auditing: Audit Evidence, Auditing Accounting Estimates, Use of Specialists, and Use of Pricing Information*

This edition of the guide has not been updated to reflect changes as a result of the issuance of the following Statements on Auditing Standards (SASs):

- SAS No. 142, *Audit Evidence* (AU-C sec. 500)²³
- SAS No. 143, *Auditing Accounting Estimates and Related Disclosures* (AU-C sec. 540)
- SAS No. 144, *Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources*

SAS No. 142 is effective for audits of financial statements for periods ending on or after December 15, 2022. SAS Nos. 143 and 144 are effective for audits of financial statements for periods ending on or after December 15, 2023. Early implementation is permitted.

The following section will be updated in a future edition. Readers should refer to the preface for further details regarding these SASs. Readers are encouraged to consult the full text of the SASs at aicpa.org.

5.44 AU-C section 501B, *Audit Evidence — Specific Considerations for Selected Items*, addresses specific considerations by the auditor in obtaining sufficient appropriate audit evidence regarding certain aspects of derivative instruments and hedging activities. 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.

²³ All AU-C sections can be found in AICPA *Professional Standards*.

Chapter 6

Property and Equipment and Other Assets

Gray shaded text in this chapter reflects guidance issued but not yet effective as of the date of this guide, September 1, 2021, but becoming effective on or prior to June 30, 2022, 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

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) as proceeds may need to be returned to the government or private grantor.

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." 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. In accordance with the

"Pending Content" in FASB ASC 705-20-25-1, the entity should account for consideration from a vendor as a reduction of the purchase price of the goods or services acquired from the vendor unless the consideration from the vendor is one of the following:

- In exchange for a distinct good or service (as described in paragraphs 19–22 of FASB ASC 606-10-25) that the entity transfers to the vendor, which is accounted for as described in FASB ASC 705-20-25-2
- A reimbursement of costs incurred by the entity to sell the vendor's products, , which is accounted for as described in FASB ASC 705-20-25-3
- Consideration for sales incentives offered to customers by manufacturers, which is accounted for as described in paragraphs 4–9 of FASB ASC 705-20-25.

The "Pending Content" in paragraphs 10–12 of FASB ASC 705-20-25 provides guidance if a rebate or refund of a specified amount of cash consideration is payable pursuant to a binding arrangement only if the entity completes a specified cumulative level of purchases or remains a customer for a specified time period.

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

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 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.

When a prospective lessee is involved in the construction or design of an underlying asset prior to lease commencement, the lessee determines whether it controls the asset that is under construction before the commencement date. If the lessee controls the asset during the construction period before the asset is transferred to the lessor, the transaction is a sale and leaseback transaction that is accounted for in accordance with the guidance in the "Pending Content" in FASB ASC 842-40. The "Pending Content" in FASB ASC 842-40-55-5 provides a list of circumstances in which a lessee controls an asset that is under construction before the commencement date. That list is not all

inclusive; there may be other circumstances that individually or in combination demonstrate that a lessee controls an underlying asset that is under construction before the commencement date. If the lessee obtains legal title, but does not obtain control of the underlying asset before the asset is transferred to the lessor, the transaction is not a sale and leaseback transaction.¹

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.

The "Pending Content" in FASB ASC 842-40-55-4 states that if a lessee incurs costs relating to the construction or design of an underlying asset before the commencement date, the lessee should account for those costs in accordance with other topics, for example, FASB ASC 360 on property, plant, and equipment. Costs relating to the construction or design of an underlying asset do not include payments made by the lessee for the right to use the underlying asset. Payments for the right to use the underlying asset are lease payments, regardless of the timing of those payments or the form of those payments (for example, a lessee might contribute construction materials for the asset under construction).

In accordance with the "Pending Content" in FASB ASC 842-40-25-1, a health care entity should apply the following requirements on revenue from contracts with customers when determining whether the transfer of an asset should be accounted for as a sale of the asset:

- a. The "Pending Content" in FASB ASC 606-10-25-1 through 25-8 on the existence of a contract
- b. The "Pending Content" in FASB ASC 606-10-25-30 on when an entity satisfies a performance obligation by transferring control of an asset.

If the transfer of the asset is a sale in accordance with the "Pending Content" in paragraphs 1–3 of FASB ASC 842-40-25, the seller-lessee should

1. Recognize the transaction price for the sale at the point in time the buyer-lessor obtains control of the asset in accordance with the "Pending Content" in FASB ASC 606-10-25-30 in accordance with

¹ FASB Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842): Amendments to the FASB Accounting Standards Codification*, was 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. However, if those not-for-profit entities had not issued financial statements or made financial statements available for issuance before June 3, 2020, that reflected adoption of the leasing standards, ASU No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, deferred the effective date by one year, to fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Early application of the amendments is permitted for all entities.

the guidance on determining the transaction price in the "Pending Content" in paragraphs 2–27 of FASB ASC 606-10-32.

2. Derecognize the carrying amount of the underlying asset.
3. Account for the lease in accordance with the "Pending Content" in FASB ASC 842-20.²

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.

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

- Example 3 in the "Pending Content" in paragraphs 40–44 of FASB ASC 842-40-55
- The "Pending Content" in paragraphs 1–9 of FASB ASC 842-20-50 describes the disclosures required for a seller-lessee.³

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

² FASB ASU No. 2016-02 was 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. However, if those not-for-profit entities had not issued financial statements or made financial statements available for issuance before June 3, 2020, that reflected adoption of the leasing standards, ASU No. 2020-05 deferred the effective date by one year, to fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Early application of the amendments is permitted for all entities.

³ FASB ASU No. 2016-02 was 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. However, if those not-for-profit entities had not issued financial statements or made financial statements available for issuance before June 3, 2020, that reflected adoption of the leasing standards, ASU No. 2020-05 deferred the effective date by one year, to fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Early application of the amendments is permitted for all entities.

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 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)⁴ 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.

⁴ The FASB ASC Master 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 Master 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."

- 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 Master 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.

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 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 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 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 954-220-45-8 and FASB ASC 958-220-55-7 require 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 Master Glossary. Accounting for contributions made is discussed in paragraph 11.47.

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

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. In accordance with FASB ASC 350-40-25-17, a software license within the scope of FASB ASC 350-40 should be accounted for as the acquisition of an intangible asset and the incurrence of a liability (that is, to the extent that all or a portion of the software licensing fees are not paid on or before the acquisition date of the license) by the licensee. The intangible asset acquired should be recognized and measured in accordance with FASB ASC 350-30-25-1 and 350-30-30-1, respectively. Technical Questions and Answers (Q&A) section 6400.53, "Accounting for Costs Incurred in Connection With the Implementation of Electronic Health Record Systems,"⁵ states that the accounting for implementation costs of those systems is similar to other information system conversions, and the guidance in FASB ASC 720-45 and FASB ASC 350-40 should be considered.

For hosting arrangements that are service contracts, an entity (customer) follows the guidance in FASB ASC 350-40 to determine which implementation costs to capitalize as an asset related to the service contract and which costs to expense. In accordance with the "Pending Contact" in FASB ASC 350-40-35-13, the entity (customer) expenses the capitalized implementation costs of a hosting arrangement that is a service contract over the term of the hosting arrangement.⁶

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.

6.38 In accordance with FASB ASC 350-20, goodwill that is not written off on the acquisition date, as discussed in paragraph 12.108, should not be

⁵ All Q&A sections can be found in *Technical Questions and Answers*. *Technical Questions and Answers* can be downloaded at <https://www.aicpa.org/resources/download/aicpa-technical-questions-and-answers-at-your-fingertips>.

⁶ FASB ASU No. 2018-15, *Intangibles — Goodwill and Other — Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract (a consensus of the FASB Emerging Issues Task Force)*, issued in August 2018, is effective for public business entities for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. For all other entities, the amendments in ASU No. 2018-15 are effective for annual reporting periods beginning after December 15, 2020, and interim periods within annual periods beginning after December 15, 2021. Early application of the amendments is permitted for all entities.

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.

In accordance with FASB ASC 350-20, goodwill that is not written off on the acquisition date, as discussed in paragraph 12.108, 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 a reporting unit, including goodwill, exceeds its fair value. 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. If, after assessing the totality of events or circumstances, an entity determines that it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then the quantitative goodwill impairment test is unnecessary. If determined to be necessary, the quantitative impairment test, which is discussed in paragraphs 4–13 of FASB ASC 350-20-35, should be used to identify goodwill impairment and measure the amount of goodwill impairment loss to be recognized, if any. If the carrying amount of the reporting unit exceeds its fair value, an impairment loss should be recognized in an amount equal to that excess. However, the impairment loss is limited to the total amount of goodwill allocated to the reporting unit. If applicable, the income tax effect from any tax deductible goodwill should be considered on the carrying amount of the entity (or the reporting unit), in accordance with FASB ASC 350-20-35-8B when measuring the goodwill impairment loss.⁷

6.39 Alternatives Available to Private Companies and Not-for-Profit Entities

⁷ 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 health care 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.

Per FASB ASC 350-20-35, entities within the scope of FASB ASC 350-20-15-4 (private companies and NFPs) 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. Those entities may also elect to perform their goodwill impairment triggering event evaluations only as of the end of each reporting period, whether the reporting period is an interim or annual period. That is, the entity would not evaluate goodwill impairment triggering events and measure any related impairment during the reporting period. For an entity that has also elected the accounting alternative for amortizing goodwill, the evaluation of a triggering event, as described in the "Pending Content" in FASB ASC 350-20-35-66, should be performed only as of each reporting date. For an entity that has not also elected the accounting alternative for amortizing goodwill, the evaluation of the triggering event should be performed as described in the "Pending Content" in FASB ASC 350-20-35-84(b).

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%) 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 958-205-45-12 states that unless donor stipulations limit the use of the assets for a period of time or for a particular purpose, donor restrictions on long-lived assets, if any, or cash to acquire or construct long-lived assets are considered to have expired when the assets are placed in service.

6.46 Thus, if contributions of long-lived assets with explicit donor restrictions are reported as donor-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 or construct long-lived assets are reported as donor-restricted support in the period received, and expirations of those donor restrictions are reported when the acquired or constructed long-lived assets are placed in service, and donor-imposed restrictions are satisfied.

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

6.48 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

🔄 Update 6-1 *Auditing: Audit Evidence, Auditing Accounting Estimates, Use of Specialists, and Use of Pricing Information*

This edition of the guide has not been updated to reflect changes as a result of the issuance of the following Statements on Auditing Standards (SASs):

- SAS No. 142, *Audit Evidence* (AU-C sec. 500)⁸

⁸ All AU-C sections can be found in AICPA *Professional Standards*.

- SAS No. 143, *Auditing Accounting Estimates and Related Disclosures* (AU-C sec. 540)
- SAS No. 144, *Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources*

SAS No. 142 is effective for audits of financial statements for periods ending on or after December 15, 2022. SAS Nos. 143 and 144 are effective for audits of financial statements for periods ending on or after December 15, 2023. Early implementation is permitted.

The following section will be updated in a future edition. Readers should refer to the preface for further details regarding these SASs. Readers are encouraged to consult the full text of the SASs at aicpa.org.

6.49 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 .03 of AU-C section 315B, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, 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.

6.50 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.

6.51 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.

6.52 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 2018) 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.

6.53 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.

6.54 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 330B, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, 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 315B. Various audit procedures and the purposes for which they may be performed are described in paragraphs .A10–.A26 of AU-C section 500B, *Audit Evidence*.

Audit Considerations

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i> ⁹	<i>Substantive Audit Procedures</i> ¹⁰
Donated Property Equipment			
Account Balances			
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
Presentation and Disclosure			
Classification and understandability	The receipt of donated property and equipment is properly reported.	Contributions of property and equipment are reviewed for restrictions and management monitors compliance with restrictions.	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.

⁹ The auditor should consider a combination of preventive and detective controls responsive to the control objectives.

¹⁰ 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			
<i>Presentation and Disclosure</i>			
Classification and under-standability	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.
<i>Property and Equipment Additions</i>			
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.
¹ For additional discussion on fair value measurements, refer to chapter 4, "Cash, Cash Equivalents, and Investments." ² AU-C section 540B, <i>Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures</i>, provides guidance on auditing fair value measurements and disclosures contained in financial statements. AU-C section 540B does not address specific types of assets, liabilities, components of equity, transactions, or industry-specific practices.			

Exhibit 6-1¹¹

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 330B, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, 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 315A, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. Various audit procedures and the purposes for which they may be performed are described in paragraphs .A10–.A26 of AU-C section 500A, *Audit Evidence*.

Audit Considerations

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i> ¹²	<i>Substantive Audit Procedures</i> ¹³
Account Balances			
Property and Equipment Held and Used			
Existence and accuracy/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.
Property and Equipment Not Held for Use in Operations			
Classification	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.

¹¹ Statement on Auditing Standards (SAS) Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the Auditing Standards Board (ASB) recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

¹² The auditor should consider a combination of preventive and detective controls responsive to the control objectives.

¹³ 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>Classes of Transactions</i>			
Donated Property Equipment			
Accuracy, Completeness	Donated property and equipment is recorded at fair value at the date of donation. ¹ Required disclosures are included.	Procedures ensure that the donation of property and equipment is known and recorded and that documentation supports the determination of the fair value. Controls ensure that required disclosures are made.	Review the documentation supporting the determination of the fair value. ² Verify that required disclosures have been made.
Classification	The receipt of donated property and equipment is properly recorded. The expiration of donor-imposed restrictions is recorded when assets are placed in service, unless use is further restricted by donors.	When equipment is placed in service, controls are in place to determine whether there are related restrictions, and if so, there are controls in place to reclassify the net assets when those restrictions are satisfied.	Review material donated property and equipment transactions to ensure the propriety of the reporting. If restricted resources were used for the purchase of property and equipment, the auditor may find it necessary to consider whether reclassifications are made on the statement of activities when the asset is placed in service. Ensure any reversionary interest has been properly accounted for in any disposals of donated or grant acquired assets.

(continued)

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 Additions			
Completeness	Property and equipment additions are in compliance with laws and regulations. Property and equipment additions are capitalized or expensed in accordance with the entity's capitalization policies.	Management regularly monitors compliance with health care planning agency regulations related to additions of property and equipment. Controls ensure that purchases are reviewed to determine if capitalization is required.	For material new construction, determine compliance with health care planning agency or other regulatory agency requirements. Verify that approvals of the appropriate health care planning agency or other regulatory agency, if required, have been obtained for property and equipment additions. Verify that purchase transactions are expensed or capitalized in accordance with the entity's policies. Compare the entity's budgeted and actual capital outlays for the period and investigate significant variances.
¹ For additional discussion on fair value measurements, refer to chapter 4, "Cash, Cash Equivalents, and Investments." ² AU-C section 540A, <i>Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures</i>, provides guidance on auditing fair value measurements and disclosures contained in financial statements. AU-C section 540A does not address specific types of assets, liabilities, components of equity, transactions, or industry-specific practices.			

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, 2021, but becoming effective on or prior to June 30, 2022, 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 one of the largest industries that raises 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."

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 the bonds are characterized as tax exempt or taxable. Generally, tax-exempt

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

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 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 Master 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. Technical Questions and Answers (Q&A) section 7100, "Definition of a Public Business Entity,"⁴ can assist in applying the definition of a *public business entity*. Although NFPs are, by definition, not public business entities, Q&A section 7100 may assist NFPs in understanding the key terms used in the various definitions of public entity, including the definitions of security, over-the-counter market, and conduit debt obligor.

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

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*.

⁴ All Q&A sections can be found in *Technical Questions and Answers*. *Technical Questions and Answers* can be downloaded at <https://www.aicpa.org/resources/download/aicpa-technical-questions-and-answers-at-your-fingertips>.

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.

Credit Enhancement⁵

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 Health care entities generally issue municipal bonds 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 issuer or obligor sells the securities 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 available to be traded thereafter in the public over-the-counter market; thus, conduit borrowers under those arrangements are considered public entities for purposes of providing certain disclosures or adopting certain accounting standards earlier than nonpublic entities (see the discussion 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

⁵ 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.

to municipal bonds is provided in the appendix, "Municipal Securities Regulation," of this chapter. In a private placement, the securities generally are sold only to qualified investors (for example, an institutional investor), rather than through an offering to the general investing public. As noted in Q&A 7100.03, "Use of the Term 'Over-the-Counter Market' in the Definition of a Public Business Entity," markets accessible by only certain investors (for example, qualified institutional or accredited investors) are not considered accessible by the 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, which limit sales only to certain investors. Q&A section 7100.14, "Private Resales (Rule 144 and Rule 144A) and the Definition of a Public Business Entity," provides further information on different types of resale rights if the entity has not filed a registration statement with the SEC.

7.13 A health care entity that is issuing municipal bonds through a financing authority prepares an official statement⁶ 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 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

⁶ In addition to the term *official statement*, an exempt offering document may also be referred to as an *offering statement*, *offering memorandum*, or *offering circular*. This chapter uses the terms *exempt offering document* and *official statement* interchangeably when discussing municipal securities.

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.⁷ 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.

⁷ The Tax Cuts and Job Act of 2017 eliminated an issuer's ability to have two tax-advantaged bond issues outstanding for the same project. Therefore, after December 31, 2017, issuers lost the ability to advance refund one tax-exempt issue with another tax-exempt issue. However, other types of advance refunding are still permitted (for example, tax-exempt to taxable).

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.

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% 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%. If the difference is less than 10%, 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. The "Pending Content" in FASB ASC 470-50-40-2A provides guidance for an early extinguishment of debt for which the fair value option has been elected in accordance with FASB ASC 815-15 on embedded derivatives or FASB ASC 825-10 on financial instruments. 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 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. FASB ASC 470-50-40-21 discusses accounting for fees between the debtor and creditor for exchanges of or modifications to line-of-credit or revolving-debt arrangements. Paragraphs 17–18 of FASB ASC 470-50-40 discuss accounting for fees and third-party costs associated with exchanges of or modifications to other debt issuances.

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 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% of the net bond proceeds must be used for exempt activities. Thus, no more than 5% 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% 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 www.irs.gov/pub/irs-drop/n-08-31.pdf.

Financial Statement Presentation and Disclosure

Balance Sheet

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. 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 should be reported as contributions from the sponsoring entity.

According to the "Pending Content" in 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 lease. 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 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 should be reported as contributions from the sponsoring entity.⁸

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.

⁸ FASB ASU No. 2016-02, *Leases (Topic 842): Amendments to the FASB Accounting Standards Codification*, was 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. However, if those not-for-profit entities had not issued financial statements or made financial statements available for issuance before June 3, 2020, that reflected adoption of the leasing standards, ASU No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, deferred the effective date by one year, to fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Early application of the amendments is permitted for all entities.

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 measureable. 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 Master 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 a 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," 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." In accordance with FASB ASC 954-210-50-2, because the form of the assets is not evident from the description on the balance sheet, the form of the assets should be disclosed in the notes to the financial statements. 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. As discussed in paragraph 4.11, when cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents are presented in more than one line item within the statement of financial position, an entity should provide the disclosures in FASB ASC 230-10-50-8.

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."

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

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 refinance 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. If investor-owned health care entities elect the fair value option for

liabilities, changes in fair value attributable to instrument-specific credit risk should be reported in other comprehensive income (see FASB ASC 825-10-45-5). If business-oriented not-for-profit health care entities elect the fair value option for liabilities, changes in fair value attributable to instrument-specific credit risk should be reported outside the performance indicator (see FASB ASC 954-220-45-8).

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 800B,⁹ *Special Considerations — Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*,¹⁰ 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. For

⁹ Paragraph renumbered as .21 by Statement on Auditing Standards (SAS) No. 139, *Amendments to AU-C Sections 800, 805, and 810 to Incorporate Auditor Reporting Changes From SAS No. 134*. SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the Auditing Standards Board (ASB) recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

¹⁰ All AU-C sections can be found in AICPA *Professional Standards*.

example, special purpose financial statements prepared in accordance with a contractual basis of accounting are developed for and directed only to 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.¹¹

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 describes the disclosure requirements for interim reporting. For example, 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.

¹¹ See paragraph .A5 of AU-C section 905B, *Alert That Restricts the Use of the Auditor's Written Communication*.

Auditing

🕒 **Update 7-1 Auditing: Audit Evidence, Auditing Accounting Estimates, Use of Specialists, and Use of Pricing Information**

This edition of the guide has not been updated to reflect changes as a result of the issuance of the following Statements on Auditing Standards (SASs):

- SAS No. 142, *Audit Evidence* (AU-C sec. 500)
- SAS No. 143, *Auditing Accounting Estimates and Related Disclosures* (AU-C sec. 540)
- SAS No. 144, *Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources*

SAS No. 142 is effective for audits of financial statements for periods ending on or after December 15, 2022. SAS Nos. 143 and 144 are effective for audits of financial statements for periods ending on or after December 15, 2023. Early implementation is permitted.

The following section will be updated in a future edition. Readers should refer to the preface for further details regarding these SASs. Readers are encouraged to consult the full text of the SASs at aicpa.org.

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 typically reviews 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" (AU-C sec. 9620B par. .01–.21), of AU-C section 620B, *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 Offerings

7.86 AU-C section 945B, *Auditor Involvement With Exempt Offering Documents*, 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 945B. An exempt offering document is the disclosure document that provides financial and nonfinancial information related to the entity issuing the exempt offering and the offering itself. As discussed in paragraph 7.13, the exempt offering document related to a municipal security offering is an official statement.

Conditions Establishing Auditor Involvement

7.87 Paragraph .08 of AU-C section 945B provides two conditions that both have to exist to establish involvement with an official statement:

- 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 (also referred to as *triggering activities*) with respect to the official statement:
 - i. Assisting the entity in preparing information included in the official statement
 - 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 920B, *Letters for Underwriters and Certain Other Requesting Parties*, or an agreed-upon procedures report in accordance with AT-C section 215, *Agreed-Upon Procedures Engagements*,¹² 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 these triggering activities is discussed in more depth in this section.

7.88 In accordance with paragraph .A6 of AU-C section 945B, 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 945B if the previously described conditions are not met. See related discussion in paragraph 7.108.

Assisting in Preparing Information

7.89 Assistance in preparing information as described in paragraph 7.87 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 7.87.

7.90 Information for this purpose 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.

¹² All AT-C sections can be found in AICPA *Professional Standards*.

7.91 AU-C section 945B 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.¹³ A member may assist the entity in drafting its official statement without impairing independence¹⁴ if the member complies with the AICPA Code of Professional Conduct.^{15,16}

7.92 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

7.93 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 in Accordance With AU-C Section 920 or an Agreed-Upon Procedures Report in Accordance With AT-C Section 215

7.94 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 920B addresses the auditor's responsibilities when engaged to issue comfort letters to a *requesting party*, as defined (typically underwriters, broker-dealers, or other financial intermediaries performing the due diligence review) and is further discussed in paragraphs 7.113–.119. AT-C section 215 addresses letters issued to parties other than a requesting party in agreed-upon procedures engagements, in lieu of a comfort or similar letter on information included in the exempt offering document, as discussed in paragraph 7.115.

Participating in Due Diligence Discussions

7.95 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.¹⁷ 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

¹³ The "Independence Rule" (ET sec. 1.200.001) of the AICPA Code of Professional Conduct. All ET sections can be found in AICPA *Professional Standards*.

¹⁴ The "Corporate Finance Consulting" interpretation (ET sec. 1.295.130.02f) of the "Nonattest Services" subtopic under the "Independence Rule" of the AICPA Code of Professional Conduct.

¹⁵ The "General Requirements for Performing Nonattest Services" interpretation (ET sec. 1.295.040) of the "Nonattest Services" subtopic under the "Independence Rule."

¹⁶ The "Corporate Finance Consulting" interpretation (ET sec. 1.295.130.03) 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.

¹⁷ 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.

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 920B.¹⁸ 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

7.96 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.

7.97 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 945B.

Providing Written Agreement for the Use of the Auditor's Report in the Official Statement

7.98 Generally, there is no regulatory requirement for the auditor to provide any type of written agreement to use the auditor's report in the official statement. If the auditor is asked to provide written agreement, the auditor may provide an inclusion letter¹⁹ 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.

¹⁸ Paragraphs .07, .11, and .A92 of AU-C section 920B, *Letters for Underwriters and Certain Other Requesting Parties*.

¹⁹ For securities exempt from registration under the Securities Act of 1933, an inclusion letter may also be referred to as an *agree-to-include letter*, an *acknowledgement letter*, or an *awareness letter*. Note that awareness letter is defined in AU-C section 925B, *Filings With the U.S. Securities and Exchange Commission Under the Securities Act of 1933*, with a different meaning in that context.

When the auditor is asked to issue a letter agreeing to the inclusion of the auditor's report in the official statement, the effective date of the letter can be the preliminary official statement date or the official statement date depending on with which document the auditor is involved.

Updating an Auditor's Report for Inclusion in the Exempt Offering Document

7.99 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.

7.100 The following examples would not constitute updating an auditor's report for purposes of paragraph 7.87:

- 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* (also referred to as the Yellow Book), issued by the Comptroller General of the United States
- 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 Official Statement

7.101 The objectives of the auditor when involved with an official statement are to perform procedures specified in AU-C section 945B 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 official statement proceedings through the final distribution, circulation, or submission of the final official 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 official statement can be completed.

7.102 In accordance with paragraph .09 of AU-C section 945B, the auditor should perform the procedures described in paragraphs .06–.18 of AU-C section 720B, *Other Information in Documents Containing Audited Financial Statements*, 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 720B

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 accordance with paragraph .09 of AU-C section 945, the auditor should perform the procedures described in paragraphs .15–.23 of AU-C section 720, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*, adapted as necessary, on the official statement. When revision of the other information in the official statement is necessary due to a material misstatement that management refuses to correct, AU-C section 720 requires the auditor to communicate the matter with those charged with governance and request that the correction be made. If the other information is not corrected after communicating with those charged with governance, the auditor is required to take appropriate action in accordance with paragraph .21 of AU-C section 720. 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.²⁰

7.103 In addition to the procedures related to other information, paragraph .10 of AU-C section 945B 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 chapter). 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:

²⁰ SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the ASB recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

- 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.

7.104 Paragraphs .11–.12 of AU-C section 945B 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.

7.105 Paragraph .13 of AU-C section 945B 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 560B, *Subsequent Events and Subsequently Discovered Facts*.²¹

7.106 As noted in paragraph .14 of AU-C section 945B, 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 560B.²²

7.107 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 560B, paragraph .15 of AU-C section 945B states the auditor should not agree to the inclusion of the auditor's report in the official statement.²³

Engagement Terms Regarding Auditor-Involvement

7.108 Auditors may include a provision in the terms of the engagement requiring the entity to obtain permission from the auditor before using the auditor's report in connection with an official statement. The existence of such a provision in an engagement letter does not establish involvement unless the auditor performs one or more of the activities in paragraph 7.87 with respect

²¹ Paragraph .11 of AU-C section 560B, *Subsequent Events and Subsequently Discovered Facts*.

²² Paragraphs .15–.18 of AU-C section 560B.

²³ Paragraphs .17–.18 of AU-C section 560B.

to the official statement. An example provision for an engagement letter may read as follows:

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

7.109 Paragraph .A3 of AU-C section 945B states that the auditor may include in the terms of the engagement a provision that any official statements issued by the entity with which the auditor is not involved, other than as determined by paragraph 7.87, will clearly indicate the auditor is not involved with the contents of such official statement. 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.

Using Government Auditing Standards Reports and References in an Official Statement

7.110 Health care entities sometimes request that auditors revise an originally issued auditor's report for use in a municipal securities offering to eliminate references made by the auditor to *Government Auditing Standards*, issued by the Comptroller General of the United States. Issuing a separate generally accepted auditing standards (GAAS) only report is permitted for this purpose because *Government Auditing Standards* acknowledge that an auditee may need a financial statement audit for purposes other than to comply with a requirement calling for an audit in accordance with *Government Auditing Standards*. As noted in paragraph 7.100, when such requests are made of the auditor it would not be considered a triggering activity to establish involvement.

Continuing Disclosure Documents

7.111 An NFP's continuing disclosures uploaded to the MSRB's EMMA system are not considered other information as discussed in AU-C section 720B. Therefore, an auditor is not required to apply the requirements of AU-C section 720B to such continuing disclosures.

7.112 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 and Other Requesting Parties

7.113 Underwriting agreements between a health care entity and its underwriters may require the entity to request the auditor to prepare a comfort letter addressed to the underwriters. AU-C section 920B defines the term *underwriters* and gives guidance to auditors²⁴ when engaged to issue letters to underwriters and to certain other requesting parties in connection with a non-issuer 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 paragraph .11 of AU-C section 920B. 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.

7.114 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 920B, 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 920B 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," in paragraph .A93-20 of AU-C section 920B for the relevant illustration.

7.115 As discussed in paragraph .13 of AU-C section 920B, 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 920B. 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 920B).

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*.

7.116 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 920B:

- 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)

7.117 If the auditor is engaged to provide negative assurance in a comfort letter on interim financial information, paragraph .45 of AU-C section 920B requires the auditor to perform a review, as discussed in AU-C section 930B, *Interim Financial Information*. A review of interim financial information may be conducted under AU-C section 930B when

- the entity's latest annual financial statements have been audited by the auditor or a predecessor auditor;
- the auditor either (i) has been engaged to audit the entity's current year financial statements, or (ii) the auditor audited the entity's latest annual financial statements and in situations in which it is expected that the current year financial statements will be audited, 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 financial information is prepared in accordance with the same financial reporting framework as that used to prepare the annual financial statements; and
- any condensed interim financial information
 - purports to be prepared in accordance with an appropriate financial reporting framework which includes appropriate form and content of the interim financial information;
 - includes a note that the financial information does not represent complete financial statements and is to be read in conjunction with the entity's latest audited annual financial statements; and
 - the condensed interim financial information accompanies the entity's latest audited annual financial statements or such audited annual financial statements are made readily available by the entity.²⁵

²⁵ According to paragraph .A3 of AU-C section 930B, *Interim Financial Information*, audited financial statements are deemed readily available if a third party user can obtain the financial statements without any further action by the entity (for example, financial statements on an entity's website may be considered readily available but being available upon request is not considered readily available).

If AU-C section 930B 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.

7.118 If the auditor has not performed such a review, paragraphs .45 and .60 of AU-C section 920B 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 GAAP and from providing negative assurance as to 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 920B.

7.119 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 920B 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 920B is illustrative only and does not set a requirement, but practice generally does not exceed a five-day cut-off period.

Reference to the Auditor as an "Expert"

7.120 When performing procedures in accordance with AU-C section 945B, 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.

Attestation Engagements Related to Municipal Securities Issuance

7.121 During the process of issuing municipal securities, health care entities or other involved parties often engage practitioners to provide certain needed information. These engagements should be conducted in accordance with the appropriate professional attestation standards as agreed to by the engaging entity and the practitioner.²⁶ For example, a health care entity or its bond counsel may engage a practitioner 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. 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 7.87. 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 involve the auditor of the financial statements with the official statement. Sometimes, the practitioner's report on an attestation engagement may only be included in the official closing documents for the offering. Also, if the practitioner providing the report on an attestation engagement is not the auditor of the financial statements included in the official statements, the issuance of the practitioner's report on an attestation engagement 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.

7.122 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" (AT-C sec. 9105 par. .01–.11), of AT-C section 105, *Concepts Common to All Attestation Engagements*.

7.123 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 7.121 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.

²⁶ Generally, these attestation engagements are performed only in accordance with 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*" (AT-C sec. 9205 par. .01–.03), of AT-C section 205, *Examination Engagements*, explains how an attestation report should be modified when the engagement is performed in accordance with *Government Auditing Standards*, and 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 330B, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, 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 315B, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. Various audit procedures and the purposes for which they may be performed are described in paragraphs .A10–.A26 of AU-C section 500B, *Audit Evidence*.

Audit Considerations

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i> ²⁷	<i>Substantive Audit Procedures</i> ²⁸
<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.

²⁷ The auditor should consider a combination of preventive and detective controls responsive to the control objectives.

²⁸ 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.

Exhibit 7-1²⁹

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 330B, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, 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 315B, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. Various audit procedures and the purposes for which they may be performed are described in paragraphs .A10–.A26 of AU-C section 500A, *Audit Evidence*.

Audit Considerations

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives³⁰</i>	<i>Substantive Audit Procedures³¹</i>
Account Balances			
Bonds Payable			
Classification	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.
Completeness, Presentation	All required disclosures are included, relevant, and understandable.	Controls are in place to ensure that all required disclosures are included in the financial statements.	Verify that all required debt disclosures have been included in the financial statements and are relevant and understandable.

²⁹ SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the ASB recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

³⁰ The auditor should consider a combination of preventive and detective controls responsive to the control objectives.

³¹ 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.

Appendix — Municipal Securities Regulation

A-1 Currently, municipal securities are exempt from all of the provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 except the antifraud provisions of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 (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 rate demand obligation (or VRDO) offerings provide certain disclosures when issuing securities (primary market disclosures) as well as at certain times thereafter (continuing disclosures, sometimes referred to as secondary market disclosures). 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, nonpayment related defaults, and incurrence of a financial obligation affecting security holders, are provided on an as-needed basis and do not involve financial statements. The requirements for event notices in Rule 15c2-12 have been revised various times over the years. The most current revision to Rule 15c2-12 was issued in August 2018 and expands the list of required event notices to 16 for continuing disclosure agreements entered into on or after February 27, 2019. Both primary and continuing disclosure documents are available through the nationally-recognized municipal securities information repository (the Electronic Municipal Market Access system, or EMMA) and to state information depositories, if one exists in the obligor's state. Additional information about continuing disclosures is provided beginning at paragraph A-6.

A-3 Rule 15c2-12, as amended, requires the underwriter of a municipal securities offering to reasonably determine that the issuer or obligated person (hereafter referred to as the *obligor*) 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 obligor provides continuing disclosure information using the MSRB's Electronic Municipal Market Access (EMMA) system.² 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

¹ For the adopting release, see 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>.

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.

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 of 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 (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

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 www.sec.gov/rules/interp/1994/33-7049.pdf.

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 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 requirements for event notices in Rule 15c2-12 have been revised various times over the years. The most current revision to Rule 15c2-12 was issued in August 2018 and expands the list of required event notices to 16 for continuing disclosure agreements entered into on or after February 27, 2019. If the primary offering of municipal securities subject to Rule 15c2-12 occurred on or before November 30, 2010, obligors under continuing disclosure agreements are required to notify the MSRB of any of 11 specific events, if determined material, in a timely manner. If the primary offering of municipal securities occurred on or after December 1, 2010, obligors under continuing disclosure agreements 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 obligors, 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

Obligors under a continuing disclosure agreement entered into on or after February 27, 2019, must also disclose the following:

- Material financial obligations incurred on or after the date on which such the continuing disclosure agreement was entered into
- Any default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation, any of which reflect financial difficulties that occurs on or after February 27, 2019, regardless of when the financial obligation was incurred

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. Technical Questions and Answers (Q&A) section 7100.05, "FINRA TRACE and MSRB EMMA Data and a Public Business Entity,"⁴ states that although EMMA provides historical trade prices, credit ratings and other information related to those securities, it does not allow execution of trades, and therefore it is not an over-the-counter market.

⁴ All Q&A sections can be found in *Technical Questions and Answers*. *Technical Questions and Answers* can be downloaded at <https://www.aicpa.org/resources/download/aicpa-technical-questions-and-answers-at-your-fingertips>.

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, 2021, but becoming effective on or prior to June 30, 2022, 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.

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 not-for-profit (NFP) entities.

Contingencies and Commitments

8.02 Self-insured obligations, other contingencies, and commitments may include the following:

- a. Losses arising from medical malpractice, employee health coverage, 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 *Accounting Standards Codification* (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 Questions and Answers (Q&A) section 6400.52, "Insurance Recoveries From

Certain Retrospectively Rated Insurance Policies,"¹ 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

¹ All Q&A sections can be found in *Technical Questions and Answers*. *Technical Questions and Answers* can be downloaded at <https://www.aicpa.org/resources/download/aicpa-technical-questions-and-answers-at-your-fingertips>.

Recoveries — Contingencies Similar to Malpractice," 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," 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, 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 The Financial Reporting Executive Committee (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," 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. Because captive insurance companies are owned by the insured health care entity, they are a form of self-insurance unless the captive insurance company mitigates its risk of loss by purchasing stop loss or re-insurance contracts from third-party insurance companies.

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. Relationships with multiprovider captive insurance companies may involve joint and several liability arrangements, which are discussed further in paragraphs 8.77–.82.

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 8.102–.108.

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 auditors should also consider the associated regulatory issues. See chapter 1, "Overview and Unique Considerations of Health Care Entities," 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 Master 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 Master 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 8.94–.95 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," 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," 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 Master 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

🔗 Update 8-1 Accounting and Reporting: Defined Benefit Plans

FASB Accounting Standards Update (ASU) No. 2018-14, *Compensation — Retirement Benefits — Defined Benefit Plans — General (Subtopic 715-20): Disclosure Framework — Changes to the Disclosure Requirements for Defined Benefit Plans*, issued in August 2018, effective for fiscal years ending after December 15, 2020, for public business entities and for fiscal years ending after December 15, 2021, for all other entities. Early adoption is permitted for all entities.

FASB ASU No. 2018-14 removes disclosures about defined benefit plans that no longer are considered cost beneficial, clarifies the requirements of certain existing disclosures, and adds two new disclosure requirements.

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

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*

8.78 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. 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.

8.79 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
- A receivable (that is assessed for impairment) for a contractual right
- An equity transaction with an entity under common control

8.80 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.

8.81 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.

8.82 FASB ASC 405-40-50 requires that a health care entity 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

8.83 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. Q&A section 6400.04, "Hospital as Collecting Agent for Physicians," provides an example.

8.84 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

8.85 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). The Further Consolidated Appropriations Act, 2020, Division N, Subtitle E, section 502, signed into law on December 20, 2019, repealed the annual fee on health insurance providers for calendar years beginning after December 31, 2020 (fee years after the 2020 fee year). As a result of the repeal, 2020 was the last fee year.

8.86 In accordance with FASB ASC 720-50, health insurers should record a liability for the annual fee for calendar years prior to 2021. 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

8.87 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

8.88 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," 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).

8.89 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.

8.90 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.

8.91 Regulations under IRC Section 501(r)² impose requirements applicable to IRC Section 501(c)(3) hospitals, which 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. Noncompliance with these regulations can result in fines and loss of tax-exempt status.

8.92 FASB ASC 954-740-50-1 requires that an NFP health care entity disclose its tax-exempt status.

8.93 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 compensation. Additional changes are expected because of health care reform, which is discussed further in chapter 1 of this guide.

² Refer to Internal Revenue Bulletin 2015-5 at www.irs.gov/irb/2015-5_irb/ar08.html.

Private Inurement and Intermediate Sanctions

8.94 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.

8.95 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% tax or up to 200% 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% 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

8.96 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

8.97 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

8.98 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)

8.99 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

8.100 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.

8.101 Q&A section 6400.54, "Financial Presentation Considerations Related to Transactions Involving Provider Taxation Programs and Similar Arrangements," discusses accounting for provider taxes imposed by those states on health care entities to make the additional provider payments. Q&A section 6400.54 states that because supplemental payments to providers under provider tax programs represent additional payment for services provided to Medicaid beneficiaries, gross presentation of the supplemental revenues and associated provider tax expenses would be appropriate. Accrual of revenue and related receivables should be reported separately from fee expenses and related

liabilities. Providers should follow guidance for revenue recognition of Medicaid supplemental payments under FASB ASC 606, *Revenue from Contracts with Customers*.

Risks and Uncertainties

8.102 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

8.103 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.

8.104 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 and price concessions to self-pay patients
- 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

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 spon-

(continued)

- Estimated net proceeds recoverable or the provisions for expected loss to be incurred, or both, on the disposition of a business or assets

8.105 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). 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. Examples 7-7-1 and 7-7-2 in the appendix, "Implementation Guidance for FASB ASC 606, *Revenue from Contracts with Customers*," to chapter 10, "Health Care Service Revenue and Related Receivables" (paragraph 10.55) provide example disclosures.

8.106 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.

8.107 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
- 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

8.108 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.

(footnote continued)

sors 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 should 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.

Auditing Contingencies and Other Liabilities

8.109 Auditing objectives and procedures for contingencies and other liabilities generally are similar to those of other entities. The 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

8.110 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 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 auditor will be able to determine the nature, extent, and timing of other auditing procedures.

8.111 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 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.

8.112 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.

8.113 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

Ⓢ Update 8-2 *Auditing: Use of Specialists and Use of Pricing Information*

This edition of the guide has not been updated to reflect changes as a result of the issuance of Statement on Auditing Standards (SAS) No. 144, *Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources*.

SAS No. 144 is effective for audits of financial statements for periods ending on or after December 15, 2023. Early implementation is permitted.

The following section will be updated in a future edition. Readers should refer to the preface for further details regarding this SAS. Readers are encouraged to consult the full text of the SAS at aicpa.org.

8.114 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.⁴ The auditor is responsible for evaluating the reasonableness of management's estimates and the adequacy of the related disclosures. AU-C section 540B, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*,^{5,6} addresses the auditor's responsibilities relating to accounting estimates, with the objective of obtaining sufficient appropriate audit evidence about whether, in the context of the applicable financial reporting framework, accounting estimates in the financial statements, whether recognized or disclosed, are reasonable, and related disclosures in the financial statements are adequate. Based on the assessed risks of material misstatement, paragraph .12 of AU-C section 540B 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.

8.115 In evaluating management's estimates of asserted and unasserted claims, the auditor would 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

⁴ See paragraphs 8.62–.76.

⁵ All AU-C sections can be found in AICPA *Professional Standards*.

⁶ AU-C section 540A, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, reflects amendments made by Statement on Auditing Standards (SAS) No. 134 to AU-C section 540B. Auditors that have implemented SAS Nos. 134–140 and the amendments to other SASs made by SAS Nos. 134–140 will use AU-C section 540A until they implement SAS No. 143, *Auditing Accounting Estimates and Related Disclosures* (AU-C sec. 540).

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.

8.116 Paragraph .15 of AU-C section 580B, *Written Representations*, requires that the auditor request management to provide written representations that all known actual or possible litigation and claims 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.

8.117 Paragraph .16 of AU-C section 501B, *Audit Evidence — Specific Considerations for Selected Items*, 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;⁷
- 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.

8.118 Unless the audit procedures required by paragraph .16 of AU-C section 501B indicate that no actual or potential litigation, claims, or assessments that may give rise to a risk of material misstatement exist, in addition to the procedures required by other AU-C sections, paragraph .18 of AU-C section 501B requires the auditor to 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 501B requires the auditor to modify the opinion in the auditor's report, in accordance with AU-C section 705B, *Modifications to the Opinion in the Independent Auditor's Report*, 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

⁷ For purposes of this section, the term *legal counsel* refers to the entity's in-house legal counsel and external legal counsel.

procedures or (b) management refuses to give the auditor permission to communicate or meet with the entity's external legal counsel.

8.119 The auditor should consider the frequency of losses due to unreported incidents and the magnitude of prior losses and underlying causes for the IBNR claims. If a basis for an accrual exists, the 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

© Update 8-3 *Auditing: Use of Specialists and Use of Pricing Information*

This edition of the guide has not been updated to reflect changes as a result of the issuance of SAS No. 144.

SAS No. 144 is effective for audits of financial statements for periods ending on or after December 15, 2023. Early implementation is permitted.

The following section will be updated in a future edition. Readers should refer to the preface for further details regarding this SAS. Readers are encouraged to consult the full text of the SAS at aicpa.org.

8.120 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.

8.121 If an actuary is involved in a substantial way in determining the amount of an entity's malpractice self-insurance liability, the auditor should follow the requirements of AU-C section 620B, *Using the Work of an Auditor's Specialist*.⁸ Paragraph .09 of AU-C section 620B 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 620B, 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;

⁸ AU-C section 620, *Using the Work of an Auditor's Specialist*, was not amended by SAS Nos. 134–140. Auditors that have implemented SAS Nos. 134–140 and the amendments to other SASs made by SAS Nos. 134–140 will use AU-C section 620A until they implement SAS No. 143.

- 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.

8.122 Paragraph .12 of AU-C section 620B⁹ 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.

8.123 The 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.

⁹ AU-C section 620, *Using the Work of an Auditor's Specialist*, was not amended by SAS Nos. 134–140. Auditors that have implemented SAS Nos. 134–140 and the amendments to other SASs made by SAS Nos. 134–140 will use AU-C section 620A until they implement SAS No. 143.

Evaluating Lawyers' Responses

8.124 Determining the outcome of pending or threatened litigation, claims, and assessments, including unasserted claims and assessments, normally is beyond the auditor's professional competence. Accordingly, the auditor's evaluation of the need for disclosures or report modifications is based primarily on the opinion of the lawyer handling the matter. The American Bar Association (ABA) has adopted a *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information* under which lawyers accept certain responsibility for responses to auditors' inquiries. However, the ABA statement 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.

8.125 Paragraph .A65 of AU-C section 501B 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."

8.126 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 501B 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.)

8.127 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 700B, *Forming an Opinion and Reporting on Financial Statements*, to determine the effect, if any, of the legal counsel's response on the auditor's report.

Income Taxes

8.128 The auditor should perform procedures to determine whether the NFP 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

🔄 Update 8-4 *Auditing: Audit Evidence, Auditing Accounting Estimates, Use of Specialists, and Use of Pricing Information*

This edition of the guide has not been updated to reflect changes as a result of the issuance of the following Statements on Auditing Standards (SASs):

- SAS No. 142, *Audit Evidence* (AU-C sec. 500)
- SAS No. 143, *Auditing Accounting Estimates and Related Disclosures* (AU-C sec. 540)
- SAS No. 144, *Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources*

SAS No. 142 is effective for audits of financial statements for periods ending on or after December 15, 2022. SAS Nos. 143 and 144 are effective for audits of financial statements for periods ending on or after December 15, 2023. Early implementation is permitted.

The following section will be updated in a future edition. Readers should refer to the preface for further details regarding these SASs. Readers are encouraged to consult the full text of the SASs at aicpa.org.

8.129 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 330B, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, 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 315B, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. Various audit procedures and the purposes for which they may be performed are described in paragraphs .A10–.A26 of AU-C section 500B, *Audit Evidence*.

Audit Considerations

Financial Statement Assertions	Specific Audit Objectives	Specific Control Objectives¹⁰	Substantive Audit Procedures¹¹
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.
		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 501B, <i>Audit Evidence — Specific Considerations for Selected Items</i> .

(continued)

¹⁰ The auditor should consider a combination of preventive and detective controls responsive to the control objectives.

¹¹ 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>
		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.
Presentation and disclosure	The program of medical malpractice insurance coverage and the basis for any loss accruals are adequately disclosed in the financial statements.		

Audit Considerations — *continued*

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
<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.
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.

Exhibit 8-1¹²

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 330B, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, 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 315B, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. Various audit procedures and the purposes for which they may be performed are described in paragraphs .A10–.A26 of AU-C section 500A, *Audit Evidence*.

Audit Considerations

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i> ¹³	<i>Substantive Audit Procedures</i> ¹⁴
Account Balances			
Malpractice Loss Contingencies			
Existence, completeness, rights and obligations, and accuracy/valuation and allocation	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.

¹² SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the Auditing Standards Board (ASB) recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

¹³ The auditor should consider a combination of preventive and detective controls responsive to the control objectives.

¹⁴ 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>
Existence, completeness, rights and obligations	The liability for malpractice claims is properly reported in the balance sheet.	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 501A, <i>Audit Evidence — Specific Considerations for Selected Items</i> .
Accuracy/valuation and allocation	The liability for malpractice claims is properly reported in the balance sheet at appropriate amounts.	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.
Completeness	The program of medical malpractice insurance coverage and the basis for any loss accruals are adequately disclosed in the financial statements.	Controls ensure that all required disclosures have been included in the financial statements.	Verify that all required disclosures are included in the financial statements.
Accuracy/valuation and allocation	Amounts have been recorded appropriately, considering the inherent uncertainty of the measurement.	The risk-management system identifies malpractice incidents and evaluates associated losses.	Determine whether uncertainties related to medical malpractice claims need to be disclosed in the independent auditor's report.

(continued)

Audit Considerations — *continued*

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
Income Taxes			
Rights and obligations, Completeness	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.
Presentation, Completeness	The entity's tax-exempt status and its tax contingencies are disclosed in the notes to the financial statements in a relevant and understandable manner.		The entity's tax-exempt status and its tax contingencies are disclosed in the notes to the financial statements in a relevant and understandable manner.

Chapter 9

Net Assets (Equity)

Gray shaded text in this chapter reflects guidance issued but not yet effective as of the date of this guide, September 1, 2021, but becoming effective on or prior to June 30, 2022, 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.

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

9.02 The FASB *Accounting Standards Codification* (ASC) Master Glossary defines *net assets* as "[t]he excess or deficiency of assets over liabilities of a not-for-profit (NFP) entity, which is divided into two 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," 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 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 classes of net assets: (a) net assets without donor restrictions and (b) net assets with donor

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.

restrictions.² As noted in the FASB ASC Master Glossary, net assets are divided into two mutually exclusive classes according to the existence or absence of donor-imposed restrictions.

9.06 The FASB ASC Master Glossary defines a *donor-imposed restriction* as

[a] donor stipulation (donors include other types of contributors, including makers of certain grants) 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 NFP,
- b. the environment in which it operates, and
- c. the purposes specified in its articles of incorporation or by-laws or comparable documents for an unincorporated association.

Some donors impose restrictions that are temporary in nature, for example, stipulating that resources be used after a specified date, for particular programs or services, or to acquire buildings or equipment. Other donors impose restrictions that are perpetual in nature, for example, stipulating that resources be maintained in perpetuity. Laws may extend those limits to investment returns from those resources and to other enhancements (diminishments) of those resources. Thus, those laws extend donor-imposed restrictions.

9.07 In addition to the two classes of net assets — net assets without donor restrictions and net assets with donor restrictions — further disaggregation of total net assets may also be reported. As explained in FASB ASC 958-205-05-6B, the two required net asset classes are a minimum classification scheme, if they are applicable. An NFP can choose to further disaggregate the two net asset classes. For example, an NFP may wish to disaggregate net assets with donor restrictions between those expected to be maintained in perpetuity and those expected to be spent over time or for a particular purpose. Additionally, FASB ASC 958-210-45-11 states that information about the amounts and purposes of board designations of net assets without donor restrictions should be provided in notes to or on the face of financial statements.

9.08 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 are not donor-imposed 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.

9.09 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.

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 *net assets with donor restrictions* and *net assets without donor restrictions*; 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 net assets with donor restrictions from net assets without donor restrictions.

Net Assets With Donor Restrictions

9.10 Some contributions have donor-imposed restrictions that require the NFP to maintain their resources 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 included in net assets with donor restrictions. Paragraphs 9.25–.31 discuss the donor-restricted net assets of endowment funds.

9.11 Other contributions have donor-imposed restrictions that limit their use 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 support a specific future program are recognized as increases in net assets with donor restrictions. 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 net assets with donor restrictions.

9.12 Net assets with donor restrictions also may change as a result of increases and decreases in existing assets or the economic benefits embodied in those assets that are subject to donor-imposed restrictions. For example, as explained in paragraphs 9.25–.28, 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 donor restricted and reported within net assets with donor restrictions until appropriated for expenditure by the NFP health care entity.

Net Assets Without Donor Restrictions

9.13 The FASB ASC Master Glossary defines *net assets without donor restrictions* as "the part of net assets of a not-for-profit entity that is not subject to donor-imposed restrictions (donors include other types of contributors, including makers of certain grants).

9.14 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 and may be included in qualitative disclosures on the availability of an NFP's financial assets in accordance with FASB ASC 958-210-50-1A(b). FASB ASC 958-210-45-11 states that information about self-imposed limits is useful, including information about voluntary resolutions by the governing board of an entity,⁴ such as resolutions to designate a portion of its net assets without donor restrictions to function as an endowment (sometimes called a board-designated endowment fund) or to designate a portion for a specific future expenditure (called board designated net assets). Information about the amounts and purposes of board designations of net assets without donor restrictions should be provided in the notes to or on the face of financial statements.

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 net assets without donor restrictions if the health care entity discloses its policy and consistently reports from period to period.

⁴ The definition of *board-designated net assets* states that some governing boards may delegate designation decisions to internal management, and that such designations are considered to be included in board-designated net assets.

9.15 For example, a health care entity might include information about voluntary resolutions to designate for funded depreciation a portion of its net assets without donor restrictions.

9.16 FASB ASC 958-810-45-1 states that noncontrolling interests⁵ 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 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 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 noncontrolling interests in a consolidated subsidiary and subsequent changes in ownership interests of that subsidiary.

Reclassifications

9.17 FASB ASC 958-220-45-13 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 beneficiary⁶ (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 net assets without donor restrictions.

9.18 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 net assets with donor restrictions to net assets without donor restrictions 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.

9.19 FASB ASC 958-205-45-9 states that if two or more restrictions that are temporary in nature 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 net assets with donor restrictions and increasing net assets without donor restrictions. In accordance with FASB ASC 958-220-45-3, reclassifications of net assets are reported separately from other

⁵ A *noncontrolling interest* is the portion of equity in a subsidiary that is not directly or indirectly attributable to a parent.

⁶ 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 AICPA Audit and Accounting Guide *Not-for-Profit Entities* provides additional guidance on split-interest gifts.

transactions in the statement of operations. Reclassifications of amounts appropriated from donor-restricted endowment funds are discussed in paragraph 9.29.

9.20 As explained in FASB ASC 958-205-45-11, if an expense is incurred for a purpose for which both net assets without donor restrictions and net assets with donor restrictions 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 to another specific external source of revenue. Explicit time restrictions, such as those discussed in FASB ASC 958-205-45-10, and implied time restrictions, such as those discussed in FASB ASC 958-605-45-5, make net assets unavailable to support expenses until the time restrictions have expired. For additional information, see paragraphs 11.12 and 11.20.

9.21 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.

9.22 In accordance with FASB ASC 958-360-45-1A, net assets with donor restrictions should be reclassified to net assets without donor restrictions when the acquired or constructed property, plant, or equipment is placed in service for the following contributions:

- a. Purpose-restricted contributions of property, plant, or equipment that are without donor-imposed stipulations specifying how long the donated asset must be used
- b. Contributions of cash restricted for the acquisition or construction of property, plant, or equipment.

9.23 The entire amount of the contribution of property, plant, or equipment or cash should be reclassified at the time the asset is placed in service. There may be circumstances in which a donor restriction might extend beyond the point at which the property, plant, or equipment is placed in service. For example, a donor might specify that a donation restricted for the acquisition of property, plant, or equipment must continue to be used for a specified period of time. In such circumstances, the restriction would expire over the period of time that the asset is to be used.

9.24 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 Questions and Answers (Q&A) section 6140.23, "Changing Net Asset Classifications Reported in a Prior Year,"⁷ states that the individual net asset classes, rather than net assets in

⁷ All Q&A sections can be found in *Technical Questions and Answers*. *Technical Questions and Answers* can be downloaded at <https://www.aicpa.org/resources/download/aicpa-technical-questions-and-answers-at-your-fingertips>.

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

9.25 The FASB ASC Master Glossary defines a *donor-restricted endowment fund* as "an endowment fund that is created by a donor stipulation (donors include other types of contributors, including makers of certain grants) requiring investment of the gift in perpetuity or for a specified term. Some donors or laws may require that a portion of income, gains, or both be added to the gift and invested subject to similar restrictions."

9.26 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 the classification of endowment funds within the NFP financial reporting model, including whether some or all of the investment return on endowments is available for spending. Paragraphs 13–13J 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 is summarized in the following four paragraphs, but it is not intended as a substitute for reading the standards themselves.

9.27 FASB ASC 958-205-45-13B states that when classifying a donor-restricted endowment fund, consideration should be given to both the donor's explicit stipulations and the applicable laws that extend donor restrictions. FASB ASC 958-205-45-13D states that the original gifted amount [of a donor-restricted endowment fund], any additional gifts to that fund, and any resulting investment returns should initially be classified as net assets with donor restrictions. Therefore, unless stated otherwise in the gift instrument, the assets in an endowment fund are donor-restricted assets until they are appropriated for expenditure by the NFP's governing board. Donors may provide specific instructions on spending from a donor-restricted endowment fund or from the components of investment return generated from the fund.

9.28 FASB ASC 958-205-45-13B states that investment return generally is considered free of donor restrictions unless its use is limited by a donor-imposed restriction or by law. In the United States, most donor-restricted endowment funds are subject to an enacted version of the Uniform Prudent Management of Institutional Funds Act of 2006 (UPMIFA) that extends a donor's restriction to use of the funds, including the investment return, until the funds are appropriated for expenditure by the governing board. Thus, if a donor or law imposes a restriction on the investment return, those returns should be reported within net assets with donor restrictions until appropriated for expenditure.

9.29 FASB ASC 958-205-45-13E states that the amount of net assets with donor restrictions in the donor-restricted endowment fund is reduced when the

governing board appropriates for expenditure funds from the endowment fund. Upon appropriation for expenditure, the restriction expires to the extent of the amount appropriated as long as all of the time restrictions have lapsed and all of the purpose restrictions have been met. At that time, the appropriated amount is reclassified from net assets with donor restrictions to net assets without donor restrictions in accordance with FASB ASC 958-205-45-9 (paragraph 9.19). However, if purpose restrictions from a donor have not yet been met, those funds should remain in net assets with donor restrictions until those purpose restrictions have been satisfied.

9.30 The FASB ASC Master Glossary defines an *underwater endowment fund* as 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. FASB ASC 958-205-45-13H states that if a donor-restricted endowment fund is an underwater endowment fund, the accumulated losses should be included together with that fund in net assets with donor restrictions. FASB ASC 958-205-50-2 describes the required disclosures for underwater endowment funds.

9.31 Paragraphs 3.16, 4.21, and 4.30 provide information about whether the income, gains, and losses of donor-restricted endowment funds are included or excluded from the performance indicator.

Disclosure

9.32 FASB ASC 958-210-45-9 requires that information about the nature and amounts of different types of donor-imposed restrictions be provided either by reporting their amounts on the face of the statement of financial position or including relative details in the notes to financial statements. FASB ASC 958-205-50-3 requires that that information include information about restrictions that affect how and when, if ever, the resources (net assets) can be used.

9.33 In accordance with FASB ASC 958-210-50-3, information about additional limitations placed on net assets, such as information about the amounts and purposes of board designations of net assets without donor restrictions, should be disclosed in the notes or on the face of the financial statements.

9.34 Paragraphs 1A–2A of FASB ASC 958-205-50 require disclosures for both donor-restricted and board-designated endowment funds. A business-oriented NFP health care entity should disclose information about net asset classification, net asset composition, changes in net asset composition, underwater endowment funds, spending policies, and related investment policies. If the entity is subject to a donor restriction or applicable laws that its governing board interprets as requiring the maintenance of purchasing power for donor-restricted endowment funds, the NFP should periodically adjust the disclosed amount that is required to be maintained either by the donor or by law to reflect that interpretation to maintain the purchasing power of the endowment fund in perpetuity.

9.35 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

© Update 9-1 **Auditing: Audit Evidence, Auditing Accounting Estimates, Use of Specialists, and Use of Pricing Information**

This edition of the guide has not been updated to reflect changes as a result of the issuance of the following Statements on Auditing Standards (SASs):

- SAS No. 142, *Audit Evidence* (AU-C sec. 500)
- SAS No. 143, *Auditing Accounting Estimates and Related Disclosures* (AU-C sec. 540)
- SAS No. 144, *Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources*

SAS No. 142 is effective for audits of financial statements for periods ending on or after December 15, 2022. SAS Nos. 143 and 144 are effective for audits of financial statements for periods ending on or after December 15, 2023. Early implementation is permitted.

The following section will be updated in a future edition. Readers should refer to the preface for further details regarding these SASs. Readers are encouraged to consult the full text of the SASs at aicpa.org.

9.36 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 330B, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*,⁸ 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 315B, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. Various audit procedures and the purposes for which they may be performed are described in paragraphs .A10–.A26 of AU-C section 500B, *Audit Evidence*.

Audit Considerations

Financial Statement Assertions	Specific Audit Objectives	Specific Control Objectives⁹	Substantive Audit Procedures¹⁰
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 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.

(continued)

⁸ All AU-C sections can be found in AICPA *Professional Standards*.

⁹ The auditor should consider a combination of preventative and detective controls responsive to the control objectives.

¹⁰ 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.

<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	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.
	Net assets with donor restrictions are reclassified as net assets without donor restrictions when donor-imposed restrictions have been fulfilled.	Controls ensure that reclassification of net assets with donor restrictions 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 operations and statement of changes in net assets when donor-imposed restrictions have been fulfilled.

Exhibit 9-1¹¹

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 330B, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, 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 315B, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. Various audit procedures and the purposes for which they may be performed are described in paragraphs .A10–.A26 of AU-C section 500A, *Audit Evidence*.

Audit Considerations

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives¹²</i>	<i>Substantive Audit Procedures¹³</i>
<i>Account Balances</i>			
<i>Net Assets (Equity)</i>			
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 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.

(continued)

¹¹ Statement on Auditing Standards (SAS) Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the Auditing Standards Board (ASB) recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

¹² The auditor should consider a combination of preventative and detective controls responsive to the control objectives.

¹³ 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>
Classification	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.
<i>Classes of Transactions</i>			
<i>Reclassifications</i>			
Classification, Completeness	Net assets with donor restrictions are reclassified as net assets without donor restrictions when donor-imposed restrictions have been fulfilled.	Controls ensure that reclassification of net assets with donor restrictions 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.
Presentation; Completeness	Net assets with donor restrictions are reclassified as net assets without donor restrictions when donor-imposed restrictions have been fulfilled.	Controls ensure that reclassification of net assets with donor restrictions occurs when donor-imposed restrictions have been fulfilled.	Determine that appropriate reclassifications are reported in the statement of operations and statement of changes in net assets when donor-imposed restrictions have been fulfilled.

Chapter 10

Health Care Service Revenue and Related Receivables

Gray shaded text in this chapter reflects guidance issued but not yet effective as of the date of this guide, September 1, 2021, but becoming effective on or prior to June 30, 2022, 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 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); workers' compensation insurers; a religious health care 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 (paragraphs 10.05–.10)

- The regulations and laws that governmental third-party payments are based on (paragraphs 10.06–.14)
- The determination of what constitutes charity care (paragraph 10.15)

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 and the payor's plans.

10.06 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 10.19–.23.

The Government Payor Environment

10.10 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.

10.11 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 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.

10.12 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 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).

10.13 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

10.14 The FASB *Accounting Standards Codification* (ASC) Master 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 10.24–27.

Types of Health Care Revenue

10.15 In accordance with the "Pending Content" in paragraphs 5–7 of FASB ASC 606-10-50, an entity should disaggregate revenue recognized from contracts with customers into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. An entity should apply the guidance in paragraphs 89–91 of the "Pending Content" in FASB ASC 606-10-55 when selecting the categories to use to disaggregate revenue. If the health care entity applies FASB ASC 280, *Segment Reporting*, it should disclose sufficient information to enable users of financial statements to understand the relationship between the disclosure of disaggregated revenue and revenue information that is disclosed for each reportable segment. However, a health care entity that is neither a public business entity nor a business-oriented not-for-profit entity that 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, may elect not to apply that disaggregation disclosure requirement provided that it discloses the information required by the "Pending Content" in FASB ASC 606-10-50-7.

10.16 Disaggregation of revenue by health care entities is discussed in paragraphs 7.7.21–7.7.25 in the appendix, "Implementation Guidance for FASB ASC 606, *Revenue from Contracts with Customers*," of this chapter (paragraph 10.55).

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; 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 The "Pending Content" in paragraphs 3–4 of FASB ASC 606-10-05 states that the core principle is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. An entity recognizes revenue in accordance with that core principle by applying the five steps, which are summarized as follows:

- Step 1: Identify the contract(s) with a customer
- Step 2: Identify the performance obligations in the contract
- Step 3: Determine the transaction price
- Step 4: Allocate the transaction price to the performance obligations in the contract
- Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation

The appendix to this chapter (paragraph 10.55) provides implementation guidance for health care entities in the form of excerpts from AICPA Audit and Accounting Guide *Revenue Recognition*.

10.19 With respect to third-party payor arrangements, governmental regulations or contractual terms will specify requirements 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. In accordance with the "Pending Content" in FASB ASC 606-10-32-9, health care entities should consider all information (historical, current, and forecast) that is reasonably available to the entity to estimate variable consideration when determining the transaction price, whether the guidance in FASB ASC 606 is applied on a portfolio or contract-by-contract basis. The "Pending Content" in FASB ASC 606-10-32-14 states that at the end of each reporting period, an entity should update the estimated transaction price (including updating its assessment of whether an estimate of variable consideration is constrained) to represent faithfully the circumstances present at the end of the reporting period and the changes in circumstances during the reporting period. The entity should account for changes in the transaction price in accordance with paragraphs 42–45 of FASB ASC 606-10-32.

10.21 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.

10.22 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 adjustments based on detailed calculations and assumptions regarding potential future adjustments. Some entities may prepare cost report analyses¹ 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.

10.23 In some situations, the amount of revenue earned under arrangements with third-party payors (for example, Medicare or Medicaid) are subject 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 a result, revenue from contracts with patients that are paid by a government payor typically contain a variable element that requires health care providers to estimate the cash flows ultimately expected to be received for services provided. Paragraphs 7.6.44–7.6.72 in the

¹ 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.

appendix to this chapter (paragraph 10.55) discuss the accounting for third-party settlement estimates.

Charity Care

10.24 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.

10.25 Example 3 in the "Pending Content" in paragraphs 102–105 of FASB ASC 606-10-55 discusses the situation in which a hospital provides medical services to an uninsured patient in the emergency room. The hospital has not previously provided medical services to this patient but is required by law to provide medical services to all emergency room patients. Because of the patient's condition upon arrival at the hospital, the hospital provides the services immediately and, therefore, before it can determine whether the patient is committed to perform its obligations under the contract in exchange for the medical services provided. Consequently, as discussed more fully in paragraphs 7.6.06–7.6.18 in the appendix of this chapter (paragraph 10.55), the contract does not meet the criteria in the "Pending Content" in FASB ASC 606-10-25-1, and in accordance with the "Pending Content" in FASB ASC 606-10-25-6, the hospital will continue to assess its conclusion based on updated facts and circumstances. After providing services, the hospital obtains additional information about the patient including a review of the services provided, standard rates for such services, and the patient's ability and intention to pay the entity for the services provided. In this example, the hospital determines that the services provided are not charity care based on the hospital's internal policy and the patient's income level.

10.26 The determination of whether an individual meets the established criteria for charity care 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 discounts given to uninsured or underinsured patients if those patients do not qualify under the health care entity's charity care policy.

10.27 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

10.28 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, however, organizations can use historical information on a portfolio basis to assist in estimating the variable consideration to be recorded as revenue. Arrangements for health care services provided to uninsured and insured patients with self-pay balances, including co-payments and deductibles are discussed in paragraphs 7.6.01–7.6.43 and related examples in the appendix of this chapter (paragraph 10.55).

Accounting and Financial Reporting Requirements

10.29 Presentation and disclosure in accordance with the "Pending Content" in FASB ASC 606 is discussed in paragraphs 7.7.16–7.7.60 and related examples in the appendix of this chapter (paragraph 10.55).

Premium and Capitation Revenues

10.30 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. When disaggregating revenue recognized from contracts with customers into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors in accordance with the "Pending Content" in FASB ASC 606-10-50-5, a health care entity might describe these revenues as premium revenues, not patient service revenues.

10.31 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.

10.32 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.

10.33 When complying with the requirements of the "Pending Content" in paragraphs 5–7 of FASB ASC 606-10-50 to disaggregate revenue recognized from contracts with customers into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by

economic factors, a health care entity should consider whether revenue earned capitation arrangements would be separately reported.

Patient Receivables

Ⓒ Update 10-1 *Accounting and Reporting: Financial Instruments — Credit Losses*

FASB Accounting Standards Update (ASU) No. 2016-13, *Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, was issued June 2016 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. To achieve this objective, the amendments in the ASU replace the incurred loss impairment methodology in current generally accepted accounting principles 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. FASB has issued four ASUs to make targeted improvements to the methodology, as follows:

- FASB ASU No. 2018-19, *Codification Improvements to Topic 326, Financial Instruments — Credit Losses*
- FASB ASU No. 2019-04, *Codification Improvements to Topic 326, Financial Instruments — Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments*
- FASB ASU No. 2019-05, *Financial Instruments — Credit Losses (Topic 326): Targeted Transition Relief*
- FASB ASU No. 2019-11, *Codification Improvements to Topic 326, Financial Instruments — Credit Losses*

For public business entities that are SEC filers, excluding entities eligible to be smaller reporting companies as defined by the SEC, FASB ASU No. 2016-13, as amended by FASB ASU No. 2018-19 and further amended by FASB ASU No. 2019-10, *Financial Instruments — Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*, is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. The one-time determination of whether an entity is eligible to be a smaller reporting company is based on an entity's most recent determination as of November 15, 2019, in accordance with SEC regulations.

For all other health care entities, including not-for-profit health care entities, FASB ASU No. 2016-13 and the ASUs making targeted improvements are effective for fiscal years beginning after December 15, 2022, and interim periods within those fiscal years. Early adoption is permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

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

Appendix D, "Accounting for Financial Instruments," of this guide provides additional information about FASB ASU No. 2016-13 and the ASUs that

make targeted improvements to its credit loss methodology. Readers are also encouraged to consult the full text of the ASUs on FASB's website at www.fasb.org.

10.34 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."

10.35 In accordance with the "Pending Content" in FASB ASC 954-310-30-1, contractual adjustments and discounts are variable consideration and should be measured in accordance with paragraphs 5–14 of the "Pending Content" in FASB ASC 606-10-32. An allowance for uncollectibles should be recorded in accordance with FASB ASC 310, *Receivables*. As noted in the "Pending Content" in FASB ASC 606-10-32-42, after contract inception, the transaction price can change for various reasons, including the resolution of uncertain events or other changes in circumstances that change the amount of consideration to which an entity expects to be entitled in exchange for the promised goods or services. The entity should account for changes in the transaction price in accordance with paragraphs 42–45 of FASB ASC 606-10-32. A health care entity should allocate to the performance obligations in the contract any subsequent changes in the transaction price on the same basis as at contract inception.

10.36 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.

10.37 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.

10.38 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

10.39 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 10.20–23, they are generally subject to reasonable estimation and reported in the financial statements in the period in which services are rendered.

10.40 For example, as noted in the "Pending Content" in FASB ASC 954-310-05-3, some third-party payors retrospectively determine final amounts reimbursable for services rendered to their beneficiaries based on allowable costs. These payors reimburse the health care 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 different from the interim payment rates. Final settlements are determined after the close of the fiscal periods to which they apply and may affect materially the health care entity's financial position and results of operations.

10.41 In accordance with FASB ASC 954-405-50-1 and FASB ASC 954-310-50-1, with regard to contractual adjustments and third-party settlements, identification and explanation of the estimated amounts that are receivable or payable by the entity should be disclosed. Per FASB ASC 954-310-45-1, 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. (See also the guidance in the "Pending Content" in paragraphs 1–5 of FASB ASC 606-10-45 on presenting receivables, contract assets, and contract liabilities).

10.42 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.

10.43 Per the "Pending Content" in FASB ASC 606-10-32-43, amounts allocated to a satisfied performance obligation should be recognized as revenue, or as a reduction of revenue, in the period in which the transaction price changes. The "Pending Content" in FASB ASC 606-10-50-12A states that an entity should disclose revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (for example, changes in transaction price). Differences between original estimates and subsequent revisions, including final settlements, 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*.

10.44 As explained in paragraphs .02 and .04 of AU-C section 540B, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*,^{2,3} a difference between the outcome of an accounting estimate and the amount originally recognized or disclosed in the financial statements does not necessarily represent a misstatement of the financial statements; rather, it could be an outcome of estimation uncertainty. The nature and reliability of information available to management to support the making of an accounting estimate varies widely, which thereby affects the degree of estimation uncertainty associated with accounting estimates.

10.45 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.

10.46 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.

10.47 The Financial Reporting Executive Committee (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.

10.48 Settlements due to or from third-party payors should be classified as current or noncurrent, depending on the expected timing of the settlements

² All AU-C sections can be found in AICPA *Professional Standards*.

³ AU-C section 540A, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, reflects amendments made by Statement on Auditing Standards (SAS) No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*, to AU-C section 540B, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*. Auditors that have implemented SAS Nos. 134–140 and the amendments to other SASs made by SAS Nos. 134–140 will use AU-C section 540A until they implement SAS No. 143, *Auditing Accounting Estimates and Related Disclosures* (AU-C section 540).

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

🕒 **Update 10-2 Auditing: Audit Evidence, Auditing Accounting Estimates, Use of Specialists, and Use of Pricing Information**

This edition of the guide has not been updated to reflect changes as a result of the issuance of the following Statements on Auditing Standards (SASs):

- SAS No. 142, *Audit Evidence* (AU-C sec. 500)
- SAS No. 143, *Auditing Accounting Estimates and Related Disclosures* (AU-C sec. 540)
- SAS No. 144, *Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources*

SAS No. 142 is effective for audits of financial statements for periods ending on or after December 15, 2022. SAS Nos. 143 and 144 are effective for audits of financial statements for periods ending on or after December 15, 2023. Early implementation is permitted.

The following section will be updated in a future edition. Readers should refer to the preface for further details regarding these SASs. Readers are encouraged to consult the full text of the SASs at aicpa.org.

10.49 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 auditor as they relate to the major components of receivables of health care entities are presented in exhibit 10-1.

10.50 AU-C section 540B⁴ and chapter 2, "General Auditing Considerations," of AICPA Audit and Accounting Guide *Revenue Recognition*, 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.

10.51 Paragraph .A8 of AU-C section 540B⁵ states that estimation involves judgments based on information available when the financial statements are prepared. For many accounting estimates, these include making assumptions about matters that are uncertain at the time of estimation. The auditor is not responsible for predicting future conditions, transactions, or events that, if known at the time of the audit, might have significantly affected management's actions or the assumptions used by management. Paragraph 2.61 states that the auditor's judgment regarding the sufficiency of the audit evidence is based

⁴ AU-C section 540A reflects amendments made by SAS No. 134 to AU-C section 540B. Auditors that have implemented SAS Nos. 134–140 and the amendments to other SASs made by SAS Nos. 134–140 will use AU-C section 540A until they implement SAS No. 143.

⁵ AU-C section 540A reflects amendments made by SAS No. 134 to AU-C section 540B. Auditors that have implemented SAS Nos. 134–140 and the amendments to other SASs made by SAS Nos. 134–140 will use AU-C section 540A until they implement SAS No. 143.

on the evidence that is, or should be, available. 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

10.52 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.

10.53 Paragraph .20 of AU-C section 330B, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, 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.

10.54 If the auditor determines that confirmation of amounts that are due from patients and third-party payors would be ineffective, the auditor should document the basis for that determination, in accordance with paragraph .32 of AU-C section 330B and obtain audit evidence from other sources. The following are examples of alternative procedures the auditor might perform:

- 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 330B 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 315B, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. Various audit procedures and the purposes for which they may be performed are described in paragraphs .A10–.A26 of AU-C section 500B, *Audit Evidence*.

Audit Considerations

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i> ⁶	<i>Substantive Audit Procedures</i> ⁷
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.

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, 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 the amount of consideration to which the entity will be entitled in exchange for transferring the health care services to the patient, less any impairment.	Allowances for uncollectibles are periodically reviewed by management to ensure that receivables are reported net of impairment. Bad-debt write-offs are authorized and properly recorded.	Examine documentation supporting the initial recognition of receivables, including consideration of standard prices, explicit and implicit price concessions, contractual adjustments, and other discounts and adjustments. Test that bad debt expense is only recorded if the health care entity had assessed the customer's ability to pay prior to providing the service and expected to collect substantially all of the discounted charges. Recompute patient receivables and reconciliation to the general ledger. Vouch subsequent receipts.
		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.

Audit Considerations — continued

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
			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.
<i>Presentation and Disclosure</i>			
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 variable consideration of patient service revenue and significant changes in estimates are disclosed.		Determine that disclosures include policies for the probability of collection and significant changes in estimates of variable consideration.

(continued)

Audit Considerations — *continued*

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
Estimated Third-Party Settlements			
<i>Account Balances</i>			
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.
<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.

Audit Considerations — continued

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
			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.
<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.

(continued)

Audit Considerations — *continued*

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
			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.

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 explicit and implicit price concessions are authorized and properly recorded. Controls ensure that charity care is not recognized as revenue. Controls ensure that changes in the estimate of the transaction price (for example, variable consideration) are recognized in revenue, while impairment losses are recognized in bad debt expense.	Review the financial statements to determine that revenue is reported at the amount of consideration to which the entity will be entitled in exchange for transferring the health care services to the patient, including consideration of standard prices, explicit and implicit price concessions, contractual adjustments, and other discounts and adjustments. Test explicit and implicit price concessions, 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 explicit and implicit price concessions under such contracts.

Exhibit 10-1⁸

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 330B 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 315B, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. Various audit procedures and the purposes for which they may be performed are described in paragraphs .A10–.A26 of AU-C section 500A, *Audit Evidence*.

⁸ SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the Auditing Standards Board (ASB) recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

Audit Considerations

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives⁹</i>	<i>Substantive Audit Procedures¹⁰</i>
<i>Account Balances</i>			
<i>Receivables for Health Care Services</i>			
Existence	Amounts reported in the financial statements represent valid receivables	Charges are generated automatically when services are performed. A medical record is prepared. Procedures ensure that amounts due from third-party payors for individual accounts are properly supported. Procedures ensure the proper recording of cash receipts.	Review and test subsequent cash receipts. Compare billing information to the documentation contained in the medical records or census records. 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. Trace the receipts applicable to patient accounts to the accounts receivable records.
Accuracy/valuation, and allocation	Amounts reported as receivables exclude charity care balances.	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.

(continued)

⁹ The auditor should consider a combination of preventative and detective controls responsive to the control objectives.

¹⁰ 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>
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.
Accuracy/valuation and allocation	Receivables are reported in the financial statements at the amount of consideration to which the entity will be entitled in exchange for transferring the health care services to the patient, less any impairment.	Allowances for uncollectibles are periodically reviewed by management to ensure that receivables are reported net of impairment. Bad-debt write-offs are authorized and properly recorded.	Examine documentation supporting the initial recognition of receivables, including consideration of standard prices, explicit and implicit price concessions, contractual adjustments, and other discounts and adjustments. Test that bad debt expense is only recorded if the health care entity had assessed the customer's ability to pay prior to providing the service and expected to collect substantially all of the discounted charges. Recompute patient receivables and reconciliation to the general ledger. Vouch subsequent receipts.

Audit Considerations — *continued*

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
		Write-offs and allowances for uncollectibles are identified and approved in accordance with the entity's established policy.	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. Review and test the method used to determine the allowances for uncollectible accounts.
Presentation	Receivables are appropriately aggregated and disaggregated by payor.	Controls ensure that receivables are properly summarized.	Determine that patient accounts are appropriately classified by payor (for example, Medicare or self-pay) to evaluate collectibility.
Completeness	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.

(continued)

Audit Considerations — continued

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
Completeness	Policies for assessing variable consideration of patient service revenue and significant changes in estimates are disclosed.	Controls ensure that all required disclosures are included in the financial statements.	Determine that disclosures include policies for the probability of collection and significant changes in estimates of variable consideration.
Estimated Third-Party Settlements			
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.

Audit Considerations — *continued*

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
Completeness, Valuation	Amounts reported in the financial statements represent valid receivables in accordance with terms of contracts with third-party payors.	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. 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.
Completeness	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.

(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>Classes of Transactions</i>			
Adjustments of Estimated Third-Party Settlements			
Completeness, Accuracy/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.	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.
Cut-off	Adjustments to receivables from third-party payors are reported in the correct period.	Procedures ensure that adjustments are recorded on a timely basis.	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			
Occurrence, completeness, classification	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.

Audit Considerations — *continued*

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
Accuracy/ valuation and allocation, Presentation	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 presented.	Controls ensure that explicit and implicit price concessions are authorized and properly recorded. Controls ensure charity care is not recognized as revenue. Controls ensure that changes in the estimate of the transaction price (for example, variable consideration) are recognized in revenue, while impairment losses are recognized in bad debt expense.	Review the financial statements to determine that revenue is reported at the amount of consideration to which the entity will be entitled in exchange for transferring the health care services to the patient, including consideration of standard prices, explicit and implicit price concessions, contractual adjustments, and other discounts and adjustments. Test explicit and implicit price concessions, 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 explicit and implicit price concessions under such contracts.

**Appendix — Implementation Guidance for FASB
ASC 606, Revenue from Contracts with Customers**

- A-1** This appendix includes excerpts from chapter 7, "Health Care Entities" of AICPA Audit and Accounting Guide *Revenue Recognition* (Revenue Recognition Guide). That guide has been developed by the AICPA Industry Revenue Recognition Task Forces, Revenue Recognition Working Group, and Auditing Revenue Task Force, to assist management in the preparation of their financial statements in accordance with U.S. generally accepted accounting principles (GAAP) and to assist practitioners in performing and reporting on their audit engagements. Specifically, that guide is intended to help entities and auditors prepare for changes related to revenue recognition as a result of FASB Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, and subsequent ASUs amending FASB Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers*. Readers should note that the positions taken by the Financial Reporting Executive Committee (FinREC) are based on facts and circumstances stated in the guide and supported by guidance in effect at the time the industry implementation papers were finalized, from 2015–2018. Readers should consider individual facts and circumstances and subsequently issued guidance to determine an appropriate accounting position.
- A-2** The following implementation issues are discussed in chapter 7 of the Revenue Recognition Guide:

<i>Issue Description</i>	<i>Paragraph Reference</i>
Identifying performance obligations	7.2.01–7.2.09
Determining the timing of satisfaction of performance obligations	7.5.01–7.5.08
Arrangements for health care services provided to uninsured and insured patients with self-pay balances, including co-payments and deductibles	7.6.01–7.6.43
Third-party settlement estimates	7.6.44–7.6.72
Risk sharing arrangements	7.6.73–7.6.108
Application of FASB ASC 606 to continuing care retirement community contracts	7.6.109–7.6.162
Application of the portfolio approach	7.7.01–7.7.15
Presentation and disclosure	7.7.16–7.7.60
Accounting for contract costs	7.7.61–7.7.73

"Application of FASB ASC 606 to Continuing Care Retirement Community Contracts" is not included in this appendix. That implementation issue is

included in appendix A, "Implementation Guidance for FASB ASC 606, *Revenue from Contracts with Customers*," of chapter 14, "Financial Accounting and Reporting by Continuing Care Retirement Communities" (paragraph 14.45) of this guide.

Step 2: Identify the Performance Obligations in the Contract

Identifying Performance Obligations

This Accounting Implementation Issue Is Relevant to Step 2: "Identify the Performance Obligations in the Contract," of FASB ASC 606.

7.2.01 The core revenue recognition principle in FASB ASC 606 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The second step in FASB ASC 606 in achieving the core revenue recognition principle is to identify the separate performance obligations in the contract¹ with a customer. It is necessary for health care entities to first determine, at contract inception, which promised goods or services are included in a contract with the patient. It is then necessary for health care entities to determine which goods or services (if any) represent separate performance obligations in order to identify the unit(s) of account to determine when to recognize revenue in step 5 of FASB ASC 606-10-25-1, with the amount of revenue to be recognized determined in accordance with FASB ASC 606-10-32-1.

7.2.02 In accordance with FASB ASC 606-10-25-14, promised goods or services in a contract are identified as performance obligations if each promise to the customer is either (a) a good or service (or a bundle of goods or services) that is distinct or (b) a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer. In accordance with FASB ASC 606-10-25-22, if a promised good or service is not distinct, a health care entity is required to combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct, which may result in accounting for all the goods or services promised in a contract as a single performance obligation.

7.2.03 In accordance with FASB ASC 606-10-25-19, a promised good or service is distinct if the patient can benefit from the good or service either on its own or together with other resources that are readily available to the patient (that is, the good or service is capable of being distinct), and the health care entity's promise to transfer the good or service to the patient is separately identifiable from other promises in the contract (that is, the promise to transfer the good or service is distinct within the context of the contract).

¹ A contract with a customer may be partially within the scope of FASB *Accounting Standards Codification* (ASC) 606, *Revenue from Contracts with Customers*, and partially within the scope of other topics in FASB ASC, including those listed in FASB ASC 606-10-15-2. If the other topics specify how to separate or initially measure one or more parts of the contract, or both, then an entity should first apply the separation or measurement guidance, or both, in those topics. An entity should exclude from the transaction price the amount of the part(s) of the contract that are initially measured in accordance with other topics and should allocate the amount of the transaction price that remains to each performance obligation in scope of FASB ASC 606. For example, FASB ASC 840 and 842, *Leases*, provides guidance on allocating an arrangement's consideration between lease element(s) and non-lease element(s).

7.2.04 FASB ASC 606-10-25-15 indicates that a series of distinct goods or services has the same pattern of transfer to the customer if both of the following criteria are met:

- a. Each distinct good or service in the series that the entity promises to transfer to the customer would meet the criteria in paragraph 606-10-25-27 to be a performance obligation satisfied over time.
- b. In accordance with paragraphs 606-10-25-31 through 25-32, the same method would be used to measure the entity's progress toward complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

7.2.05 FASB ASC 606-10-25-21 states the following:

In assessing whether an entity's promise to transfer goods or services are separately identifiable in accordance with paragraph 606-10-25-19(b), the objective is to determine whether the nature of the promise, within the context of the contract, is to transfer each of those goods or services individually or, instead, to transfer a combined item or items to which the promised goods or services are inputs. Factors that indicate that two or more promises to transfer goods or services to a customer are not separately identifiable include, but are not limited to, the following:

- a. The entity provides a significant service of integrating goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted. In other words, the entity is using the goods or services as inputs to produce or deliver the combined output or outputs as specified by the customer. A combined output or outputs might include more than one phase, element, or unit.
- b. One or more of the goods or services significantly modifies or customizes, or are significantly modified or customized by, one or more of the other goods or services promised in the contract.
- c. The goods or services are highly interdependent, or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract. For example, in some cases, two or more goods or services are significantly affected by each other because the entity would not be able to fulfill its promise by transferring each of the goods or services independently.

Consideration of Contract Terms

7.2.06 A health care organization should consider the terms of the contract with a patient to determine the performance obligation(s). FASB ASC 606-10-25-3 states the following:

Some contracts with customers may have no fixed duration and can be terminated or modified by either party at any time. Other contracts may automatically renew on a periodic basis that is specified in the

contract. An entity shall apply the guidance in this Topic to the duration of the contract (that is, the contractual period) in which the parties to the contract have present enforceable rights and obligations.

7.2.07 FASB ASC 606-10-25-4 states, "For the purpose of applying the guidance in this Topic, 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 (or parties)."

7.2.08 At the October 31, 2014, TRG meeting, the TRG addressed the issue of termination (or cancellation) clauses in a contract by either of the parties and stated in paragraph 11 of its TRG Agenda Ref. No. 10, *Contract Enforceability and Termination Clauses*:

If a contract can be terminated by each party at any time without compensating the other party for the termination (that is, other than paying amounts due as a result of goods or services transferred up to the termination date), the duration of the contract does not extend beyond the goods or services already transferred. This is the case whether or not the contract has a specified contract period.

7.2.09 At the November 2015 TRG meeting, the TRG addressed the issue of contract termination (or cancellation) when only one party has the right to terminate the contract and stated in paragraph 10 of its TRG Agenda Paper 49, *November 2015 Meeting — Summary of Issues Discussed and Next Steps*

...TRG members supported the view that the legally enforceable contract period should be considered the contract period. Since that meeting, stakeholders have raised further questions (Issue 2) about evaluating a contract when only *one* party has the right to terminate the contract. TRG members agreed with the staff analysis that the views expressed at the October 2014 TRG meeting would be consistent regardless of whether both parties can terminate, or whether only one party can terminate. TRG members highlighted that when performing an evaluation of the contract term and the effect of termination penalties, an entity should consider whether those penalties are substantive.

Step 5: Recognize Revenue When (or As) the Entity Satisfied a Performance Obligation

Determining the Timing of Satisfaction of Performance Obligations

This Accounting Implementation Issue Is Relevant to Step 5: "Recognize Revenue When (or as) the Entity Satisfied a Performance Obligation" of FASB ASC 606.

7.5.01 In accordance with FASB ASC 606-10-25-23, health care entities are required to recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (that is, an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset. In accordance with FASB ASC 606-10-25-24, each performance obligation should be evaluated at contract inception to determine if it is satisfied over time or at a point in time.

7.5.02 The notion of control is easier to apply when considering a good as opposed to a service. However, FASB ASC 606 points out that the rights to the results of services are assets, even if they are often consumed immediately upon

receipt. By considering when the customer gains control over the results of a service, the notion of control can also be applied to services. Often, the evidence that a customer has gained control of a service will be that it has realized or consumed the benefits of that service, as described in FASB ASC 606-10-25-25.

7.5.03 As stated in FASB ASC 606-10-25-27:

An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time, if one of the following criteria is met:

- a. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (see paragraphs 606-10-55-5 through 55-6).
- b. The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced (see paragraph 606-10-55-7).
- c. The entity's performance does not create an asset with an alternative use to the entity (see paragraph 606-10-25-28), and the entity has an enforceable right to payment for performance completed to date (see paragraph 606-10-25-29).

7.5.04 As noted in FASB ASC 606-10-25-30, "[if] a performance obligation is not satisfied over time in accordance with paragraphs 606-10-25-27 through 25-9, an entity satisfies the performance obligation at a point in time."

Measuring Progress Toward Complete Satisfaction of a Performance Obligation

7.5.05 FASB ASC 606-10-25-31 notes as follows:

For each performance obligation satisfied over time in accordance with paragraphs 606-10-25-27 through 25-29, an entity should recognize revenue over time by measuring the progress toward complete satisfaction of that performance obligation. The objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to a customer (that is, the satisfaction of an entity's performance obligation).

7.5.06 FASB ASC 606-10-25-32 indicates the following:

An entity should apply a single method of measuring progress for each performance obligation satisfied over time, and the entity should apply that method consistently to similar performance obligations and in similar circumstances. At the end of each reporting period, an entity should remeasure its progress toward complete satisfaction of a performance obligation satisfied over time.

7.5.07 FASB ASC 606-10-25-33 states the following:

Appropriate methods of measuring progress include output methods and input methods. Paragraphs 606-10-55-16 through 55-21 provide guidance for using output methods and input methods to measure an entity's progress toward complete satisfaction of a performance obligation. In determining the appropriate method for measuring progress,

an entity should consider the nature of the good or service that the entity promised to transfer to the customer.

7.5.08 The following examples related to various health care services are meant to be illustrative, and the actual identification of performance obligations should be based on the facts and circumstances of an entity's specific situation.

Example 7-5-1 — Performance Obligations — Inpatient Health Care Services

Acute Care Hospital (ACH) provided an inpatient surgical procedure to a patient who required four days of care in the hospital. This procedure required ACH to provide and coordinate numerous goods or services to the patient (including a patient room, meals, nursing care, physician services, therapy services, drugs, supplies, and so forth) within the four days of care. In this example, ACH is acting as the principal for the inpatient services provided.

ACH considered if the room provided to the patient includes a lease component. If a lease component is identified, that component would be accounted for in accordance with FASB ASC 840 or 842, *Leases*, and any non-lease components would be accounted for in accordance with FASB ASC 606.

This example presumes that ACH concluded there is not a lease of the patient room to the patient. In this example, ACH concluded that the bundle of goods and services provided during this inpatient stay should be accounted for as a single performance obligation. In reaching this conclusion, ACH considered the following factors:

- a. Although the patient could have benefitted from some of the individual goods or services (for example, room, meals, drugs) provided as part of the inpatient care and surgery (that is, some of the individual goods or services are capable of being distinct), the nature of ACH's promise to the patient was to transfer a combined service (the inpatient surgical procedure and related goods and services). Additionally, the patient's expectation is that he or she will receive the full scale of the combined care during the inpatient stay.
- b. The overall provision of care may include identifying goods or services to be provided, including how much nursing care and physician services are necessary, which drugs to administer, and how long the patient will need to stay in the facility and be provided a room, meals, and supplies. In coordinating the patient's care during the inpatient stay, ACH provided a significant service of integrating the goods or services promised in the contract into a bundle of goods and services that represents the combined service for which the patient has contracted.
- c. Substantially all of the goods or services provided during the inpatient stay are highly dependent on, or highly interrelated with, other goods or services promised in the contract. For example, a patient is not in a position to decide whether or not to purchase an imaging procedure that is required to determine a course of treatment or to guide a surgical procedure, without significantly affecting that course of treatment or surgical procedure. Similarly, a patient is not in a position to decide whether or not to purchase a general anesthetic when general anesthesia is required for a surgical procedure.

- d. In this example, the individual promised goods or services are not substantially the same and do not represent a series of distinct goods and services. In this case, the goods and services are not substantially the same during the inpatient stay because different and additional goods and services were provided in connection with the surgical procedure at the beginning of the stay, but fewer and different goods and services were provided post-surgery as the patient recovered. The goods and services provided on Day 1 are substantially different from the goods and services provided on Day 4 in terms of the actual services provided, the level of direct physician activity, and the amount of drugs or other supplies. Because the goods and services provided on Day 1 were substantially different than the goods and services provided on Day 4 and were not provided in the same pattern, ACH determined that the goods and services provided during the other three days of the stay do not constitute a series of distinct goods and services.

In accordance with FASB ASC 606-10-25-27, ACH determined that the inpatient procedure should be accounted for over time (versus point in time) because the patient simultaneously received and consumed the benefits provided by ACH as ACH performed.

In this example, the patient is covered by insurance and the payment for the inpatient services is based on diagnostic-related group codes. ACH is entitled to a payment from the insurer, and a related deductible or coinsurance payment from the patient, for all goods and services related to the inpatient stay that is calculated without regard to the amount of resources that ACH provides to the patient. ACH considered all of the factors in step 3 of FASB ASC 606 and determined that these payments represent the transaction price.

The revenue recognized at the reporting date by ACH is determined by multiplying the transaction price by a measure of the progress toward the complete satisfaction of the performance obligation to be incurred over the complete inpatient stay.

To measure the progress in satisfying the performance obligation at the reporting date, ACH considered various input and output methods and determined its undiscounted charges represented the best proxy of its progress on satisfying the performance obligation. ACH reached this conclusion because it establishes its charges to reflect the level of effort it incurs to provide goods or services to its patients. As a result, in this case, ACH measured progress toward complete satisfaction of the performance obligation by using undiscounted charges incurred as of the reporting date relative to the total expected undiscounted charges to be incurred over the inpatient stay.

Example 7-5-2A — Performance Obligations — Outpatient Health Care Services — Discrete Visit

Physician A provides goods and services to a patient during an annual physical exam that included performing inquiry with the patient, obtaining certain vital statistics, performing certain lab tests, and providing any additional goods and services as necessary depending on the information obtained during the annual physical exam. In this scenario, the patient's insurance company pays a specified amount per outpatient visit based on ambulatory payment classification codes.

Physician A concluded that the goods (for example, supplies) and services provided during this exam represent a single performance obligation even though

the underlying tasks performed in each patient's annual physical exam will vary by patient. Because the patient simultaneously received and consumed the benefits of the services provided in the physical exam in accordance with FASB ASC 606-10-25-27a, Physician A concluded that the revenue should be recognized over time; however, in this case, because all of the goods and services were provided when the exam was performed (including the lab services), the revenue recognition would be the same as point in time because all of the goods and services were provided the same day. Physician A based these conclusions using similar criteria as ACH in example 7-5-1.

During the previously discussed physical exam, because it was the beginning of flu season, Physician A inquired if the patient had obtained a flu shot. Because a flu shot is not part of the standard protocol for the annual physical exam (that is, if the annual physical exam occurred in April, the patient would likely not need to obtain a flu shot at that particular time), and the patient could obtain a flu shot from Physician A or the patient could obtain the flu shot from a different source entirely unrelated to Physician A, the flu shot was viewed as a separate performance obligation by Physician A. Because the patient simultaneously received and consumed the benefits of the services provided by the flu shot in accordance with FASB ASC 606-10-25-27a, the revenue from the flu shot should be recognized over time. However, the recognition would be the same as point in time for this particular service because the length of the service was only a few minutes. In some instances, communication of lab results or other visit-related follow-up services may be provided on a separate day from the actual visit. Physician A should consider if these services are administrative in nature or if these services are part of the performance obligation or represent a separate performance obligation. If the services do not provide additional goods or services to the patient and are considered administrative in nature, the transaction price would not be allocated to these services. However, if these services represent the transfer of additional goods or services that are part of the performance obligation or create a separate performance obligation, a portion of the transaction price should be allocated to these goods or services.

Example 7-5-2B — Performance Obligations — Outpatient Health Care Services — Physical Therapy

ABC Physical Therapy (ABC PT) provides Patient A physical therapy services three times per week in 30 minute increments to strengthen Patient A's back. Patient A's physician orders a total of 12 visits. In this scenario, Patient A's insurance company will only pay for the actual number of visits the patient attends (not to exceed the prescribed 12 visits) at a fixed amount per visit. ABC PT concluded that, in this case, each visit would be a separate performance obligation. ABC PT reached this conclusion because the patient has the unilateral right to terminate the contract after each visit with no penalty or compensation due. If a contract can be terminated by either party at any time without compensating the other party for the termination (that is, other than paying amounts due as a result of goods or services transferred up to the termination date), the duration of the contract does not extend beyond the goods or services already transferred. That is the case whether or not the contract has a specified contract period (in this example, the 12 visits). Because the patient simultaneously received and consumed the benefits of the physical therapy services in accordance with FASB ASC 606-10-25-27a as each visit occurs ABC PT concluded that the revenue would be recognized over time.

ABC PT determined that each subsequent visit is an option for which there is not a material right as the price of each visit is a standard price consistent with

the price for the initial visit (that is, there is no discount for each subsequent visit). As a result, ABC PT should recognize revenue for each subsequent visit as it occurs.

Example 7-5-3 — Performance Obligations — Skilled Nursing Facility Services

Traditional Skilled Nursing Facility (TSNF) provides nursing home care to Resident A. As part of Resident A's care, TSNF provides on a daily basis, room and board, administration of medications, program activities, and, on certain days, in-house physical therapy services. The length of Resident A's stay at TSNF is not determinable because the date of discharge is based on patient progress; however, the contract with the patient is for a 30-day period, with automatic renewal unless one of the parties provides notice of termination. Although the contract is for 30 days, Resident A may terminate the contract on a daily basis with no penalty for termination. The amount billed for the services described are based on a daily rate to be paid by Resident A, or its third-party payor based on the actual days for which care is provided.

TSNF considered if the room provided to the resident includes a lease component. If a lease component is identified, that component would be accounted for in accordance with FASB ASC 840 or 842, and any non-lease components would be accounted for in accordance with FASB ASC 606.

This example presumes that TSNF concluded there is not a lease of the patient room to the patient.

Although Resident A could benefit from some of the individual goods or services (for example, room, meals, drugs) provided as part of the individual plan of care (that is, some of the individual goods or services are capable of being distinct), the nature of TSNF's promise to Resident A is to transfer a combined item (skilled nursing facility services) to which the promised goods or services noted previously are inputs.

TSNF is responsible for the overall provision of care, which includes identifying goods or services to be provided, including how much skilled nursing care is necessary, which drugs to administer, and how long Resident A will need to stay in the facility and require a room, meals, and supplies.

TSNF concludes that each day that Resident A receives services represents a separate contract and performance obligation based on the fact that Resident A has the unilateral right to terminate the contract after each day with no penalty or compensation due. If a contract can be terminated by either party at any time without compensating the other party for the termination (that is, other than paying amounts due as a result of goods or services transferred up to the termination date), the duration of the contract does not extend beyond the goods or services already transferred. That is the case whether or not the contract has a specified contract period.

TSNF determined that the daily renewal is an option in which there is not a material right as the price of the renewal is a price consistent with the price for the initial day (that is, there is no discount for the renewal). As a result, TSNF would account for the renewal (that is, each day) when exercised by Resident A.

While at TSNF, Resident A requested that TSNF provide her transportation services to her physician's office. Transportation for this type of request is not covered by TSNF in its normal routine of care and is a service the facility

provides to its residents requiring an additional fee based on miles driven and the type of vehicle required for the transport.

This transportation service for Resident A is capable of being distinct from the standard goods and services provided in the contract and is not a service that is provided in similar increments on a regular basis as part of the care contract with Resident A. Resident A could also purchase this service from other service providers and TSNF does not provide a discount on the transportation services. TSNF concluded that the transportation service provided by TSNF is a separate performance obligation that should be recognized as revenue as the service is provided.

Because the patient simultaneously received and consumed the benefits of the services provided by TSNF in accordance with FASB ASC 606-10-25-27a, TSNF concluded that the revenue should be recognized over time.

Revenue Streams

Arrangements for Health Care Services Provided to Uninsured and Insured Patients With Self-Pay Balances, Including Co-Payments and Deductibles

This Accounting Implementation Issue Is Relevant to the Application of FASB ASC 606 to Health Care Services Provided to Uninsured and Insured Patients With Self-Pay Balances.

Background

7.6.01 Certain health care entities are required by law or regulation to treat emergency conditions (for example, through a hospital's emergency department) and often provide services to uninsured or underinsured patients regardless of the patient's ability to pay. More specifically, in 1986, Congress enacted the Emergency Medical Treatment & Labor Act to ensure public access to emergency services regardless of ability to pay. Additionally, Section 1867 of the Social Security Act imposes specific obligations on Medicare-participating hospitals that offer emergency services to provide a medical screening examination when a request is made for treatment of an emergency medical condition regardless of an individual's ability to pay.

7.6.02 In addition, some not-for-profit health care entities are tax-exempt under IRC Section 501(c)(3) as charitable organizations and, therefore, have certain requirements to maintain their tax-exempt status. IRC Section 501(r) imposes certain requirements on organizations that operate one or more hospital facilities, including establishing written financial assistance and emergency medical care policies, limiting amounts charged for emergency or other medically necessary care to individuals eligible for assistance under the hospital's financial assistance policy, and making 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.

7.6.03 Further, some not-for-profit health care entities provide services to patients regardless of their ability to pay because of their charitable mission or to support their tax-exempt status, or both. There are other types of health care entities that do not provide emergency services or may not have a stated

mission to provide medically necessary services but that also provide services to patients before determining their intent or ability to pay.

Determining If an Enforceable Contract Between a Health Care Entity and a Patient Exists

7.6.04 FASB ASC 606-10-25-2 discusses that enforceability of the rights and obligations in a contract is a matter of law. Therefore, a health care entity may consider involvement of internal or external legal counsel, or both, in making the overall determination of when a legally enforceable contract with its patients is in place.

7.6.05 FASB ASC 606-10-25-1 explains that an entity should account for a contract with a customer when all five criteria of FASB ASC 606-10-25-1 are met. FASB ASC 606-10-25-1a states that one requirement is that the "parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations." In accordance with FASB ASC 606-10-25-1a, a health care entity may consider if it has a written contract with the patient by considering whether the patient signed any forms, such as a patient responsibility form, which would be considered a written contract. If the health care entity determines it does not have a written contract (for example, the patient refuses to sign a patient responsibility form), it may consider if it has an oral or implied contract based on the entity's customary business practices. If the patient schedules health care services in advance (for example, elective surgery), the health care entity may consider if it has an oral or implied contract. If the patient does not schedule the services in advance (for example, a patient that was admitted through the emergency room while unconscious or against their will), the health care entity may perform an analysis of the specific facts and circumstances to assess enforceability, including looking at customary business practices.

Determining If a Patient Is Committed to Perform His or Her Obligations and If It Is Probable That the Entity Will Collect Substantially All of the Consideration to Which It Expects to Be Entitled

7.6.06 Example 3, "Implicit Price Concession," in paragraphs 102–105 of FASB ASC 606-10-55 illustrates that the health care entity may be unable to evaluate an uninsured patient's commitment to perform his or her obligations (for example, pay for services rendered) or determine if it is probable that it will collect the consideration to which it is entitled until it obtains certain information about the patient. Until that determination is made, a contract with the customer cannot be presumed to exist in the revenue model. In the example, the health care entity is not able to determine whether the patient is committed to perform his or her obligations or that it is probable that it will collect the consideration to which it is entitled until after the health care entity has provided services.

7.6.07 In accordance with FASB ASC 606-10-25-1, if the health care entity determines that the patient or other payor is not committed to perform his or her obligation(s) or that it is not probable that the entity will collect the consideration to which it is entitled, the criteria in FASB ASC 606-10-25-1 have not been met and a contract with a customer does not exist. A health care entity may make this determination based on past history with that patient or because the patient qualifies for the health care entity's charity care policy.

Example 3 in FASB ASC 606-10-55 indicates that the patient did not qualify for charity care or government subsidies (for example, Medicaid) and, therefore, does not illustrate how to apply the guidance in FASB ASC 606 in situations in which the entity obtains some information about the patient, but additional time is needed to determine if, and how much, insurance coverage exists.

7.6.08 For example, a patient may be admitted to the emergency room of a health care entity and be unresponsive. The health care entity is obligated to provide services to the patient as required by law. If the health care entity subsequently determines that the patient is uninsured, it may try to qualify the patient for Medicaid coverage. Depending on the state, the Medicaid qualification process can take from several weeks to over a year. The health care entity may consider the information in the following paragraphs to determine if a contract, as defined in FASB ASC 606, exists for a patient whose insurance coverage has not yet been determined (such as "pending Medicaid").

7.6.09 Although the party responsible for payment has not yet been determined, the health care entity may have historical information for pending Medicaid patients to determine the transaction price based on the percentage of those contracts it estimates will

- a. qualify for Medicaid,
- b. qualify for the health care entity's charity care policy (therefore, those contracts are not within the scope of the revenue model), and
- c. become uninsured self-pay.

7.6.10 This approach of using historical information for pending Medicaid patients may provide a health care entity a basis to conclude that a patient in "pending Medicaid" status meets the requirements in FASB ASC 606-10-25-1. FinREC believes that this approach may be applied to an individual contract or a portfolio of similar contracts as described in FASB ASC 606-10-10-4, although in practice, will generally be applied to a portfolio of similar contracts. In accordance with discussion at the July 2015 TRG meeting and FASB ASC 606-10-32-9, a health care entity should consider all information that is reasonably available to the entity to estimate variable consideration, whether the guidance in FASB ASC 606 is applied on a portfolio or contract-by-contract basis. Refer to the "Application of the Portfolio Approach" section in paragraphs 7.7.01–7.7.15 for discussion on application of the portfolio approach for contracts with patients.

7.6.11 A health care entity may estimate the transaction price for an individual contract considering the likelihood of each outcome for the contract (for example, Medicaid, self-pay, and charity care) and the expected reimbursement rate for each. A health care entity may also apply the guidance to a portfolio of contracts if it reasonably expects that the effects on the financial statements would not differ materially from applying to an individual contract. For the percentage of contracts expected to qualify for Medicaid, a health care entity may consider applying the guidance in FASB ASC 606 in a similar manner as other Medicaid patients. For the percentage of contracts expected to qualify for charity care, the health care entity would not recognize revenue in accordance with FASB ASC 954-605-25-10 (which was not amended by FASB Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*). For the percentage of contracts expected to become uninsured self-pay, a health care entity may follow example 3 in paragraphs 102–105 of FASB ASC 606-10-55.

7.6.12 This approach is consistent with example 22, "Right of Return," in paragraphs 202–207 of FASB ASC 606-10-55, whereby the entity applies historical experience to a portfolio of contracts to estimate products that will be returned and, therefore, does not recognize revenue for those products. This is also similar to a health care entity that estimates the number of patients who will qualify for charity care and, therefore, does not recognize revenue for those patients.

7.6.13 If a health care entity does not have historical experience to estimate the outcome for a pending Medicaid account prior to receiving the Medicaid qualification determination (for example, the account is an outlier), it may determine that a contract does not exist because it has not met the requirements in FASB ASC 606-10-25-1. That is, the health care entity has not yet determined that the patient or other payor is committed to perform his or her obligation(s) (that is, pay for services rendered) based on its past history, including whether the patient qualifies for charity care, or if it is probable that it will collect the consideration to which it is entitled.

7.6.14 If at a later date the health care entity determines it has sufficient historical evidence to estimate the outcome for a pending Medicaid account or the Medicaid program subsequently approves the patient for coverage, the health care entity would reassess the criteria in FASB ASC 606-10-25-1 to determine if a contract exists in accordance with FASB ASC 606-10-25-6.

7.6.15 If the Medicaid program subsequently denies coverage, the health care entity may attempt to qualify the patient for its charity care policy. If the patient qualifies for charity care, a contract does not exist for purposes of applying FASB ASC 606, in accordance with FASB ASC 954-605-25-10. If the patient does not qualify under the health care entity's charity care policy, the fact pattern may be similar to the one provided in example 3 in paragraphs 102–105 of FASB ASC 606-10-55.

7.6.16 There are other FASB ASC 606-10-25-1 considerations for a health care entity even when the payor has been determined. Example 3 in paragraphs 102–105 of FASB ASC 606-10-55 illustrates that for an uninsured emergency room patient for which the health care entity had not previously provided medical services (that is, the health care entity had no history with that specific patient), the health care entity may designate the patient to a customer or payor class based on its review of the patient's information. The review of the patient's information may include determining if the patient has insurance coverage, a co-payment, or a deductible. If a patient has no insurance or if a portion of the balance is due from the patient (for example, a deductible), the health care entity evaluates the patient's ability and intention to pay in accordance with FASB ASC 606-10-25-1e, which may include consideration of whether any negative evidence exists with respect to the health care entity's history with that particular patient.

7.6.17 A situation in which services were previously provided to the patient and no consideration was collected may provide strong evidence that the patient does not have the intent or ability to pay. However, if no such evidence exists, the health care entity may be able to conclude that its expectation related to collectibility for that patient is no different than for any other patient in the customer class.

7.6.18 A health care entity should consider the guidance pertaining to the portfolio approach (as described in FASB ASC 606-10-10-4) to determine if

that practical expedient can be applied and, if so, at what level. For example, a health care entity may evaluate whether to establish separate portfolios for uninsured self-pay patients, insured patients with co-payments, insured patients with deductibles, emergency room uninsured self-pay, elective surgery that is not medically necessary or covered by insurance, and so on. Refer to the "Application of the Portfolio Approach" section in paragraphs 7.7.01–7.7.15 for discussion on application of the portfolio approach for contracts with patients.

Determining If Amounts That Are Not Probable of Collection From Patients With Self-Pay Balances Constitute Implicit Price Concessions

7.6.19 To determine if it is probable that the health care entity will collect substantially all of the consideration to which it will be entitled as required in FASB ASC 606-10-25-1e, a health care entity will need to determine the transaction price as described in FASB ASC 606-10-32-2. If the transaction price includes an estimate of variable consideration (for example, a price concession), the transaction price may be less than the stated price in the contract. FASB ASC 606-10-32-8 discusses two methods for estimating variable consideration (the expected value method and the most likely amount), the selection of which is dependent on which method an entity expects to better predict the amount of consideration to which the entity will be entitled. In accordance with FASB ASC 606-10-32-11, some or all of an amount of estimated variable consideration should be considered in the transaction price 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.

7.6.20 FASB ASC 606-10-32-9 indicates that to estimate the transaction price, a health care entity should consider all information that is reasonably available, including historical, current, and forecasted information. As such, the health care entity should consider the historical cash collections from a customer class identified (for example, self-pay) to estimate the transaction price for a patient (that is, how much the health care entity expects to be entitled for the services provided). In accordance with the discussion at the July 2015 TRG meeting on the portfolio practical expedient and FASB ASC 606-10-32-9, a health care entity is required to consider all information that is reasonably available to the entity to estimate variable consideration whether the guidance in FASB ASC 606 is applied on a portfolio or contract-by-contract basis (refer to the "Use of Historical Experience to Estimate Contractual Adjustments From Third-Party Payors, Governmental Programs, Self-Pay Discounts, and Implicit Price Concessions" section in paragraphs 7.7.13–7.7.15 for further discussion).

7.6.21 Variable consideration can result from discounts, price concessions, or other similar items. FASB ASC 606-10-32-7 indicates that variable consideration may be explicitly stated in the contract. In determining whether a health care entity has provided an implicit price concession to a patient with a self-pay balance, a health care entity needs to determine, in accordance with paragraphs 7a–7b of FASB ASC 606-10-32, whether "the customer has a valid expectation arising from an entity's customary business practices, published policies, or specific statements that the entity will accept an amount of consideration that is less than the price stated in the contract. That is, it is expected that the entity will offer a price concession," or "facts and circumstances indicate that the entity's intention, when entering into the contract with the customer, is to offer a price concession to the customer."

7.6.22 As noted in paragraph BC194 of ASU No. 2014-09, the boards decided not to develop detailed guidance for differentiating between a price concession and impairment losses. Therefore, a health care entity should use judgment and consider all relevant facts and circumstances to determine if it has implicitly offered a price concession or has accepted the risk of default by the patient of the contractually agreed-upon consideration (that is, customer credit risk). It is important to note that an implicit price concession does not have to be specifically communicated or offered to the patient by the entity.

7.6.23 Under FASB ASC 606-10-32-7b, to determine whether a health care entity has provided an implicit price concession to a patient with a self-pay balance, a health care entity should determine whether facts and circumstances indicate an intention to provide a price concession. Example 3 in paragraphs 102–105 of FASB ASC 606-10-55 provides a specific set of facts and circumstances related to a hospital that provides medical services to an uninsured patient in the emergency room. FASB ASC 606-10-55-104 indicates that if a health care entity "expects to accept a lower amount of consideration," it may conclude that "the promised consideration is variable" (that is, the health care entity is providing an implicit price concession).

7.6.24 A health care entity may consider the following factors to determine whether it intends to provide an implicit price concession:

- a. The health care entity has a customary business practice of not performing a credit assessment prior to providing services (for example, because it is required by law or regulation, or has a mission to provide medically necessary or emergency services prior to assessing a patient's ability or intent to pay).
- b. The health care entity continues to provide services to a patient (or patient class) even when historical experience indicates that it is not probable that the entity will collect substantially all of the discounted charges (gross or standard charges less any contractual adjustments or discounts) in the contract. In evaluating the probability that the entity will collect substantially all of the discounted charges, the entity should evaluate the entire amount of discounted charges for the contract and not just the patient responsibility portion.

7.6.25 If one of those factors is present, FinREC believes that the health care entity has implicitly provided a price concession to the patient (or patients in the patient class), even if it will continue to attempt to collect the full amount of discounted charges.

7.6.26 When a health care entity determines the consideration is variable, the entity would only include in the transaction price an estimate of the variable consideration that meets the constraint under paragraphs 11–12 of FASB ASC 606-10-32. Therefore, the entity's calculation of the implicit price concession should incorporate the entity's expectations of cash collections at a level at which it is probable that the cumulative amount of revenue recognized would not result in a significant revenue reversal. Consistent with paragraph BC215 of ASU No. 2014-09, there may be circumstances in which the calculation of variable consideration already incorporates the principles on which the guidance for constraining estimates of variable consideration is based.

7.6.27 To assist with the determination of whether it is probable that there will not be a significant revenue reversal when the cash is collected, FASB ASC

606-10-32-12 provides factors for an entity to consider. The following are factors for health care entities to consider when evaluating if it is probable there will not be a significant revenue reversal when the cash is collected in contracts with patients with self-pay balances:

- a. Whether the amount of consideration from patients with self-pay balances is highly susceptible to factors outside the entity's influence (for example, a health care entity may consider the current economic conditions in the market it serves)
- b. The entity's experience with similar types of contracts (for example, a health care entity may consider the extent of its experience with similar patients or portfolios of similar patients)
- c. How long the period is until the uncertainty is resolved (for example, a health care entity may consider how long it generally takes to collect the consideration from similar patients)
- d. Its practice of offering price concessions or changing payment terms (for example, a health care entity may adjust the standard charges based on its uninsured discount or prompt-pay discount policy)
- e. The number of possible consideration amounts (for example, a health care entity may consider the historical range of collection history with similar patients and whether the range is broad (significant differences from reporting period to reporting period) or narrow (insignificant differences from reporting period to reporting period))

7.6.28 In a contract with a patient with a self-pay balance for an "elective" procedure that is scheduled in advance and does not involve a medical emergency, the health care entity may be able to assess the patient's intent and ability to pay prior to or at the time of service, and determine that it is probable that it will collect substantially all of the consideration to which it is entitled. In that situation, the health care entity may determine that it has not provided an implicit price concession.

7.6.29 If the health care entity determines that it has not provided an implicit price concession because the factors in paragraph 7.6.24 are not present, it is still required to determine whether it is probable that it will collect substantially all of the consideration to which it is entitled in order to determine whether it has a contract under FASB ASC 606-10-25-1e. If a health care entity determines it does not meet the requirements of FASB ASC 606-10-25-1, it would not recognize revenue until one of the criteria in FASB ASC 606-10-25-7 is met. Refer to the "Other Considerations" section in paragraphs 7.6.37–7.6.43 for further discussion.

Determining How to Account for Subsequent Changes in the Estimate of the Transaction Price

7.6.30 If the entity concludes that it has provided an implicit price concession for the amount it doesn't expect to collect (that is, the consideration is variable), the entity must also consider how to account for subsequent changes in the estimate of the transaction price relating to the amount expected to be received. FASB ASC 606-10-32-14 requires an entity to update the estimated transaction price, including updating the assessment of whether an estimate of variable consideration is constrained, at the end of each reporting period. This requirement to update the estimated transaction price applies regardless

of whether the entity determines the transaction price based on an individual contract (individual patient basis) or a portfolio of similar contracts (patient class).

7.6.31 Factors that may result in a change in the estimate of the transaction price (that is, when the entity expects to be entitled to more or less than it originally estimated) prior to receiving payment include whether the health care entity obtained additional information about an insured patient's deductible, co-payment or co-insurance coverage, or other information about the patient's personal financial situation. For example, the health care entity may subsequently learn that an uninsured patient qualifies for Medicaid or that an uninsured patient qualifies for charity care.

7.6.32 Health care entities that apply the portfolio approach to a patient class will need to consider additional information they may obtain about patients in the patient class that may result in a change in the estimate of the transaction price in order to update the estimate of the transaction price each reporting period.

7.6.33 When a health care entity determines it has provided an implicit price concession based on the factors discussed in paragraph 7.6.24 or other factors, FinREC believes that subsequent changes to the estimate of variable consideration should generally be accounted for as increases or decreases in the implicit price concession (adjustments to patient service revenue). Because the assessment of the implicit price concession inherently considers the amount the entity expects to collect from the patient (or patient class), FinREC believes that changes in the entity's expectation of the amount it will receive from the patient (or patient class) will be recorded in revenue unless there is a patient-specific event that is known to the entity that suggests that the patient no longer has the ability and intent to pay the amount due and, therefore, the changes in its estimate of variable consideration better represent an impairment (bad debt). FASB ASC 606-10-32-43 states that "amounts allocated to a satisfied performance obligation shall be recognized as revenue, or as a reduction of revenue, in the period in which the transaction price changes." Therefore, if the change in the transaction price occurs after the service has been provided to the patient, the changes in the estimate of the variable consideration would be recognized as additional revenue, or a reduction to revenue, in the period in which the estimate of the transaction price changes.

7.6.34 If an entity experiences frequent subsequent adjustments that result in decreases to patient revenue, the entity should re-assess whether its estimation process, including the constraint, is appropriate. In addition, when an entity subsequently collects significantly less than its original estimate of variable consideration, there may be facts and circumstances that indicate there has been an adverse change in the patient's credit worthiness (for example, the patient filed for bankruptcy or lost their job), and the difference may be better classified as an impairment loss (bad debt) rather than a change in the transaction price. However, as discussed in paragraph 7.6.30, an entity is required to update its estimate of the transaction price at the end of each reporting period and should not wait for subsequent cash collections to do so.

Determining What Constitutes an Impairment Loss or Bad Debt

7.6.35 In estimating the transaction price, a health care entity may determine that it has not provided an implicit price concession (because the factors in paragraph 7.6.24 are not present) but, rather, that it has chosen to accept

the risk of default by the patient, and that uncollectible amounts better represent impairment losses or bad debts. For example, a health care entity that (i) provides elective surgeries, (ii) does not meet the factors in paragraph 7.6.24, and (iii) determines that it is probable that it will collect substantially all of the consideration to which it is entitled based on its initial assessment of the patient's creditworthiness, may determine that any amount it does not expect to collect represents an impairment loss or bad debt.

7.6.36 In determining what constitutes an impairment loss, a health care entity considers the effects of customer credit risk after the determination that the arrangement meets the criteria for a contract under FASB ASC 606-10-25-1, and revenue and a receivable are recognized for the services provided. For example, a health care entity may have collection experience with a customer class that indicates it collects substantially all (for example, 98%) of the amount it bills to that customer class. The contracts with those patients would meet FASB ASC 606-10-25-1, and the health care entity would recognize revenue and receivables for the amount it bills (100%) along with a provision for bad debts (2%) based on valuation of the receivables. An example of where an impairment loss may be recorded after contract inception for a self-pay patient balance may be the subsequent inability of a patient to pay his or her portion of a bill for an elective procedure as a result of his or her loss of employment or filing for bankruptcy and for which the health care entity had assessed the patient's ability to pay prior to providing the service and expected to collect substantially all of the discounted charges.

Other Considerations

7.6.37 In accordance with FASB ASC 606-10-25-1, a contract with a customer exists only when all of the criteria are met. In addition to the criteria in items a and e of FASB ASC 606-10-25-1 discussed in previous paragraphs, a health care entity should also consider the criteria for a contract in FASB ASC 606-10-25-1 to determine that a contract with a patient exists within the scope of the model. This includes identifying each party's rights regarding the goods or services transferred (a health care entity has a right to payment for services provided to a patient), identifying payment terms (generally, gross charges less any contractual adjustments or self-pay discounts), and that the contract has commercial substance (entity expects its cash flows to change as a result of the services provided).

7.6.38 For arrangements with patients that do not meet one or more of the criteria in FASB ASC 606-10-25-1, the health care entity should continually reassess the arrangement as facts and circumstances change, in accordance with FASB ASC 606-10-25-6. If partial payment is received, the health care entity should reassess whether the criteria in FASB ASC 606-10-25-1 are met and a contract with a customer exists, including whether it has provided an implicit price concession. If consideration is received from the patient and the criteria in FASB ASC 606-10-25-1 are still not met, the health care entity would apply the guidance in paragraphs 7–8 of FASB ASC 606-10-25 to determine when to recognize the consideration received as revenue.

7.6.39 FASB ASC 606-10-25-7 indicates that when a contract with a customer does not meet the criteria in FASB ASC 606-10-25-1 and an entity receives consideration from the customer, the entity should recognize the consideration received as revenue only when one or more of the following events has occurred:

- a. The entity has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the entity and is nonrefundable.
- b. The contract has been terminated, and the consideration received from the customer is nonrefundable.
- c. The entity has transferred control of the goods or services to which the consideration that has been received relates, the entity has stopped transferring goods and services to the customer (if applicable) and has no obligation under the contract to transfer additional goods or services, and the consideration received from the customer is nonrefundable.

7.6.40 In accordance with FASB ASC 606-10-25-7, a health care entity would have to determine that the consideration received from the patient is nonrefundable. If the consideration received is nonrefundable, the service has already been performed for the patient, and all, or substantially all, of the consideration promised by the patient has been received, revenue may be recognized under FASB ASC 606-10-25-7a. If the consideration received is nonrefundable and the contract is considered terminated, revenue may be recognized under FASB ASC 606-10-25-7b. A health care entity would have to assess when the contract is terminated. Contract termination is a legal matter and may require involvement of legal counsel. If the consideration received is nonrefundable and the health care entity has stopped performing services to the patient and has no obligation to perform additional services under the contract, revenue may be recognized under FASB ASC 606-10-25-7c.

7.6.41 In accordance with FASB ASC 606-10-25-8, if a health care entity does not meet the guidance in FASB ASC 606-10-25-7 to recognize revenue, it would recognize the consideration received from the patient as a liability until one of the events in FASB ASC 606-10-25-7 occurs or until the criteria in FASB ASC 606-10-25-1 are subsequently met (see FASB ASC 606-10-25-6).

7.6.42 When determining the transaction price, the health care entity should also consider whether a significant financing component exists, as required in paragraphs 15–20 of FASB ASC 606-10-32.

7.6.43 The following examples are meant to be illustrative, and the determination of the application of the guidance in FASB ASC 606 should be based on the individual facts and circumstances. The illustrative examples based on a single contract are intended to expand on example 3 in paragraphs 102–105 of FASB ASC 606-10-55. However, many health care entities may elect to use the portfolio approach (as described in FASB ASC 606-10-10-4) for recognizing revenue from self-pay patients. Refer to the "Application of the Portfolio Approach" section in paragraphs 7.7.01–7.7.15 for discussion on application of the portfolio approach for contracts with patients.

Example 7-6-1 — Implicit Price Concession Based on Single Contract — Uninsured Self-Pay Patient With No Uninsured Discount

A hospital treats a patient with an emergency condition and does not assess the patient's ability to pay at the time of service. Upon discharge, the hospital determines that the patient does not have insurance coverage, does not qualify for financial assistance (that is, the hospital's charity care policy, hospital uninsured discount policy, or government entitlement program) and, therefore, is considered an *uninsured self-pay patient*. The standard charges for services

provided to the patient are \$10,000, and a bill is sent to the patient for this amount.

The hospital intends to pursue collection of the entire amount and may engage the use of external collection agencies to do so. That is, the hospital does not intend to give up collecting the standard charges. However, the hospital has a long history of providing services to uninsured self-pay patients and collecting amounts that are substantially less than its standard charges because it is required to provide emergency services regardless of the patient's ability to pay under the Social Security Act. Based on its experience with similar uninsured self-pay patients, the hospital only expects to collect \$1,000 from the patient.

The facts and circumstances indicate that the entity's intention when entering into the contract with the customer was to provide an implicit price concession to the customer because (a) the hospital is required to provide emergency services regardless of the patient's ability to pay under the Social Security Act, and (b) the hospital continues to provide services to uninsured self-pay patients even when historical experience indicates that it is not probable that the entity will collect substantially all of the discounted charges (gross or standard charges less any contractual adjustments or discounts). Therefore (after consideration of the constraint in paragraphs 11–12 of FASB ASC 606-10-32), the hospital determines that \$1,000 is the transaction price. The hospital concludes that it is probable that it will collect the \$1,000 and that the other criteria in FASB ASC 606-10-25-1 are also met and, therefore, records patient revenue and accounts receivable of \$1,000.

FASB ASC 606-10-32-14 requires the hospital to update the estimated transaction price, including updating the assessment of whether the estimate of variable consideration is constrained, at the end of each reporting period. If the entity subsequently determines it will collect \$1,100, instead of the \$1,000 it initially estimated, FinREC believes the entity should generally account for the difference as a reduction to the implicit price concession (that is, an increase to the estimate of the transaction price) in accordance with paragraphs 42–43 of FASB ASC 606-10-32 because the entity has additional information to update its estimate of the transaction price.

If the entity subsequently determines it will only collect \$900, instead of the \$1,000 it initially estimated, it will need to evaluate whether it has obtained any adverse information regarding the patient's financial condition to determine if an impairment exists. If no adverse information regarding the patient's financial condition has been obtained, FinREC believes the entity should generally account for the difference as an increase to the implicit price concession (that is, a reduction to the estimate of the transaction price) because the health care entity determined that it intended to provide an implicit price concession. If an entity experiences frequent subsequent adjustments that result in decreases to patient revenue, the entity should re-assess whether its estimation process, including its application of the constraint, is appropriate.

Example 7-6-2 — Implicit Price Concession Based on Single Contract — Uninsured Self-Pay Patient With Uninsured Discount

A hospital treats a patient with an emergency condition. The hospital is required to provide emergency services regardless of the patient's ability to pay under the Social Security Act as well as based on its stated mission. In addition, based on the requirements of IRC Section 501(r), the hospital makes reasonable efforts to determine whether patients are eligible for assistance under its financial assistance policy.

During the patient's hospital stay and before discharge, the hospital determines that the patient qualifies for the hospital's uninsured discount policy and grants the patient a 75% discount (that is, an explicit price concession) similar to a contractual adjustment for local managed care companies. The standard charges for services provided to the patient are \$40,000. Upon billing, the hospital discounts the charges by 75%, or \$30,000, based on its uninsured discount policy.

The discounted charges for services provided to the patient are \$10,000, and a bill is sent to the patient for this amount. The hospital intends to pursue collection of the discounted charges and may engage the use of external collection agencies to do so. That is, the hospital does not intend to give up collecting the discounted charges. However, based on its experience with similar patients, the hospital only expects to collect \$1,000 from the patient. The hospital has a history of providing services to uninsured patients and collecting amounts that are substantially less than its discounted charges.

The facts and circumstances indicate that the entity's intention when entering into the contract with the customer was to provide a price concession to the customer because (a) the hospital is required to provide emergency services regardless of the patient's ability to pay under the Social Security Act; (b) as per its stated mission and in accordance with IRC Section 501(r), the hospital is required to limit amounts charged for emergency services to individuals eligible for assistance under the hospital's financial assistance policy; and (c) the hospital continues to provide services to uninsured self-pay patients even when historical experience indicates that it is not probable that the entity will collect substantially all of the discounted charges. Therefore (after consideration of the constraint in paragraphs 11–12 of FASB ASC 606-10-32), the hospital determines that \$1,000 is the transaction price. The hospital concludes that it is probable that it will collect the \$1,000 and that the other criteria in FASB ASC 606-10-25-1 are also met and records patient revenue and accounts receivable of \$1,000.

Example 7-6-3 — Implicit Price Concession Based on Portfolio Approach — Uninsured Self-Pay Patients

A hospital elects to apply the portfolio approach (as described in FASB ASC 606-10-10-4) for recognizing revenue from uninsured self-pay patients. The hospital identifies the *uninsured self-pay customer class* as a portfolio of contracts based on qualitative and quantitative factors, including an analysis that shows that the uninsured self-pay customer class shares similar collection patterns based on historical information (that is, variances from reporting period to reporting period in the percentage of collections have been insignificant in the aggregate). Therefore, the hospital concludes that the expected outcome from using a portfolio approach is not expected to materially differ from an individual contract approach.

During the reporting period, the uninsured self-pay portfolio has total gross charges of \$1,000,000. Based on its historical experience with the uninsured self-pay customer class, the hospital determines that these patients qualify for financial assistance (for example, charity care policy, uninsured discount policy) totaling \$750,000, or 75%. Therefore, the adjustments of \$750,000 represent discounts (explicit price concessions) and are included as a reduction to the transaction price.

The discounted charges for services provided to the patients total \$250,000. However, the hospital has a history of providing services to uninsured patients and collecting payments that are substantially less than its discounted charges. Based on its collection history from patients in this customer class, the hospital concludes it is probable it will collect \$50,000 of the discounted charges from the uninsured self-pay patients in the portfolio. In addition, based on an assessment of other facts and circumstances, the entity concludes that the other criteria in FASB ASC 606-10-25-1 are met.

Because the facts and circumstances indicate that the entity's intention, when entering into the contracts with the patients, was to provide an implicit price concession, it may conclude that \$50,000 is the transaction price (variable consideration) after consideration of the constraint in paragraphs 11–12 of FASB ASC 606-10-32 and record patient revenue and accounts receivable of \$50,000.

FASB ASC 606-10-32-14 requires the hospital to update the estimated transaction price, including updating the assessment of whether the estimate of variable consideration is constrained, at the end of each reporting period. If the hospital subsequently determines it will collect \$55,000, instead of the \$50,000 it initially estimated, FinREC believes the entity should generally account for the difference as a reduction to the implicit price concession (that is, an increase to the estimate of the transaction price) in accordance with paragraphs 42–43 of FASB ASC 606-10-32 because the entity has additional information to update its estimate of the implicit price concession.

If the entity subsequently determines it will only collect \$45,000, instead of \$50,000 it initially estimated, it will need to evaluate whether it has obtained any adverse information regarding the financial condition of the patients in the portfolio to determine if an impairment exists. If no adverse information regarding the patients' financial condition has been obtained, FinREC believes the entity should generally account for the difference as an increase to the implicit price concession (that is, a reduction to the estimate of the transaction price) because the health care entity determined that it intended to provide an implicit price concession. If an entity experiences frequent subsequent adjustments that result in decreases to patient revenue, the entity should re-assess whether its estimation process, including its application of the constraint, is appropriate.

Example 7-6-4 — Implicit Price Concession Based on Single Contract — Insured patient with high deductible plan

An urgent care clinic treats an insured patient with a high deductible plan but, prior to providing service, does not determine whether or not the patient has a patient responsibility (for example, whether or not the patient has met his or her deductible for the period) and, if so, whether the patient has the ability to pay it. The standard charges for the services provided to the patient are \$5,000. After services are provided, the patient presents proof of coverage with a commercial insurance company. Based on its contract with the commercial payor, the clinic determines there is a contractual adjustment of \$3,000 (that is, an explicit price concession). Therefore, the discounted charges for services provided to the patient are \$2,000.

The clinic has a history of providing services to insured patients with high deductible plans and collecting amounts that are substantially less than its discounted charges. The clinic considered that the services were provided early in the calendar year and, therefore, patients with high deductible plans may

not have met their deductible. Based on its historical experience with patients with high deductible plans during similar time periods in prior years, the clinic estimates that it only expects to collect \$200 for the contract. The clinic intends to pursue collection of the \$2,000 and may engage the use of external collection agencies to do so. That is, the clinic does not intend to give up collecting the discounted charges.

Because the facts and circumstances indicate that the entity's intention, when entering into the contract with the customer, was to provide an implicit price concession, it concludes that \$200 is the transaction price (variable consideration) after consideration of the constraint in paragraphs 11–12 of FASB ASC 606-10-32. The clinic concludes that it is probable that it will collect the \$200 and that the other criteria in FASB ASC 606-10-25-1 are also met and records patient service revenue and accounts receivable of \$200.

Example 7-6-5 — Implicit Price Concession Based on Portfolio Approach — Insured patients with high deductible plans

An urgent care clinic elects to apply the portfolio approach (as described in FASB ASC 606-10-10-4) for recognizing revenue from patients. The urgent care clinic identifies a portfolio of contracts for patients with high deductible plans provided by insurance carrier A based on qualitative and quantitative factors, including an analysis that shows that the customer class shares similar collection patterns based on historical information (that is, variances from reporting period to reporting period in the percentage of collections from period to period have been insignificant in the aggregate). Therefore, the urgent care clinic concludes that the expected outcome from applying a portfolio approach is not expected to materially differ from an individual contract approach.

During the reporting period, the portfolio of insured patients with high deductible plans provided by insurance carrier A has total gross charges of \$500,000. Based on its agreement with this insurance carrier, the urgent care clinic recognizes a contractual adjustment of 60%, or \$300,000, of gross charges. Therefore, the adjustments of \$300,000 represent explicit price concessions and reduce the transaction price. The discounted charges for services provided to the patients total \$200,000.

The urgent care clinic has a practice of providing services to patients with high deductible plans even though it historically collects amounts that are substantially less than its discounted charges from patients in this customer class. The clinic considered that the services were provided early in the calendar year and, therefore, patients with high deductible plans may not have met their deductible. Based on the collection history from this customer class during similar time periods in prior years, the urgent care clinic concludes it is probable it will collect \$80,000 of the discounted charges from the customers in the portfolio. The \$80,000 was determined based on amounts expected to be received from patients and amounts expected to be received from insurance carrier A for patients who have met all or a portion of their deductible. In addition, based on an assessment of other facts and circumstances, the entity concludes that the other criteria in FASB ASC 606-10-25-1 are met.

Because the facts and circumstances indicate that the entity's intention, when entering into the contracts with these customers, was to provide implicit price concessions to the customers, it may conclude that \$80,000 is the transaction price (variable consideration) after consideration of the constraint in paragraphs 11–12 of FASB ASC 606-10-32 and records patient service revenue and accounts receivable of \$80,000.

Example 7-6-6 — No Implicit Price Concession Based on Single Contract — Uninsured Self-Pay Patient

An uninsured self-pay patient schedules an elective cosmetic surgery at an outpatient surgery center that has a policy of performing a credit assessment prior to providing elective surgery to its patients. The gross charges for the procedure are \$4,000. Prior to surgery, the outpatient surgery center assesses the patient's ability to pay and grants the patient special pricing of \$3,000 (that is, an explicit price concession or discount of \$1,000), which is similar to what it would charge an insured patient. The outpatient surgery center collects \$1,500 upfront and agrees to bill the patient the remaining \$1,500 after the surgery. Based on its credit assessment, the outpatient surgery center determines that it is probable that it will collect the remaining \$1,500 due from the patient and does not intend to provide a further price concession or discount. The outpatient surgery center records patient service revenue of \$3,000, accounts receivable of \$1,500, and cash of \$1,500.

Based on a subsequent change in facts and circumstances, the surgery center determines that it only expects to collect \$500 of the \$1,500 billed to the patient. Therefore, the remaining \$1,000 that it does not expect to collect represents an impairment loss (bad debt expense).

Example 7-6-7 — Implicit Price Concession Based on Portfolio Approach — Insured patients with co-payment

A health care entity provides services to patients during a reporting period and determines that they are covered by insurance carrier B and that each patient has a patient responsibility (co-payment). Because of its not-for-profit mission, the health care entity does not have a policy of assessing patients' intent and ability to pay their patient responsibility portion prior to providing service.

Because of the similar characteristics of the patients (that is, each patient is covered by insurance carrier B and has a similar co-payment), the health care entity applies a portfolio approach. This portfolio of contracts is identified based on qualitative and quantitative factors, and the entity concludes that the expected outcome from using a portfolio approach is not expected to materially differ from an individual contract approach.

Its insurance carrier B portfolio includes both the insurance and co-payment amounts. The standard charges for services provided to patients in this portfolio total \$1,000,000 for the reporting period. Based on its contractual agreement with insurance carrier B, the health care entity applies contractual adjustments of 50%, or \$500,000, and nets these adjustments against the standard charges. The contractual adjustments represent explicit price concessions. The contractual adjustments are recognized as a reduction to the transaction price. The remaining charges of \$500,000 include \$475,000 in amounts due from insurance carrier B and \$25,000 in co-payment amounts due from the patients.

Based on its historical experience, the health care entity expects to collect all of the amounts due from insurance carrier B (\$475,000) but only expects to collect 40% or \$10,000 of the co-payment amounts due from the patients. In total, the health care entity expects to collect \$485,000. Because the health care entity has a business practice of providing services to patients regardless of their ability to pay, it determines that the \$15,000 it does not expect to collect of patient co-payments represents an implicit price concession. Therefore, the health care entity determines that the transaction price, after consideration of the constraint in paragraphs 11–12 of FASB ASC 606-10-32, is \$485,000 (gross charges of \$1,000,000, less contractual adjustments of \$500,000, less the

implicit price concessions of \$15,000) and that collection of substantially all of the transaction price is probable.

The health care entity determines that the other criteria in FASB ASC 606-10-25-1 are met because it has legally enforceable contracts with the patients, the contracts have commercial substance, the services provided and payment terms can be identified, and the parties have approved the contracts.

The health care entity would only include the estimate of variable consideration (\$485,000) in the transaction price after consideration of the constraint in paragraphs 11–12 of FASB ASC 606-10-32. The health care entity considers the likelihood of a revenue reversal and the potential magnitude of a reversal considering its level of experience with similar types of contracts, the range of possible outcomes, the amount of time before payment is expected, and the susceptibility to external factors.

Based on its expectation of payment from insurance carrier B, the health care entity concludes that it is probable that a significant revenue reversal in the cumulative amount of revenue recognized (\$485,000) will not occur as the uncertainty is resolved (that is, as payments are received).

The health care entity recognizes patient revenue and accounts receivable of \$485,000. If the entity subsequently determines it will collect more or less than the amount initially estimated, the entity should account for the difference similar to preceding example 7-6-3.

Third-Party Settlement Estimates

This Accounting Implementation Issue Is Relevant to the Application of FASB ASC 606 to Third-Party Settlement Estimates.

Background

7.6.44 In the health care industry, the amount of revenue earned under arrangements with government programs (for example, Medicare or Medicaid) 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 a result, revenue from contracts with patients that are paid by a government payor typically contain a variable element that requires health care providers to estimate the cash flows ultimately expected to be received for services provided.

7.6.45 Under a retrospective rate-setting system, a health care entity may be entitled to receive additional payments or be required to refund amounts received in excess of interim payment rate amounts under the system. For example, 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 results 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.

Identifying the Contract

7.6.46 A unique aspect of health care is the involvement of multiple parties in health care service transactions. In addition to the patient and the health care provider, often a third party (an insurer, managed care company, or government program) will pay for some or all of the services on the patient's behalf. For the purposes of FASB ASC 606, FinREC believes that the "contract with the customer" refers to the arrangement between the health care provider and the patient. However, separate contractual arrangements often exist between health care providers and third-party payors which establish amounts the third-party payor will pay on behalf of a patient for covered services rendered. Although those separate contractual agreements are not themselves considered "contracts with customers" under FASB ASC 606, those agreements should be considered in determining the transaction price for services provided to a patient covered by that third-party payor.

7.6.47 When the third-party payor is a government program (for example, Medicare or Medicaid), the contractual arrangement between the health care provider and the government program is commonly referred to as an entity's "provider agreement." The provider agreement specifies the terms of the provider agreement, the grounds for terminating a provider agreement, the circumstances under which payment for new admissions may be denied, and the circumstances under which payment may be withheld for failure to complete timely utilization review. The term of the provider agreement is generally one year, and it automatically renews unless the health care provider withdraws or is debarred from the government program. Payments under provider agreements are made subject to complex laws and regulations which include an ability for the government payor to retrospectively adjust the rates it pays based upon the filing of the cost report and subsequent program audits. Therefore, the payments received under a provider agreement for a cost report year (that is, the aggregate transaction price associated with Medicare or Medicaid patient contracts entered into during the cost report year) is subject to retrospective adjustment. These are referred to as third-party settlement adjustments.

7.6.48 Several years may elapse before all potential adjustments related to a particular cost report year are resolved such that the transaction price associated with Medicare or Medicaid patient contracts for that year is known with certainty. Examples of these potential adjustments include the disproportionate share hospital program and the intern and resident program. As a result, revenue arising from services that will be paid for by government payors typically contains a variable element that requires health care providers to estimate the cash flows ultimately expected to be received for services provided during each reporting period.

Determining the Transaction Price

7.6.49 FASB ASC 606-10-32-2 states the following:

An entity shall consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both.

*Variable Consideration***7.6.50** In accordance with FASB ASC 606-10-32-8

[a]n entity shall estimate an amount of variable consideration by using **either** of the following methods [the expected value method and the most likely amount method], depending on which method the entity expects to better predict the amount of consideration to which it will be entitled... (emphasis added)

Entities should determine which method is a better predictor of the amount of consideration to which the health care entity will be entitled. In addition, example 22, "Right of Return," and example 23, "Price Concessions," in paragraphs 204 and 211 of FASB ASC 606-10-55, respectively, state "...To estimate the variable consideration to which the entity will be entitled, the entity **decides to use** the expected value method (see paragraph 606-10-32-8a) because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled." (emphasis added). As such, a health care entity can use either the expected value method or the most likely amount method in determining the amount of consideration to which it will be entitled. In accordance with FASB ASC 606-10-32-8, the health care entity should use the method to estimate the amount of variable consideration that it believes will better predict the amount of consideration to which it will be entitled. That is, the selection of an estimation method is not intended to be a "free choice" and the method selected must be applied consistently for similar types of contracts.

7.6.51 In accordance with FASB ASC 606-10-32-8b, "The most likely amount – The most likely amount is the single most likely amount in a range of possible consideration amounts (that is, the single most likely outcome of the contract). The most likely amount **may** be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (for example, an entity either achieves a performance bonus or does not)." (emphasis added)

7.6.52 FASB ASC 606-10-32-8b does not indicate that the most likely amount can only be used or must be used if the contract has only two possible outcomes. FinREC believes that health care entities may apply the most likely amount method to estimate third-party settlements even if the outcome is not binary as long as that entity believes it will better predict the amount of consideration to which it will be entitled.

7.6.53 Whichever method (the expected value or the most likely amount) a health care entity uses to determine the amount of variable consideration, certain factors may be considered including the following:

- a. Historical and current reimbursement information including third-party settlements
- b. Historical and current experience with the fiscal intermediary
- c. Current charges, allowable costs, and relevant patient statistics

7.6.54 Many health care entities have significant historical experience related to third-party settlements. FASB ASC 606-10-32-9 states, "An entity shall apply one method consistently throughout the contract when estimating the effect of an uncertainty on an amount of variable consideration to which the entity will be entitled. In addition, an entity shall consider all the information (historical, current, and forecasted) that is reasonably available to the entity and shall identify a reasonable number of possible consideration amounts." In

accordance with paragraph BC 195 of FASB ASU No. 2014-09, the method selected should be applied consistently to contracts with similar characteristics and in similar circumstances. As such, a health care entity should apply one method (the expected value or the most likely amount) when estimating third-party settlements for a cost report year with similar characteristics and in similar circumstances as described in FASB ASC 606-10-32-9.

7.6.55 A contract with a patient may have more than one uncertainty related to variable consideration and depending on the method the entity expects to better predict the amount of consideration to which it is entitled, as discussed in paragraph BC 202 of ASU No. 2014-09, the entity may use different methods for different uncertainties. In estimating the amount of variable consideration under either of the methods, and as discussed in FASB ASC 606-10-32-9 and paragraph BC 201 of ASU No. 2014-09, an entity can use a reasonable basis for estimation and is not required to consider all possible outcomes using unnecessarily complex methods or techniques.

Constraining Estimates of Variable Consideration

7.6.56 FASB ASC 606-10-32-11 requires a health care entity to include in the transaction price some or all of an amount of variable consideration estimated in accordance with FASB ASC 606-10-32-8 only to the extent 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. This means that, in estimating variable consideration, it is necessary that a health care entity determine that it is probable there will not be a significant revenue reversal when the cash is collected or paid based on final settlement with the government payor. Each health care entity will need to evaluate their facts and circumstances to determine the likelihood and magnitude of the potential reversal in revenue. To assist with that determination, FASB ASC 606-10-32-12 provides factors for an entity to consider. The following are some factors to consider with examples of how a health care entity may apply them to arrangements with third-party payors:

- d. Whether the amount of the third-party settlement is highly susceptible to factors outside the entity's influence — For example, a health care entity may consider the fact that a third party (that is, Medicare or Medicaid) determines the amount of the third-party settlement based on specific rules and regulations. Further, Medicare or Medicaid has control over the review and final settlement of the cost report.
- e. The entity's experience with third-party payor settlements for similar types of contracts — In many cases, health care providers' experience in estimating third-party settlements associated with Medicare and Medicaid programs will extend back many years. A health care entity should consider its history with the Medicare or Medicaid programs in determining each component of variable consideration related to third-party settlements.
- f. How long the period is until the uncertainty is resolved — Several years may elapse before all potential adjustments for third-party settlements related to a particular cost report year are known and before the amount of revenue to which the health care entity is entitled is known with certainty.

- g. Its practice of offering price concessions or changing payment terms — As it relates to third-party settlements, health care entities generally do not change the payment terms with Medicare or Medicaid because these governmental payors determine the prices and terms for all services and communicate the prices they will pay to health care entities. There is generally no negotiation between Medicare or Medicaid and a health care entity as it relates to price or contract terms.
- h. The number of possible consideration amounts — For example, a health care entity may consider the historical range of third-party settlements and whether the range is broad (significant differences from reporting period to reporting period) or narrow (insignificant differences from reporting period to reporting period).

7.6.57 Many health care entities have been in operation for many years and have sufficient history related to estimated third-party settlements such that a health care entity can assess whether it is probable that there will not be significant reversals of revenue in future periods. In some cases, the constraint may already be incorporated into the entity's estimation process and would not require a separate evaluation. As noted in paragraph BC 215 of ASU No. 2014-09, "Although some respondents explained that they reasoned that this guidance would inappropriately require a two-step process, the Boards observed that an entity would not be required to strictly follow those two steps if the entity's process for estimating variable consideration already incorporates the principles on which the guidance for constraining estimates of variable consideration is based. For example, an entity might estimate revenue from sales of goods with a right of return. In that case, the entity might not practically need to estimate the expected revenue and then apply the constraint guidance to that estimate, if the entity's calculation of the estimated revenue incorporates the entity's expectations of returns at a level at which it is probable that the cumulative amount of revenue recognized would not result in a significant revenue reversal." The historical information used by a health care entity to estimate the transaction price related to third-party settlements may include historical cost report settlement activity, as well as denied claims or recoupments of amounts previously received by the health care entity based on a review by a Recovery Audit Contractor (RAC).

7.6.58 As discussed in FASB ASC 606-10-32-12, determining the amount of variable consideration to include in the transaction price should consider both the likelihood and magnitude of a revenue reversal. Given the nature of third-party settlements, these amounts are not always determined for each contract between a health care provider and a patient, but rather are often based on a number of contracts included in the determination of the third-party settlement. FinREC believes that, for third-party settlements, the evaluation to determine if a potential reversal of cumulative revenue recognized is significant, is a comparison between the third-party settlement amount (the reimbursement to or from the third-party payor subject to settlement) and the total consideration for services rendered pursuant to the contracts that are included in the settlement determination (that is, using a portfolio approach). For example, assuming the fiscal year and the cost report year are the same, the third-party settlement amount related to Medicare Part A patients for the fiscal year would be compared to the total consideration from all payors (for example, including co-pays and deductibles) for Medicare Part A patients who received services during the fiscal year. An estimate of variable consideration is not constrained

if the potential reversal of cumulative revenue recognized is not significant, or if a potential reversal is significant but probable not to occur. The amount of revenue reversal deemed significant will vary across entities depending on the facts and circumstances. If the entity determines that it is probable that the inclusion of its estimate will not result in a significant revenue reversal, that amount is included in the transaction price.

7.6.59 When a health care entity does not have significant historical experience or that experience has limited predictive value, the health care entity may constrain its estimate of variable consideration as noted in paragraphs 11–13 of FASB ASC 606-10-32 and would, therefore, be precluded from recognizing revenue for the constrained amount until such time as it has better historical experience or the uncertainty associated with the additional payments or refunds (that is, the third-party settlement) is subsequently resolved. In other words, the health care entity would only recognize revenue up to the amount of variable consideration that is not subject to a significant reversal until such time as additional information is obtained or the uncertainty associated with the additional payments or refunds is subsequently resolved. This could result in the health care entity constraining some or all of the revenue of an individual component of a third-party settlement (for example, disproportionate share reimbursement) for which the entity does not have sufficient historical experience.

7.6.60 When a health care entity has sufficient historical experience, the health care entity may not have to constrain its estimates of variable consideration as noted in paragraphs 11–13 of FASB ASC 606-10-32 and would therefore not be precluded from recognizing the entity's estimate of the third-party settlement adjustment. A health care entity would need to consider how to determine the amount of variable consideration to recognize based on the method the entity expects to better predict the amount of consideration to which it will be entitled.

7.6.61 Historically, health care entities may have used a variety of methods to evaluate third-party settlements. For instance, some health care entities may evaluate settlements with government payors on an individual facility and individual cost report year basis and some may aggregate historical information to evaluate third-party settlements. For example, many health care entities evaluate each cost report by facility and by year, individually. However, some third-party settlement issues may apply to multiple cost reports and health care entities should use all available information regarding the cost report settlement process to evaluate similar third-party settlement issues. The determination of the method to use to estimate the amount of variable consideration the entity expects to better predict the amount of consideration to which it will be entitled (that is, the expected value method or the most likely amount method) is not dependent upon whether the health care entity uses a portfolio approach or an individual contract approach to evaluate arrangements with third-party payors. The portfolio approach is described in FASB ASC 606-10-10-4. Refer to the "Application of the Portfolio Approach to Contracts With Patients" section in paragraphs 7.7.01–7.7.15 for discussion on application of the portfolio approach.

Reassessment of Variable Consideration

7.6.62 Differences between original estimates and subsequent revisions, including final settlements, represent changes in the estimate of variable

consideration and should be included in the period in which the revisions are made in accordance with FASB ASC 606-10-32-14. These differences should be disclosed in the financial statements. See section "Presentation and Disclosure" in paragraphs 7.7.16–7.7.60 for further information on disclosures. These 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*.

Existence of a Significant Financing Component in the Contract

7.6.63 FASB ASC 606-10-32-15 states, "In determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer."

7.6.64 A health care entity should evaluate all of the facts and circumstances including payment terms and the reasons for any difference between the time period for settlement and the difference in the amount received as consideration from the government payor to determine if a significant financing component exists.

7.6.65 If a health care entity receives advances, the health care entity should consider the reasons for the advance and evaluate if a significant financing component exists.

7.6.66 To assist in determining if a significant financing component exists, FASB ASC 606-10-32-17 indicates that a contract with a customer would not have a significant financing component if certain factors exist. The following are the factors to consider with examples of how a health care entity may apply them to third-party settlements:

- a. The customer paid for the goods or services in advance, and the timing of the transfer of those goods or services is at the discretion of the customer — Consideration from a third-party payor on a patient's behalf is generally not paid in advance of a health care entity providing services to patient.
- b. A substantial amount of the consideration promised by the customer is variable, and the amount or timing of that consideration varies on the basis of the occurrence or nonoccurrence of a future event that is not substantially within the control of the customer or the entity (for example, if the consideration is a sales-based royalty) — Contracts with patients generally include a substantial amount of variable consideration because third-party payors do not pay standard provider charges. In addition, the amount and timing of the consideration related to third-party settlements may vary on the basis of the occurrence or nonoccurrence of a future event that is not substantially with the control of the health care entity or the patient. For example, with respect to the timing of cost report settlements, neither the health care entity nor the patient has control over when a cost report is reviewed and settled because that is determined by the third-party payor (for example, Medicare or Medicaid).

- c. The difference between the promised consideration and the cash selling price of the good or service (as described in paragraph 606-10-32-16) arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference (For example, the payment terms might provide the entity or the customer with protection from the other party failing to adequately complete some or all of its obligations under the contract.) — For health care providers, the amount of the third-party adjustment arises due to the normal course of cost report settlements and is not a result of the provision of a financing arrangement with the government payor. The information the government payor uses to determine a final settlement for a given cost report year is generally submitted by the health care provider in a cost report several months after the end of the reporting period. The government payor reviews or audits the information provided in the cost report and determines a final settlement amount. The final settlement could either be additional consideration owed to the health care provider or a return of consideration back to the government payor.

7.6.67 Although the timing between the service to the Medicare or Medicaid beneficiary and final settlement or payment is often more than one year, FinREC believes that a significant financing component likely does not exist for third-party settlements because the timing of the payment is at the discretion of the third-party payor and does not involve the patient (that is, the customer).

Transition

7.6.68 Under the full retrospective transition method (retrospective application to each prior period presented) described in FASB ASC 606-10-65-1, health care entities are required to apply the standard to all contracts presented in the financial statements (subject to certain practical expedients). Under the modified retrospective transition method (cumulative effect recognized on the date of initial application), health care entities may apply the standard to either all contracts or only to contracts that are not completed as of the adoption date.

7.6.69 A health care entity that elects to apply the modified retrospective transition method only to contracts that are not completed as of the date of initial application should evaluate its contracts to determine if all or substantially all of the revenue was recognized under legacy GAAP (that is, they are completed contracts) before the date of initial application. For example, for contracts with patients where a third-party settlement has not been finalized for a specific cost report year as of the date of initial application, the health care entity should compare the estimated settlement amount for that payor to the amount of revenue recognized under legacy GAAP for patients subject to retroactive settlement by that payor to determine if all or substantially all of the revenue has been recognized. If all or substantially all of the revenue has not been recognized, the contracts with patients subject to retroactive settlement by that payor for the open cost report year would be considered open contracts and FASB ASC 606 will need to be applied to those contracts for purposes of determining the cumulative effect adjustment at the date of initial application.

7.6.70 The following example is intended to be illustrative, and the actual determination of the amount of a third-party settlement may differ based on the facts and circumstances of a health care entity's specific situation.

Federal and state governments fund a significant portion of health care services in the United States through their role as third-party payors in programs such as Medicare and Medicaid. Under those programs, payments for services provided to program beneficiaries are determined under complex government rules and regulations. The programs may subject the health care entity to potential retrospective adjustments; therefore, the actual amount of consideration from the third-party may not be known with certainty for several years. As a result of the uncertainty, consideration from providing services to government program beneficiaries generally represents variable consideration under FASB ASC 606.

Example 7-6-8 — Illustrative Use of the Expected Value Method — Medicare Program

Hospital X participates in the Medicare program and accepts Medicare's rates as payment in full for services rendered to Medicare beneficiaries during a cost report year. During a cost report year, Medicare makes payments to Hospital X for patients eligible under the program based on various interim payment methodologies. It may take two or more years from the year that services are rendered by Hospital X for Medicare to validate the claims and issue a Notice of Final Program Reimbursement to close out a cost report year. Each reporting period, management estimates the potential program adjustments and accrues a third-party settlement asset or liability for Hospital X to adjust the estimated revenue (variable consideration) for that cost report year. The Medicare transaction price before adjustment is \$50 million based on contracts included in the determination of the third-party settlement.

Management determines that the expected value method (a probability-weighted approach) would be the best predictor of the variable consideration for patient services provided to Medicare beneficiaries during the cost report year and identifies four possible outcomes for the potential program adjustments (cost report settlements) that would reduce the amount of variable consideration. The probability of each possible outcome is as follows:

Possible adjustment amounts	Probability	Probability-weighted amounts	Medicare transaction price (as adjusted for variable consideration)
\$—	20%	\$—	
1,000,000	55%	550,000	
3,000,000	15%	450,000	
5,000,000	10%	500,000	
		\$1,500,000	\$48,500,000

The amounts associated with each outcome are aggregated to arrive at the estimated adjustment amount of \$1.5 million which decreases the transaction price estimate from \$50 million to \$48.5 million. In accordance with paragraphs 11–12 of FASB ASC 606-10-32, management also evaluates whether it is probable

that a significant reversal in the amount of cumulative revenue recognized will occur (that is, whether a constraint on recognition is required). In assessing whether the amount of revenue to be recognized should be constrained, management considered if a subsequent settlement would result in a significant reversal of cumulative revenue once the cost reports are fully settled. Based on the information available, management determined that it is probable that a significant reversal of revenue would not occur. As such, Hospital X would record Medicare revenue for the cost report year of \$48.5 million.

7.6.71 The following example is intended to be illustrative, and the actual determination of the amount of a third-party settlement may differ based on the facts and circumstances of a health care entity's specific situation. An entity will need to use professional judgement to evaluate the claims that could be subject to a RAC program audit. The following example is not intended to be a comprehensive description of the RAC program.

Under the Medicare program, payments to health care entities for services provided to program beneficiaries are determined under complex government rules and regulations. The program may subject the health care entity to potential retroactive adjustments; therefore, the actual amount of consideration from Medicare may not be known with certainty for several years. As a result of the uncertainty, consideration from providing services to Medicare beneficiaries generally represents variable consideration under FASB ASC 606.

The RAC program was created through the Medicare Modernization Act of 2003 to identify and recover improper payments to health care providers under Medicare's fee-for-service payment methodology. The United States Department of Health and Human Services was required by law to make the RAC program permanent for all states by January 1, 2010.

The RAC's mission is to identify and correct Medicare improper payments through the efficient detection of overpayments or underpayments made on claims for health care services provided to Medicare beneficiaries, so that the Centers for Medicare & Medicaid Services (CMS) can implement actions that will prevent future improper payments.

Under the program, a RAC generally reviews claims on a post payment basis. These reviews can be automated or they can be complex. For complex reviews, the health care entity is required to submit to the RAC medical record documentation to support the claim.

After a RAC has completed the review, a demand letter is sent to the health care entity notifying them of any changes to payments previously received as a result of the review. If the review resulted in a net overpayment for all of the claims reviewed, the health care entity has four options: (a) pay the amount, (b) allow recoupment from future payments by Medicare, (c) request or apply for an extended payment plan, or (d) appeal the review.

If a health care entity decides to appeal the review, there are five levels in the appeals process. Often, the appeals process takes years to complete given the complex government rules and regulations used to determine payments for health care services to Medicare beneficiaries.

Example 7-6-9 — Illustrative Use of the Expected Value Method — Recovery Audit Contractor Program

Hospital X participates in the Medicare program and receives payments for services provided to Medicare beneficiaries under a fee-for-service payment

methodology. During the year, inpatient services are provided to Medicare beneficiaries which results in numerous claims to Medicare.

Hospital X has experience with RAC audits and demand letters that challenge the appropriate classification of certain types of patients as inpatient. Based on its experience in reviewing and appealing similar claims, management determined that the expected value method would be the best predictor of the variable consideration for these patient services provided to Medicare beneficiaries related to claims that may be the subject of a RAC audit, because Hospital X has a large number of contracts with similar characteristics.

Over the past three years, Hospital X has an overall 90% success rate with claims having similar classification issues, including RAC audit appeals. That is, for claims with a similar classification issue that were resolved during that period, only 10% of the amounts previously billed were ultimately recouped as overpayments. Management's method of evaluating the success rate over the past three years inherently considers the probability of the expected outcome of each claim and incorporates the constraint. Although the RAC audit and appeals process are outside of its control, Hospital X determines that it has sufficient historical experience to estimate the success rate for similar claims, as noted previously, and therefore concludes that it is probable that a significant reversal in the cumulative revenue recognized will not occur as the uncertainty is resolved. As a result, and based on known or knowable information, management estimates the transaction price by reducing the billed amount by 10% at the time revenue is initially recognized for all similar claims based on claims expected to be audited and the historical success rate of 90%.

Based on an audit in a subsequent year, the RAC challenges the classification of some of the claims submitted by Hospital X for patients classified as inpatient (that is, the RAC concluded that Hospital X should have billed these claims as outpatient instead of inpatient) and determines that Hospital X was overpaid. The RAC issues a demand letter indicating an overpayment to Hospital X.

Based on a review of the RAC's findings by Hospital X, management believes the classification of these patients as inpatient is correct and files an appeal. Significant time may pass before the appeal is processed through the five levels of the appeals process. Management previously included an estimate of the amount of overpayments for the claims in the initial transaction price based on its 90% historical success rate. Hospital X determined that it does not need to update the estimate of the transaction price as the result of the RAC audit because the RAC audit and demand letter are consistent with its historical experience and would not change its overall success rate.

Hospital X will continue to update its historical success rate in subsequent periods based on actual results of RAC audits, demand letters, appeals experience, and other known or knowable information to determine if the historical success rate remains appropriate to apply. At the end of each reporting period, Hospital X should update the estimated transaction price in accordance with FASB ASC 606-10-32-14 and paragraphs 42–45 of FASB ASC 606-10-32.

7.6.72 The following example is intended to be illustrative, and the actual determination of the amount of a third-party settlement may differ based on the facts and circumstances of a health care entity's specific situation and the Medicare rules and regulations in effect at the time the calculations are performed.

Under the Medicare program, payments to health care entities for services provided to program beneficiaries are determined under complex government rules

and regulations. The program may subject the health care entity to potential retroactive adjustments; therefore, the actual amount of consideration from Medicare may not be known with certainty for several years. As a result of the variability in reimbursement, the amounts a health care entity is entitled to for providing services to Medicare beneficiaries generally include variable consideration under FASB ASC 606.

The Medicare program provides for additional payments to eligible hospitals that provide services to a disproportionately higher share of indigent patients based on formulas defined in the Medicare regulations. These additional payments are commonly referred to as DSH payments. The primary method used to determine whether a hospital qualifies for DSH payments is based on a complex statutory formula that results in a Medicare DSH percentage. The hospital's Medicare DSH percentage is used to determine whether the hospital qualifies for any additional payments, and if it qualifies, the amount of additional payments.

For illustrative purposes, assume the statutory formula in the Medicare regulations specifies that if the Medicare DSH percentage is less than 15%, the hospital will not receive any additional payments. However, a hospital with a DSH percentage in excess of 15% qualifies for additional payments, the specific amount of which depends on whether the DSH percentage is in excess of 20.1%. That is, the statutory formula calls for additional payments for hospitals with a DSH percentage between 15% and 20.1% and increased additional payments for hospitals with a DSH percentage of 20.2% or higher. The Medicare regulations for determining DSH payments are complex and are subject to ongoing review and change by the government. Therefore, a health care provider should determine the DSH rules and regulations currently in effect at the time the calculations are performed, which may differ from the formula described previously.

Example 7-6-10 — Illustrative Use of the Most Likely Amount Method — Disproportionate Share Hospital Program

Hospital X participates in the Medicare program and accepts payments from Medicare as specified in the Medicare regulations (fee for service payments and retroactive settlements) for services rendered to Medicare beneficiaries during a cost report year (in this case, the hospital's fiscal year).

Hospital X is an urban hospital with more than 100 beds that provides inpatient services to a large number of indigent patients each year. Over the past several years, Hospital X has received DSH payments based on the statutory formula. Because it has more than 100 beds, Hospital X is not subject to a DSH reimbursement cap. The additional DSH payments have been audited by the Medicare Administrative Contractor in connection with Hospital X's routine cost report audit process for the past several years and the additional payments have been validated without a significant adjustment (that is, changes over the past several years have not resulted in significant adjustments to the estimated settlement).

Because Hospital X's cost report is prepared and filed with the Medicare program within five months after its cost report year end, Hospital X performs a calculation of the estimated Medicare DSH percentage during its financial statement close process to determine the estimated amount of additional payments it expects to receive for DSH for the cost report year related to services provided to Medicare beneficiaries during the cost report year.

Management determines that the most likely amount method (derived from the single most likely amount in a range of possible consideration amounts) would be the best predictor of the variable consideration for services provided to Medicare beneficiaries related to the DSH payments because there are only three possible outcomes. Management identifies the following three possible outcomes for the potential additional payments related to DSH.

<i>Possible additional payments</i>	<i>Description</i>
\$3 million	Hospital X has a Medicare DSH percentage equal to or in excess of 20.2%. Based on the relevant statutory formula and the amount of Medicare payments received during the year, Hospital X expects to receive \$3 million in additional payments.
\$1.2 million	Hospital X has a Medicare DSH percentage between 15% and 20.1%. Based on the relevant statutory formula and the amount of Medicare payments received during the year, Hospital X expects to receive \$1.2 million in additional payments.
\$0	Hospital X has a Medicare DSH percentage less than 15% and is therefore not eligible to receive any additional payments.

Hospital X has experience with calculating the Medicare DSH percentage. Each year, upon subsequently filing the Medicare cost report, Hospital X reconciles the estimated amount determined in connection with their financial statement close process to the calculation included in the Medicare cost report. Based on its experience with determining the Medicare DSH percentage, Hospital X determines there have been no significant differences between the calculation included in the cost report and the estimated amount determined during the financial statement close process. In addition, based on their experience, Hospital X has historically exceeded the 20.2% DSH percentage threshold. For the current cost report year, management determines its Medicare DSH percentage exceeds the 20.2% threshold based on its patient mix. Therefore, management believes the most likely amount of consideration related to DSH is \$3 million. Hospital X considered whether the most likely amount should be constrained. However, based on its history of receiving Medicare DSH additional payments and its history of Medicare cost report audits that have validated the Medicare DSH percentage, Hospital X determined that it is probable there will not be a significant reversal in the amount of cumulative revenue recognized when the cost report is audited and the uncertainty is subsequently resolved. Hospital X includes \$3 million for the DSH additional payments in the transaction price that is recorded at the end of the reporting period.

Risk Sharing Arrangements

This Accounting Implementation Issue Is Relevant to the Application of FASB ASC 606 to Risk-Sharing Arrangements.

7.6.73 Under this scenario, a health care provider (hereafter referred to as *hospital*) is responsible for services rendered to the patient in an inpatient hospital stay. Different health care providers (hereafter referred to individually as *post-acute provider* or collectively as *post-acute providers*) are responsible for services rendered to the patient after discharge, such as for inpatient care in a nursing home or rehabilitation facility, or outpatient services such as physical therapy or home health, or both. The hospital and the post-acute provider are not related parties. The factors noted herein address the considerations of the hospital. This scenario focuses on payment implications for the hospital (that is, the hospital that performs the surgery). Revenue recognition for post-acute providers is outside the scope of this section.

Background

7.6.74 The Comprehensive Care for Joint Replacement (CJR) model was effective April 1, 2016, in 67 metropolitan areas for Medicare beneficiaries undergoing the most common orthopedic inpatient surgeries, which are hip and knee replacements (also called *lower extremity joint replacements* or *LEJR*). This model holds participant hospitals financially accountable for the quality and cost of episodes of care associated with hip and knee replacements to encourage hospitals, physicians, and post-acute care providers to work together to improve the quality and coordination of care from the initial hospitalization through recovery.

7.6.75 The episode of care evaluated in this model begins with the admission of a patient to a hospital who is ultimately discharged under certain joint replacement diagnostic codes and ends 90 days after discharge of the patient. The episode of care length is intended to cover the expected period of recovery of the patient. Generally, all episodes that *end* between January 1 and December 31 are included in a *performance year*. Although the hospital is held financially responsible for the entire episode of care, the episode includes post-acute services (and other services, with certain limitations) that are often rendered by post-acute providers.

7.6.76 Hospitals and post-acute providers bill and are paid under usual payment system rules (referred to as *fee-for-service*) for all related services rendered to Medicare beneficiaries who have LEJR procedures. Subsequent to the end of a performance year (that is, the calendar year), actual spending (that is, the total amount paid by Medicare for the related services) is compared to the Medicare target price for the respective hospital for the entire episode of care of each beneficiary. Depending on the hospital's quality and episode spending performance (including spending by Medicare for other providers involved in the episode of care), the hospital may receive an additional payment from Medicare or be required to repay a portion of the fee for service payments. Settlement of these amounts is expected to occur three to six months subsequent to the end of a performance year. The settlement is not specific to any patient but is based on all of the episodes of care for CJR in the performance year.

7.6.77 Under the CJR model, hospitals may also enter into separate agreements with various post-acute providers for the coordination of care of a patient during an episode of care. For example, a hospital provides the initial acute care, a second provider may provide rehabilitation services, and a third provider may provide home care services. Revenue recognition for such agreements is outside the scope of this issue. In addition, the separate agreements a hospital may enter into with various post-acute providers may include a gain or loss sharing

component. These gain or loss sharing arrangements are outside the scope of this issue.

7.6.78 A hospital should continually evaluate the CJR model and other similar risk sharing arrangements for changes and updates to these programs to determine the impact, if any, on the accounting treatment for these programs.

Identify the Contract with a Customer

7.6.79 A health care provider should first determine that the five criteria in FASB ASC 606-10-25-1 have been met for there to be a contract with a customer within the scope of FASB ASC 606. For the purposes of FASB ASC 606, FinREC believes the "contract with the customer" refers to the arrangement between the health care provider and the patient.

7.6.80 Separate contractual arrangements (also referred to as *provider agreements* or *participation agreements*) exist between health care providers and third-party payors (for example, the Centers for Medicare and Medicaid Services or CMS), which establish amounts to be paid on behalf of a patient (who is the third-party's beneficiary). These separate contractual arrangements between the health care providers and third-party payors are not considered separate "contracts with the customer" under FASB ASC 606. However, these agreements should be considered in determining the transaction price for the goods and/or services rendered to patients.

7.6.81 In accordance with FASB ASC 606-10-25-1ae, a contract with a customer exists only when all of the criteria in that paragraph are met. Hospitals should consider the criteria in FASB ASC 606-10-25-1 to determine that a contract with a patient exists and that the contract is legally enforceable. FinREC believes that a hospital should consider the following items when evaluating if the criteria in FASB ASC 606-10-25-1 are met:

- a. Parties have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations of the contract. A hospital should consider if it has a written contract with the patient by considering whether the patient signed any forms, such as a patient responsibility form, which would be considered a written contract. If the hospital determines it does not have a written contract but the patient schedules the elective surgery in advance, the hospital may consider if it has an oral or implied contract.
- b. Each party's rights regarding the goods or services to be transferred can be identified. A hospital should consider if it has a right to payment for services provided to a patient based on the contract.
- c. Payment terms can be identified for the goods or services to be transferred. Under the CJR model, hospitals receive Medicare fee-for-service payments for services provided to patients that are subject to adjustment based on the difference between actual Medicare spend and a pre-determined bundle target price. There may also be a co-pay or deductible due from the patient.
- d. The contract has commercial substance. The hospital should consider if it expects its future cash flows to change as a result of the services provided.
- e. It is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods

or services that will be transferred to the customer. A hospital should consider if it is probable that the entity will collect substantially all of the consideration to which it is entitled in exchange for goods or services transferred to Medicare beneficiaries; this includes amounts due from the Medicare program and deductibles and co-pays due from patients. Refer to the "Arrangements for Health Care Services Provided to Uninsured and Insured Patients With Self-Pay Balances, Including Co-Payments and Deductibles" section in paragraphs 7.6.01–7.6.43. Also refer to the "Third-Party Settlement Estimates" section in paragraphs 7.6.44–7.6.72 for additional information related to factors to consider in determining if it is probable that the entity will collect substantially all of the consideration to which it is entitled in exchange for goods or services transferred to Medicare beneficiaries.

Identify the Performance Obligations in the Contract

7.6.82 FASB ASC 606-10-25-14 provides that at contract inception, an entity should assess the goods or services promised in a contract with a patient and should identify as a performance obligation each promise to transfer to the patient a good or service (or a bundle of goods or services) that is distinct.

7.6.83 To be distinct, a performance obligation must meet both of the following criteria in FASB ASC 606-10-25-19:

- a. The customer can benefit from the good or service either on its own or together with the other resources that are readily available to the patient (that is, the good or service is capable of being distinct).
- b. The entity's promise to transfer the good or service to the patient is separately identifiable from other promises in the contract (that is, the good or service is distinct within the context of the contract).

7.6.84 FinREC believes that generally, the goods and services provided by the hospital in a CJR episode will be considered a single combined performance obligation for inpatient health care services. Refer to the section, "Identifying Performance Obligations" in paragraphs 7.2.01–7.2.09 for additional information related to factors to consider in identifying performance obligations.

7.6.85 Although there is no contractual requirement, some hospitals may perform certain additional care coordination activities or case management services. A hospital may choose to perform these activities as it may be in the best interest of the hospital in an effort to control costs. Hospitals should evaluate the nature of the care coordination services or case management services that are provided to the patient. These activities may include, for example, the following:

- a. Providing notification to the patient that the patient is a participant in a bundled payment arrangement
- b. Providing coordination of the post-acute care plan
- c. Calling the patient to ensure he or she is taking prescribed medications

FASB ASC 606-10-25-17 provides that promised goods or services do not include activities that an entity must undertake to fulfill a contract unless those activities transfer a good or service to the customer. FinREC believes that generally, these types of care coordination activities do not transfer an additional

good or service to the patient and are administrative in nature and would not be considered separate performance obligations. Hospitals should, however, consider if there are implied promises to the patient to provide post-acute transitional services or coordination of care with other post-acute providers. These implied promises could be considered performance obligations if the promises are considered distinct. Based on each hospital's facts and circumstances regarding arrangements in place, a hospital should evaluate if care coordination activities should be considered separate performance obligations in its contracts with customers based on the criteria in FASB ASC 606-10-25-19.

Determine the Transaction Price

7.6.86 The transaction price (the amount of consideration to which the hospital expects to be entitled) will be established by the rules and regulations of the Medicare program.

7.6.87 For reconciliation and settlement purposes, CMS will group a hospital's CJR episodes by the performance year (that is, the calendar year) in which the episode ends, and accumulate information on all claims filed by all providers relative to those episodes. Approximately three to six months after a performance year ends, CMS performs a reconciliation calculation for each hospital, as described in the "Background" section, and determines an interim settlement for that performance year's episodes in the aggregate (not on a patient-by-patient basis). The actual spending data used in calculating this settlement will be incomplete because claims associated with episodes in the latter part of the performance year may still be in process (and, therefore, would not have been filed or processed, or both, as of the reconciliation cut-off date). Twelve months later (that is, 15 to 18 months after the end of the performance year), a second reconciliation is performed using complete claims information and the final determination is made as to whether the hospital is entitled to a bonus payment or, instead, has incurred a penalty that is owed back to CMS.

7.6.88 For purposes of applying step 3, hospitals may group individual patient contracts into portfolios that mirror these CMS performance year groupings and establish transaction prices on a portfolio basis.² Refer to section "Application of the Portfolio Approach to Contracts With Patients" in paragraphs 7.7.01–7.7.15.

Variable Consideration

7.6.89 An entity is required to estimate variable consideration using either the expected value method or the most likely amount method (as described in FASB ASC 606-10-32-8) and include some or all of that estimate in the transaction price to the extent it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the related uncertainty is resolved (as described in FASB ASC 606-10-32-11). This limitation on including variable consideration in the transaction price is referred to as the *constraint*. An entity should consider the factors in FASB ASC 606-10-32-12 when evaluating the extent to which variable consideration should be constrained.

² The *portfolio basis* refers to the use of the portfolio practical expedient as contemplated in FASB ASC 606-10-10-4. For simplicity, this section assumes that a hospital will establish a single portfolio for each Centers for Medicare and Medicaid Service (CMS) performance year. If a hospital desires to establish multiple portfolios for a performance year (for example, separate portfolios by Medicare Severity-Diagnosis Related Group (MS-DRG) or by each of its four target episode prices for that year), it must be mindful that the CMS reconciliation (and, therefore, the settlement amount) will be performed at the aggregate level.

7.6.90 The hospital's promised consideration from CMS consists of the normal Medicare Severity-Diagnosis Related Group (MS-DRG) payments for the patient contracts in a portfolio plus or minus a bonus or penalty amount, respectively, determined for the portfolio of the CMS performance year as a whole. The retrospective settlement feature and its linkage to a performance-based bonus or penalty means that as described in FASB ASC 606-10-32-6, the transaction price has a variable component.

7.6.91 The hospital will initially include the MS-DRG revenue in the transaction price. The impact of the potential retrospective adjustment (that is, variable consideration) will need to be considered at each financial reporting date. Therefore, each portfolio of contracts may have an associated adjustment of the transaction price based on the estimate of variable consideration related to the CJR program, along with a corresponding balance sheet account that reflects the estimated amount due to or from CMS for potential CJR program settlements. Amounts due to or from CMS for estimated CJR program settlements are generally included in the balance sheet within the same line item as other settlements with CMS.

7.6.92 Estimating the potential bonus or penalty amount associated with a CMS performance year requires consideration of (a) the overall actual episode spending compared to target episode prices, (b) whether (and, if so, how) the target episode prices used in the calculation will (or are likely to) be adjusted based on the hospital's quality score, and (c) the extent and financial impact of potential overlaps with other CMS payment models, for which CMS will make adjustments in the final reconciliation.

- a. *Actual episode spending.* The actual episode spending for a CMS performance year will be determined after all claims attributable to that performance year (both hospital and post-acute care) have been processed by CMS. A hospital's estimate of this amount will depend on its facts and circumstances, including the extent to which it has visibility into the data associated with the claims that have been filed with CMS by post-acute providers involved in the episode of care, and its historical information regarding variables such as the total number of expected episodes during the performance year, the severity of each episode, and expectations related to complications and readmissions.
- b. *Quality score.* The hospital will obtain its quality score for the performance year from the first CMS reconciliation report, which will be received approximately three to six months after the end of the performance year.
- c. *Potential overlap with other models.* For example, Medicare shared savings program participants also participating in a program with a bundled payment.

In this situation, the bonus or penalty is not associated only with the hospital's own performance; instead, it arises in connection with a risk sharing activity involving other providers.

7.6.93 In accordance with paragraphs 11 and 12 of FASB ASC 606-10-32, a hospital is required to estimate the amount of variable consideration by applying the constraint guidance and cannot default to a conclusion whereby no variable consideration is included in the transaction price. If a hospital determines that it cannot estimate the performance-based bonus or penalty such

that it is probable that a significant revenue reversal would not occur upon resolution of the final amounts, the portion of consideration that is variable should be excluded from the transaction price until it becomes probable that there will not be a significant reversal of cumulative revenue recognized. (Refer to the "Accounting Considerations When the Transaction Price Is Constrained" section in paragraphs 7.6.98–7.6.100.)

7.6.94 However, if the hospital has sufficient data such that it is probable that a significant revenue reversal would not occur upon resolution of the final amount, that amount should be estimated using one of the two methods described in FASB ASC 606-10-32-8 (whichever is the better predictor), and the initial CJR program estimate established to reflect that amount. After the performance year ends, CMS performs the first reconciliation and determines an interim settlement amount. In accordance with FASB ASC 606-10-32-14, a hospital should update the estimated transaction price at each reporting date, including the assessment of whether the estimate of variable consideration is constrained, based on the available information. The hospital should also increase or decrease its estimated amount due to or from CMS to reflect any interim settlements received or paid at the time this becomes known. The hospital should continue to evaluate and update the estimate as necessary based on additional information that becomes known in a period.

7.6.95 Approximately 15 to 18 months after the end of the performance year, CMS performs the second reconciliation and determines whether the hospital has earned a bonus or incurred a penalty. At that time, the estimated amounts are "trued up" to reflect the actual bonus or penalty amount, and the final settlement amount is determined. These adjustments represent changes in the estimate of variable consideration and should be included in revenue in the period (quarter or annual) in which the change in estimate is made in accordance with FASB ASC 606-10-32-14. These differences should be disclosed in the financial statements. See the "Presentation and Disclosure" section in paragraphs 7.7.16–7.7.60 for further information on disclosures. These 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.

Uncertainties Associated With the Variable Consideration

7.6.96 In accordance with FASB ASC 606-10-32-12, hospitals should evaluate uncertainties associated with the bonus or penalty calculations that could increase the likelihood or the magnitude of a revenue reversal include the following:

- a. Whether a hospital earns a bonus or incurs a penalty will depend on the performance of parties other than the hospital and, thus, is largely outside of the hospital's influence
- b. The large number and broad range of possible consideration amounts
- c. The extent to which the hospital has access to data involving claims filed by post-acute providers
- d. The CJR program is new with no prior history and available data may have low predictive value
- e. There are contingencies inherent in the bonus or penalty calculation formula. For example:

- i. The hospital's exposure to loss (or upside potential for a bonus) will be determined based on highly aggregated data for all episodes ending within a performance year, and the quantity and severity of episodes and exposure to losses from occurrence of complications or readmissions will not be known until several months after the performance year ends. Therefore, for example, costly readmissions close to the end of the performance year could affect a portfolio's overall performance enough to change a hospital from a bonus position to a penalty position.
- ii. The target episode prices used in the reconciliation might increase or decrease as a result of quality scores earned by the hospital during the performance year. The quality score is based on performance with all patients during the performance year and, therefore, is not determined until several months after the end of the performance year. The hospital will be informed of its quality score at the same time it is informed of the results of the first reconciliation (typically, in the second quarter of the calendar year that follows the end of the performance year).

7.6.97 Several of these uncertainties directly relate to the lack of experience or history with the CJR program. As a hospital progresses through the performance years of the program and obtains experience and data that can produce more reliable estimates, uncertainties associated with the likelihood or magnitude of a revenue reversal should diminish. In addition, to the extent that a hospital uses providers within its own health system to provide the post-acute care, the uncertainty associated with performance that is outside of the hospital's influence may be diminished.

Accounting Considerations When the Transaction Price Is Constrained

7.6.98 Until a hospital concludes it is probable that a significant revenue reversal would not occur upon resolution of the final amount, at each financial reporting date, the reduction of the transaction price (due to the constraint) for the estimate of variable consideration associated with the portfolio for that performance year should reflect the minimum amount of consideration from CMS under the stop-loss limits applicable to that performance year. The reduction of the transaction price (due to the constraint) will reduce the net patient service revenue associated with CJR to reflect the amount that is at risk of being returned to Medicare. Once a hospital concludes it is probable that a significant revenue reversal will not occur upon resolution of the final amount, at each reporting date, a hospital should adjust the transaction price based on its updated estimate of the amount payable to CMS under the stop-loss limits applicable to that performance year.

7.6.99 After the performance year ends, a hospital will obtain additional data that might allow it to update its estimate of the amount of variable consideration that should be included in the transaction price. For example:

- a. If a hospital has robust independent data related to the claims filed across the spectrum of care,³ a hospital can make an estimate of

³ The hospital is likely to have robust independent data related to the claims filed across the spectrum of care if, for example, the post-acute care after discharge is provided by affiliates of the

(continued)

total spending as soon as all claims have been filed or when it is able to calculate the amount of outstanding claims not yet submitted to CMS by the post-acute provider. For those hospitals, the information provided by the CMS reconciliation reports and the CMS data feed will simply serve as a check or confirmation of the hospital's independent data.

- b. A hospital without robust independent data could use spending information supplied in the first CMS reconciliation report, which will be made available to hospitals in the second quarter following the end of a performance year. However, because the claims information will be incomplete, this would need to be supplemented with updated information from the quarterly CMS data feed or by an estimate of the missing claims from post-acute providers (if predictive historical information is available).

When a hospital possesses the additional data, variable consideration will be estimated in the manner described in FASB ASC 606-10-32-8, and the initial CJR program estimate will be adjusted to reflect the revised estimate.

7.6.100 The hospital should use information from the claims data from the post-acute providers to update the estimated transaction price, including the assessment of whether the estimate of variable consideration is constrained.

Interim Reporting Considerations

7.6.101 When estimates are established related to an estimated bonus or penalty for a performance year, it may be necessary to apportion those amounts among interim periods (for example, because a hospital issues quarterly financial statements or because of a need to include only a portion of a performance year's estimates in fiscal year results). To avoid the possibility of recognizing revenue in one interim period that might be reversed in another, and in light of the fact that the amount of bonus or penalty is based on the outcome of performance for the entire performance year, FinREC believes that the estimated bonus or penalty should be determined in each interim period on a pro-rata basis in proportion to the services rendered in the interim period, with each interim period bearing a reasonable portion of the anticipated annual amount consistent with the objective in FASB ASC 606-10-25-23. In accordance with FASB ASC 270-10-45-3 and FASB 606-10-32-14, the hospital should continue to evaluate and update the estimate as necessary based on additional information that becomes known in a period.

Interaction of Portfolios, Performance Years, and Fiscal Years

7.6.102 CMS bases bonus and penalty calculations on performance year (that is, calendar year) activity rather than on the hospital's fiscal year activity, which may result in timing differences. Even when the financial reporting year and the CMS performance year coincide, the cases included in the CMS performance year will differ from those included in the financial reporting year due to the 90-day time lag between the patient's discharge from the hospital and

(footnote continued)

hospital (if the hospital and post-acute providers are part of a health system) or if the hospital has collaboration agreements under which the post-acute providers have agreed to provide information to the hospital.

the end of the patient's CJR episode. Hospitals must be mindful of these timing differences to ensure that transaction prices appropriately reflect the bonuses or penalties associated with the CJR cases included in revenue for a particular financial reporting period.

7.6.103 As a result of differences between the CMS performance year and a hospital's fiscal year, a hospital's revenue recognition process for a fiscal year might involve three portfolios of contracts: one related to the CMS performance year that began during the hospital's fiscal year; one related to the CMS performance year that ended during the hospital's fiscal year; and one related to a prior performance year whose second reconciliation (and final settlement) will occur during the hospital's fiscal year. The chart "Activity in Estimates During the Year Ended June 30, 2019," in paragraph 7.6.108 illustrates, for two June 30 year-end hospitals with different circumstances, how the reduction of the transaction price (constraint) based on the estimate of variable consideration for each of those portfolios might affect revenue recognition for the fiscal year ending June 30, 2019.

7.6.104 These interactions add a layer of additional complexity to revenue recognition that must be taken into account in developing systems and establishing internal controls over CJR program processes related to financial reporting. Potential implications include:

- a. The hospital must ensure that its patients are included in the correct portfolios, taking into account the 90-day difference between the discharge date from the hospital and the end of the episode (which determines the CMS performance year to which the episode will be assigned).
- b. Important metrics such as target episode prices, stop-gain or stop-loss limits, and quality scores are unique to a given performance year. Using the incorrect year's metrics when making estimates and establishing estimates could cause a material overstatement or understatement of revenue.
- c. Hospitals will need to allocate the effects of adjustments to CJR program estimates and, ultimately, the final determination of a bonus or penalty, between fiscal years in a systematic and rational manner. This will assist the hospital with disclosure requirements in FASB ASC 606-10-50-12A related to disclosure of revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods.

Presence of a Significant Financing Component

7.6.105 Although the timeframe over which the hospital performs the LEJR procedure, receives the MS-DRG payment, receives or pays an interim bonus or penalty settlement at first reconciliation, and makes final settlement with CMS may cover several years, FinREC believes that a significant financing component does not exist because the timing of the payment is at the discretion of CMS and does not involve the patient (that is, the customer). Refer to section "Third-Party Settlement Estimates" in paragraphs 7.6.44–7.6.72 for factors to consider related to determining the existence of a significant financing component in a contract.

Allocate the Transaction Price to the Performance Obligations in the Contract

7.6.106 For considerations related to step 4, when more than one performance obligation is identified, refer to paragraphs 28–45 of FASB ASC 606-10-32.

Recognize Revenue When (or As) the Entity Satisfies a Performance Obligation

7.6.107 For considerations related to step 5, refer to section "Determining the Timing of Satisfaction of Performance Obligations" in paragraphs 7.5.01–7.5.08.

7.6.108 The following example is intended to be an illustration of retrospective adjustments. The actual determination of the retrospective adjustment should be based on the facts and circumstances of an entity's specific situation.

Example 7-6-11 — Comprehensive Illustration — CJR Step 3 and Step 5

Hospital Y has a June 30 fiscal year end. This illustration shows how the retrospective adjustment associated with CMS Performance Year (PY) 3 (2018) will affect Hospital Y's financial statements for fiscal years ending June 30, 2018, 2019, and 2020. Note that in the fiscal year ending June 30, 2018, Hospital Y will need to similarly consider the impact of PY2 (2017), as well as PY1 (2016), if Hospital Y is entitled to a bonus or is subject to a penalty.

During the fiscal year ending June 30, 2018, Hospital Y's MS-DRG payment for LEJR procedures is \$12,500. The target episode price for PY3, established by CMS in advance of the performance year, is \$25,000. The stop-gain or stop-loss percentage for PY3 is 10% of the target episode price, which is the maximum bonus or penalty applicable to Hospital Y.

To simplify the example, it does not include considerations related to incorporating the data for patients whose 90-day post-discharge period is not complete at the end of a reporting period. Refer to "Interaction of Portfolios, Performance Years, and Fiscal Years" (paragraphs 31–33 herein) for additional information.

As of June 30, 2018

Seventy Medicare patients that received LEJR procedures during the fiscal year ending June 30, 2018, have episodes ending in PY3. Hospital's general ledger reflects \$875,000 of patient service revenue for the MS-DRG payments from CMS (\$12,500 MS-DRG payment × 70 patients) for those patients. However, because the MS-DRG payments will be retrospectively adjusted by the performance bonus or penalty associated with PY3, Hospital Y must determine how much patient service revenue to recognize in its financial statements for the year ending June 30, 2018, relative to the 70 patients.

The penalty or bonus is determined based on services provided to the patients from the time of admission through the 90 days after a patient's discharge from Hospital Y. The target episode price established by CMS in advance of the PY3 performance year for an "acceptable" quality score was \$25,000. Based on information from CMS, Hospital Y believes the quality score will fall into the "acceptable" range and believes that it is probable that a significant reversal of the cumulative revenue recognized as a result of the quality score possibly being lower will not occur. In PY3, the maximum penalty that can be

imposed on Hospital Y in PY3 is capped at \$2,500 per episode (10% of the target episode price). Similarly, the maximum bonus that Hospital Y could receive is capped at \$2,500 per episode (10% of the target episode price). Therefore, Hospital Y's range of potential compensation for each of the 70 patients is \$10,000 to \$15,000 (\$12,500 MS-DRG payment $\pm$ \$2,500 maximum bonus or penalty). Because Hospital Y has not concluded whether it has earned a bonus or incurred a penalty when PY3 ends, Hospital Y determines that the amount of variable consideration included in the transaction price (and, therefore, recognized) should be constrained. Because Hospital Y determined it will be entitled to at least \$10,000 of revenue for each patient, a reduction of the transaction price (constraint) based on the estimate of variable consideration of \$175,000 is established to reduce revenue.

The reduction of the transaction price (constraint) for the estimate of variable consideration is calculated as follows:

MS-DRG payment	875,000
Less:	
Minimum consideration per patient	10,000
Number of patients	70
Total minimum consideration	700,000
Total reduction of the transaction price (constraint)	175,000

The journal entry to record the reduction of the transaction price (constraint) is as follows:

Contractual adjustment – CJR program – PY3 (revenue)	175,000
Estimated liability for CJR program settlement – PY3	175,000

At June 30, 2018, the estimated net patient service revenue recognized in the financial statements for services rendered to the 70 CJR patients would be \$700,000. Changes to the variable consideration associated with those patients will be reported in subsequent periods.

As of March 31, 2019

PY3 ends halfway through Hospital's fiscal year ending June 30, 2019. Ultimately, the PY ended December 31, 2018, contained 100 episodes (70 from Hospital Y's fiscal year ended June 30, 2018, and 30 from the first and second quarters in the fiscal year ending June 30, 2019 — that is, the quarters ended September 30, 2018, and December 31, 2018). During the quarter ended March 31, 2019, Hospital Y determines that it has sufficient data to make a reasonable initial estimate of the PY3 penalty or bonus estimate that was previously constrained.

Hospital estimates that the CMS total spending for the 100 episodes in this portfolio, including the MS-DRG payments made to Hospital Y and the amounts billed for services provided by all other post-acute providers associated with the episodes, will be \$2.6 million.

The original target episode price established by CMS of \$25,000 was based on an assumption that Hospital Y's quality score for PY3 would fall within the

"acceptable" range. The target episode price will be updated to reflect Hospital Y's actual quality score earned for the PY, which will be provided in the first reconciliation report that has not yet been received. The range of possible prices is as follows:

Below acceptable quality adjusted target price	\$24,500
Acceptable quality adjusted target price	\$25,000
Good quality adjusted target price	\$25,500
Excellent quality adjusted target price	\$26,000

Hospital Y also estimates, based on known or knowable information from prior periods and the current period, the various probabilities associated with the quality scores it will likely receive for PY3 as follows:

Below acceptable	5%
Acceptable	20%
Good	60%
Excellent	15%

Based on the foregoing, Hospital Y estimates that its probability-weighted quality-adjusted target price per patient will be \$25,425.

	Quality adjusted target price per patient	Probability	Probability weighted amounts
Below acceptable	\$24,500	5%	\$1,225
Acceptable	25,000	20%	5,000
Good	25,500	60%	15,300
Excellent	26,000	15%	3,900
Probability-weighted quality-adjusted target price per patient			\$25,425

The total of the estimated quality-adjusted target episode payments is \$25,425 × 100 patients = \$2,542,500. The estimated stop-gain or stop-loss amount is \$254,250 (\$2,542,500 × 10%). In accordance with paragraphs 11 and 12 of FASB ASC 606-10-32, Hospital Y evaluates whether it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur (that is, whether a constraint on recognition is required) when the uncertainty associated with the variable consideration is subsequently resolved. Based on the information available, management determined that it is probable that a significant reversal of revenue would not occur. As such, Hospital Y would recognize \$25,425 of revenue for each patient.

The difference between the total estimated CMS spend and the aggregate estimated target episode prices is \$57,500 (\$2,600,000 – \$2,542,500). Because the difference is less than the estimated stop-loss amount of \$254,250, Hospital Y's

estimated liability to the program is \$57,500 for PY3. Because the penalty is associated with episodes in two different fiscal years, Hospital Y must apportion the penalty among the episodes in each period in a systematic and rational manner. Hospital Y elects to use a proration based on number of episodes. So, 70 out of 100 in the year ended June 30, 2018 = \$40,250 ($\$57,500 \times 70 \div 100$) and 30 out of 100 in the year ended June 30, 2019 = \$17,250 ($\$57,500 \times 30 \div 100$).

Therefore, the updated estimate of variable consideration associated with the 70 patients treated in fiscal year ended June 30, 2018, is \$40,250. Because Hospital Y's updated estimated experience was more favorable than the amount recorded in the year ended June 30, 2018, an adjustment to the amount recorded is needed. The amount is calculated as follows:

Total reduction of the transaction price (constraint) as of June 30, 2018, based on prior period estimate	\$175,000
Revised reduction of the transaction price (constraint) related to services performed in the year ended June 30, 2018, based on the updated current period estimate	\$40,250
Amount of the previously-constrained transaction price related to the year ended June 30, 2018, to be recognized as revenue in the current period	\$134,750

The revised aggregate transaction price is \$834,750. The journal entry to record the adjustment of the transaction price (due to the constraint) based on the estimate of variable consideration related to PY3 (2018) is as follows:

Estimated liability for CJR program settlement – PY3	\$134,750
Contractual adjustment for CJR – PY3 (2018) (revenue)	\$134,750

The journal entry to record the adjustment of the transaction price (due to the constraint) based on the estimate of variable consideration related to PY3 (2019) is as follows:

Contractual adjustment for CJR – PY3 (2019) (revenue)	\$17,250
Estimated liability for CJR program settlement – PY3	\$17,250

These journal entries are reflected in Hospital Y's quarter ended March 31, 2019, financial statements.

As of June 30, 2019

In the quarter ended June 30, 2019, Hospital Y receives the first reconciliation report for PY3. The total CMS spending shown on the reconciliation report is \$2.3 million. Hospital Y's actual quality score is "good," resulting in a total quality-adjusted target price of \$2,550,000 ($\$25,500 \times 100$ patients); the stop-gain or stop-loss limit is \$255,000 ($\$2,550,000 \times 10\%$); and Hospital is entitled to an interim bonus payment of \$250,000 ($\$2,550,000 - \$2,300,000$).

Hospital Y evaluates the impact of this information on its estimate of variable consideration previously recorded for the year ended June 30, 2018. Hospital

attributes the spending difference to PY3 claims that have not yet been processed by CMS and determines that its original spending estimate of \$2.6 million should not be revised. However, the aggregate target episode price will need to be adjusted to reflect the outcome of the quality score. As a result, Hospital Y's revised estimate of the penalty amount is \$50,000 (\$2,600,000 – \$2,550,000).

The difference between the previous estimate of the penalty and the revised estimate is \$7,500 (\$57,500 – \$50,000). Hospital Y apportions the required "true-up" in the same proportions as it did the original estimate — 70 out of 100 in the year ended June 30, 2018 = \$5,250; and 30 out of 100 in the year ended June 30, 2019 = \$2,250 resulting in a revised transaction price for the 70 episodes in the year ended June 30, 2018, of \$840,000. Hospital Y records the following adjustment related to PY3 (2018):

Estimated liability for CJR program settlement – PY3	\$5,250
Contractual adjustment for CJR – PY3 (2018) (revenue)	\$5,250

In addition, Hospital Y records the following adjustment related to PY3 (2019):

Estimated liability for CJR program settlement – PY3	\$2,250
Contractual adjustment for CJR – PY3 (2019) (revenue)	\$2,250

Hospital receives an interim payment, which is recorded as follows:

Cash	\$250,000
Estimated liability for CJR program settlement – PY3	\$250,000

As Hospital Y previously estimated a liability, the interim payment is recorded as an additional liability.

These journal entries are reflected in Hospital Y's financial statements as of and for the year ended June 30, 2019.

As of June 30, 2020

In the quarter ended June 30, 2020, Hospital Y receives the second reconciliation report for PY3. The total CMS spending shown on the reconciliation report is \$2,525,000, indicating Hospital Y has earned a bonus of \$25,000 for PY3 (\$2,550,000 – \$2,525,000). Because CMS paid \$250,000 in the interim settlement, Hospital Y will be required to return \$225,000 (\$250,000 – \$25,000) to CMS.

Because Hospital Y had previously estimated that it would pay a penalty of \$50,000, a final adjustment of the estimate to reflect the change from penalty to bonus of \$75,000 (allocated consistently with prior periods) is recorded. The final aggregate transaction price related to the 70 episodes in the year ended June 30, 2018, is \$892,500. Hospital Y records the following adjustment related to PY3 (2018):

Estimated liability CJR program settlement – PY3	\$52,500
Contractual adjustment for CJR – PY3 (2018) (revenue)	\$52,500

In addition, Hospital Y records the following adjustment related to PY3 (2019):

Estimated liability CJR program settlement – PY3	\$22,500
Contractual adjustment for CJR – PY3 (2019) (revenue)	\$22,500

Hospital closes the PY3 settlement and records the actual final settlement with CMS as follows:

Estimated liability for CJR program settlement – PY3	\$225,000
Cash	\$225,000

Activity in Estimates During the Year Ended June 30, 2019

In the financial statements for the year ended June 30, 2019, the patient service revenue reported by the following two hospitals will be affected by estimates of the transaction price (constraint) associated with three CMS performance years – PY4 (2019), PY3 (2018), and PY2 (2017). The patterns in which each hospital has recognized variable consideration are affected by its varying levels of access to data on which to base estimates.

	Regional Hospital <i>Has an internal system which provides "real time" visibility into clinical activities and claims filed by post-acute providers, in addition to receiving information from CMS on a two-month lag</i>	Community Hospital <i>Receives information on claims and clinical activities of most post-acute providers on a two-month lag</i>
PY4 (2019) <i>(begins in year ended June 30, 2019)</i>	Estimate settlement amount and record initial estimate	Based on experience and individual facts and circumstances, estimate settlement amount and record initial estimate usually based on maximum possible payback (using PY4 stop-loss limit) and continue to evaluate on a periodic basis

(continued)

	Regional Hospital <i>Has an internal system which provides "real time" visibility into clinical activities and claims filed by post-acute providers, in addition to receiving information from CMS on a two-month lag</i>	Community Hospital <i>Receives information on claims and clinical activities of most post-acute providers on a two-month lag</i>
PY3 (2018) <i>(begins in year ended June 30, 2018)</i> <i>First reconciliation report will be received during April to June 2019</i>	"True up" initial estimate if necessary; reflect adjustment in financial statements for the year ended June 30, 2019 Adjust "Due to or from CMS" based on first reconciliation payment received or made Disclose revenue recognized in the current period from performance obligations satisfied in previous periods (see paragraph 32c)	Make estimate of settlement amount Adjust estimate and reflect in financial statements for the year ended June 30, 2019 Adjust "Due to or from CMS" based on first reconciliation payment received or made Disclose revenue recognized in the current period from performance obligations satisfied in previous periods (see paragraph 32c)
PY2 (2017) <i>(begins in year ended June 30, 2017)</i> <i>Final settlement in year ended June 30, 2019</i> <i>Second reconciliation report received during April to June 2019</i>	"True up" estimate and "Due to or from CMS" to reflect final bonus or penalty payment Reflect adjustment in financial statements for the year ended June 30, 2019 Disclose revenue recognized in the current period from performance obligations satisfied in previous periods (see paragraph 32c)	"True up" estimate and "Due to or from CMS" to reflect final bonus or penalty payment Reflect adjustment in financial statements for the year ended June 30, 2019 Disclose revenue recognized in the current period from performance obligations satisfied in previous periods (see paragraph 32c)

Other Related Topics

Application of the Portfolio Approach

This Accounting Implementation Issue Is Relevant to the Application of the Portfolio Approach in FASB ASC 606.

Application of the Portfolio Approach to Contracts With Patients

7.7.01 Health care entities may use a portfolio approach as a practical expedient to account for patient contracts as a collective group, rather than individually, if, as required in FASB ASC 606-10-10-4, the financial statement effects are not expected to materially differ from an individual contract approach. This approach may be applied by health care entities that have a large volume of similar contracts with similar classes of customers (as described in paragraph BC488a of ASU No. 2014-09), to reduce the complexity and cost of applying FASB ASC 606.

7.7.02 It is important that health care entities exercise judgment when determining portfolios. FASB ASC 606 specifies the need for similar characteristics among contracts (or performance obligations) to be grouped together, but permits the application of a "reasonable approach to determine the portfolios that would be appropriate for its types of contracts," as stated in paragraph BC69 of ASU No. 2014-09. The phrase "similar characteristics," as stated in FASB ASC 606-10-10-4, is not explicitly defined. FASB explained its rationale for including a portfolio practical expedient in paragraphs BC69–BC70 of ASU No. 2014-09, noting that it would be a practical way to apply FASB ASC 606. FASB specifically indicated that judgment would be required in selecting the size and composition of the portfolio such that the entity would not expect the portfolio results to differ materially from the application of FASB ASC 606 to each specific contract.

7.7.03 Health care entities typically have contracts with patients that may involve different payors and provide different services with different payment terms. The following are some considerations for a health care entity to determine in grouping contracts with similar characteristics for inclusion in a portfolio:

- Type of service — inpatient, outpatient, skilled nursing, home health, emergency room, elective procedures, non-elective procedures, physician practice, and so on.
- Type of payors — insurance contract (Blue Cross, Aetna, Emblem Health, and so on), insurance contract with patient responsibility (co-pay, deductible), governmental programs (Medicare, Medicaid), uninsured self-pay, and so on. In some cases, there may be multiple payors (for example, insurance and co-payment) in a single patient contract. Health care entities may also consider the size of co-pay or deductible (for example, high deductible).
- Whether contracts are entered into at or near the same time (for example, the same quarter).

A health care entity may include some or a combination of the preceding considerations in its determination of a portfolio.

7.7.04 Based on FASB ASC 606-10-10-4, FinREC believes that a health care entity should consider both the sufficiency of the portfolio data (that is, how much experience it has with a portfolio) and the homogeneity of the data (that is, the similarity of patient accounts within a portfolio) to ensure that revenue recognized on a portfolio basis results in no material differences when compared with an individual contract approach.

7.7.05 It is important that a health care entity make a determination about whether to apply the portfolio approach on a system-wide basis (for example, some or all the health care facilities in a health care entity's system) or

tailor a separate approach for each individual health care facility in the system. Some of the considerations in this determination may be if the health care facilities have the same contracted insurance reimbursement rates, charge master pricing, mix of services, and so on. An additional consideration is whether contracts from different billing systems can be included in a portfolio or if the characteristics are different such that they should not be in the same portfolio.

7.7.06 Health care entities may consider historical cash collections and reimbursement rates by type of service or payor, or both, and then group those contracts with similar collection history or reimbursement rates into a portfolio. Once the collection history or reimbursement rates are determined, applying these historical rates to individual contracts or a portfolio of contracts should not change the result materially because the same historical or reimbursement rates are used in both cases and would support the requirement in FASB ASC 606-10-10-4 that the financial statement impact of applying the guidance to a portfolio of contracts does not differ materially from applying this guidance to individual contracts. A health care entity should monitor these portfolios and update them periodically to account for changes in collection patterns and reimbursement rates of different classes of patients, implementation of state insurance exchanges, and changes to Medicaid and other state or local plans as required under FASB ASC 606-10-10-4.

Application of the Portfolio Approach to Performance Obligations

7.7.07 A health care entity may also consider applying the portfolio approach to similar performance obligations if there are multiple performance obligations identified in its contracts with patients or customers.

Impact of Electing Not to Apply the Portfolio Approach

7.7.08 Because the portfolio approach, as described in FASB ASC 606-10-10-4, was designed as a practical expedient, it is important that a health care entity exercise discretion and judgment in determining whether to apply the method to some or all of its contracts with patients. In addition, health care entities may decide to apply the portfolio approach to one class of patients but not to another. That is, a health care entity may apply an individual contract approach for some contracts (for example, significant balance accounts), and a portfolio approach to the rest of its accounts.

7.7.09 If a health care entity chooses not to apply the portfolio approach to some or all of its contracts, then it would apply the revenue model on a contract-by-contract basis.

Adding or Removing an Individual Contract to or From a Portfolio

7.7.10 FinREC believes that a contract can be added to a portfolio when the health care entity determines that the contract has similar characteristics with the other contracts in the portfolio such that the financial statement impact would not differ materially, and similarly, that a contract should be removed from a portfolio if the health care entity subsequently identifies that the contract does not have similar characteristics with other contracts in the portfolio in accordance with FASB ASC 606-10-10-4.

7.7.11 It may take up to several weeks after providing service to a patient for a health care entity to determine the payor for the contract (for example, whether the patient is eligible for Medicaid, qualifies for charity care, or is uninsured). In the interim, it is important that the health care entity determine

the portfolio classification of the individual patient for revenue recognition purposes. Some health care entities may initially classify a patient as pending Medicaid and subsequently reclassify the patient to Medicaid, self-pay, or charity care once eligibility has occurred. Refer to "Arrangements for Health Care Services Provided to Uninsured and Insured Patients With Self-Pay Balances, Including Co-Payments and Deductibles", included in paragraphs 7.6.01–7.6.43 for further considerations regarding patients classified as Medicaid pending.

7.7.12 Some health care entities may reclassify the remaining self-pay balance (co-payments or deductibles) into a separate portfolio after the insurance payor has paid.

Use of Historical Experience to Estimate Contractual Adjustments From Third-Party Payors, Governmental Programs, Self-Pay Discounts, and Implicit Price Concessions

7.7.13 In accordance with FASB ASC 606-10-32-9, health care entities should consider all information (historical, current, and forecast) that is reasonably available to the entity to estimate variable consideration when determining the transaction price, whether the guidance in FASB ASC 606 is applied on a portfolio or contract-by-contract basis. Estimates may include

- contractual adjustments under third-party payor arrangements and governmental programs such as Medicare and Medicaid;
- discounts to self-pay patients, if provided; and
- implicit price concessions provided to certain self-pay patients as discussed in "Arrangements for Health Care Services Provided to Uninsured and Insured Patients With Self-Pay Balances, Including Co-Payments and Deductibles," included in paragraphs 7.6.01–7.6.43, and example 3 in paragraphs 102–105 of FASB ASC 606-10-55.

7.7.14 At the July 2015 TRG meeting, the TRG discussed if an entity is applying the portfolio practical expedient when it considers evidence from other, similar contracts to develop an estimate using the expected value method. As noted in paragraph 25 of TRG Agenda Ref. No. 44, *July 2015 Meeting — Summary of Issues Discussed and Next Steps*:

In some circumstances, an entity will develop estimates using a portfolio of data to account for a specific contract with a customer. For example, to account for a specific contract with a customer, an entity might consider historical experience with similar contracts to make estimates and judgments about variable consideration and the constraint on variable consideration for that specific contract. On question 1, TRG members agreed with the staff's view that the use of a portfolio of data is not the same as applying the portfolio practical expedient.

7.7.15 Thus, in accordance with the discussion at the July 2015 TRG meeting on the portfolio practical expedient, an entity is not required to apply the portfolio practical expedient when considering evidence from other, similar contracts to develop an estimate of variable consideration. An entity could choose to apply the portfolio practical expedient, but it is not required to do so. At each reporting period, in accordance with FASB ASC 606-10-32-14, a health care entity should compare the characteristics of the contracts included in the historical experience to the characteristics of the portfolio or individual contract to which the historical evidence is being applied. The entity's considerations of the applicable historical experience to apply to a contract (or portfolio) may

be similar to its determination of which portfolios it may use, as discussed in paragraph 7.7.03. Historical collection experience for a contract (or a portfolio of contracts) may include historical experience from more than one payor source (for example, insurance payment and patient co-payment).

Presentation and Disclosure

This Accounting Implementation Issue Is Relevant for Accounting for Presentation and Disclosure Requirements Under FASB ASC 606 and FASB ASC 340-40.

Background

7.7.16 It is critical that the discussions and conclusions reached in this section be read in conjunction with the discussions and conclusions reached in the following revenue recognition implementation sections:

- a. "Arrangements for Health Care Services Provided to Uninsured and Insured Patients With Self-Pay Balances, Including Co-Payments and Deductibles" in paragraphs 7.6.01–7.6.43
- b. "Application of the Portfolio Approach" in paragraphs 7.7.01–7.7.15
- c. "Application of FASB ASC 606 to Continuing Care Retirement Community Contracts" in paragraphs 7.6.109–7.6.162
- d. "Accounting for Contract Costs" in paragraphs 7.7.61–7.7.73
- e. "Third-Party Settlement Estimates" in paragraphs 7.6.44–7.6.72
- f. "Risk Sharing Arrangements" in paragraphs 7.6.73–7.6.108
- g. "Identifying Performance Obligations" in paragraphs 7.2.01–7.2.09 and "Determining the Timing of Satisfaction of Performance Obligations" in paragraphs 7.5.01–7.5.08

Disclosure Requirements

7.7.17 FASB ASC 606-10-50-1 states the following:

The objective of the disclosure requirements in this Topic is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. To achieve that objective, an entity shall disclose qualitative and quantitative information about all of the following:

- a. Its contracts with customers (see paragraphs 606-10-50-4 through 50-16)
- b. The significant judgments, and changes in the judgments, made in applying the guidance in this Topic to those contracts (see paragraphs 606-10-50-17 through 50-21)
- c. Any assets recognized from the costs to obtain or fulfill a contract with a customer in accordance with paragraph 340-40-25-1 or 340-40-25-5 (see paragraphs 340-40-50-1 through 50-6).

7.7.18 FASB ASC 606-10-50-2 states the following:

An entity shall consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the

various requirements. An entity shall aggregate or disaggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have substantially different characteristics.

7.7.19 FASB ASC 606-10-50-3 states the following:

Amounts disclosed are for each reporting period for which a statement of comprehensive income (statement of activities) is presented and as of each reporting period for which a statement of financial position is presented. An entity need not disclose information in accordance with the guidance in this Topic if it has provided the information in accordance with another Topic.

7.7.20 A health care entity that is neither a public business entity nor a not-for-profit entity that 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 is not required to make certain of the disclosures required of public entities. These differences are described further in each of the following sections.

Contracts With Customers

Disaggregation of Revenue

7.7.21 FASB ASC 606-10-50-5 states that "[a]n entity shall disaggregate revenue recognized from contracts with customers into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors."

7.7.22 In accordance with FASB ASC 606-10-50-6, if the health care entity applies FASB ASC 280, *Segment Reporting*, the health care entity should also disclose sufficient information to enable users of its financial statements to understand the relationship between the disclosure of disaggregated revenue (in accordance with FASB ASC 606-10-50-5) and revenue information that is disclosed for each reportable segment. Based on the guidance in paragraphs 1 and 5 of FASB ASC 606-10-50, a health care entity may consider evaluating the guidance in paragraphs 89–91 of FASB ASC 606-10-55 when selecting the disaggregated revenue categories.

7.7.23 A health care entity may disclose revenue by the major type of payor (for example, Medicare, Medicaid, commercial insurance, self-pay) as each payor generally pays different rates for services, which impacts the nature, amount, timing, and uncertainty of revenue and cash flows. A health care entity should consider the level of disaggregation based on the significance of each payor to its revenue, how its different arrangements with those payors impact the nature, amount, timing, and uncertainty of revenue and cash flows, how it internally analyzes its major payors, and how it presents its payors externally in earnings releases, annual reports, or investor presentations. For example, Medicaid may be disaggregated from Medicaid managed care or commercial insurance may be disaggregated by significant commercial payors, and self-pay may be disaggregated between uninsured self-pay and copayments and deductibles. FinREC believes that a health care entity should consider if disaggregation is by primary payor or if primary payors should be separately disclosed which may include copayments and deductibles).

7.7.24 In addition to the major type of payor disaggregation disclosure, a health care entity might also consider whether the nature, amount, tim-

ing, and uncertainty of revenue and cash flows are impacted by factors such as geographical considerations (for example, regions of the country that a health care system uses when evaluating financial performance or making resource allocation decisions), method of reimbursement (for example, percent of charges, cost, fixed, capitated, or risk sharing), timing of transfer of goods or services (for example, inpatient and outpatient services, which occur over time or sales of retail pharmacy and equipment, which occur at a point in time), and whether the health care entity has different operating segments or service lines (for example, hospital inpatient, hospital outpatient, nursing home, physician, home care, health plan, assisted/independent living, and other non-health care services).

7.7.25 FASB ASC 606-10-50-7 indicates that the quantitative disaggregation disclosure guidance in paragraphs 5–6 of FASB ASC 606-10-50 and paragraphs 89–91 of FASB ASC 606-10-55 is not required for entities that are neither a public business entity nor a not-for-profit entity that 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. However, if an entity that is neither a public business entity nor a not-for-profit entity that 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 elects not to provide those disclosures, it must provide, at a minimum, revenue disaggregated according to the timing of transfer of goods or services (for example, revenue from goods or services transferred to customers over time, and revenue from goods transferred to customers at a point in time) and qualitative information about how economic factors (such as type of customer, geographical location of customers, and type of contract) affect the nature, amount, timing, and uncertainty of revenue and cash flows.

Contract Balances

7.7.26 In accordance with FASB ASC 606-10-45-1, "[w]hen either party to a contract has performed, an entity shall present the contract in the statement of financial position as a contract asset or contract liability, depending on the relationship between the entity's performance and the customer's payment. An entity shall present any unconditional rights to consideration separately as a receivable."

7.7.27 When a health care entity has an unconditional right to payment, subject only to the passage of time, the right is treated as a receivable (refer to FASB ASC 606-10-45-4). For a health care entity, patient accounts receivable, including billed and unbilled accounts, including in-house patients, for which the health care entity has the unconditional right to payment, and estimated amounts due from third-party payors for retroactive adjustments, are receivables if the entity's right to consideration is unconditional and only the passage of time is required before payment of that consideration is due. For unbilled accounts, including in-house patients, a health care entity should evaluate its payor arrangements and potentially consult with legal counsel to determine whether it has an unconditional right to payment at the end of each reporting period.

7.7.28 FASB ASC 606-10-45-3 states that "[i]f an entity performs by transferring goods or services to a customer before the customer pays consideration or before payment is due, the entity shall present the contract as a contract asset, excluding any amounts presented as a receivable. A contract asset is an entity's right to consideration in exchange for goods or services that the entity has

transferred to a customer." Nonrefundable advance payments by a patient to a health care entity before goods or services are provided (for example, long-term care residents and continuing care retirement communities [CCRC] advance fees) are contract liabilities. A contract liability does not include amounts that are expected to be refunded pursuant to, for example, rights of return, or other provisions. In those cases, a separate refund liability must be recorded (refer to FASB ASC 606-10-32-10).

7.7.29 FASB ASC 954-310-45-1 states that

[a]lthough the aggregate amount of receivables may include balances due from patients and third-party payors (including final settlements and appeals), the amounts due from third-party payors for retroactive adjustments of items such as final settlements or appeals shall be reported separately in the financial statements.

7.7.30 FASB ASC 606-10-45-5 indicates that an entity is not prohibited from using alternative descriptions in the statement of financial position for contract assets and contract liabilities, although the entity should provide sufficient information for a user of the financial statements to distinguish between receivables and contract assets.

7.7.31 FASB ASC 606-10-50-8 requires a health care entity to make certain disclosures regarding contract balances. Those requirements and considerations for a health care entity are as follows:

- a. "The opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers, if not otherwise separately presented or disclosed." For many health care entities, receivables (for example, patient accounts receivable or estimated amounts due from third-party payors for retroactive adjustments) are likely to be presented on their balance sheets as separate line items. Health care entities should also consider whether contract assets are separately presented on their balance sheet. If it is determined that sufficient information is not presented on the balance sheet, the opening and closing balances of receivables, contract assets, and contract liabilities should be disclosed in the notes to the financial statements. CCRC and similar entities with other contract balances (for example, nonrefundable advance fees) may also need to consider disclosure of additional details.
- b. "Revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period." Health care entities will need to disclose reductions in a contract liability balance as a result of services provided during the reporting period. For example, this may apply to CCRCs and similar entities with nonrefundable advance fees recorded as contract liabilities.

7.7.32 In accordance with FASB ASC 606-10-50-9, a health care entity "shall explain how the timing of satisfaction of its performance obligations (see paragraph 606-10-50-12(a)) relates to the typical timing of payment (see paragraph 606-10-50-12(b)) and the effect that those factors have on the contract asset and the contract liability balances. The explanation provided may use qualitative information." A health care entity might explain how CCRC nonrefundable advance fees are recognized or disclose that patients and third-party payors are generally billed several days after services are rendered to a patient. Amounts related to services provided to patients for which the entity has not

billed and that do not meet the conditions of unconditional right to payment at the end of the reporting period are presented as contract assets. Amounts billed that have not yet been collected and that meet the conditions for unconditional right to payment are presented as patient receivables, not contract assets.

7.7.33 Paragraph 10 of FASB ASC 606-10-50 states that "[a]n entity shall provide an explanation of the significant changes in the contract asset and the contract liability balances during the reporting period. The explanation shall include qualitative and quantitative information." FASB ASC 606-10-50-10 provides examples of changes in an entity's balances of contract assets and contract liabilities such as a business combination or a cumulative catch-up adjustment to revenue, including adjustments arising from a change in the estimate of the transaction price (and any changes in the assessment of whether an estimate of variable consideration is constrained). Changes in contract liabilities of CCRCs may include changes in nonrefundable advance fees.

7.7.34 FASB ASC 606-10-50-11 indicates that the disclosure requirements in paragraphs 8–10 and 12A of FASB ASC 606-10-50 related to timing of the satisfaction of its performance obligations and explanation of the significant changes in the contract asset and liability balances during the reporting period are not required for entities that are neither a public business entity nor a not-for-profit entity that 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. However, if an entity that is neither a public business entity nor a not-for-profit entity that 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 elects not to provide these disclosures, the entity should provide the disclosure in FASB ASC 606-10-50-8a, which requires the disclosure of the opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers, if not otherwise separately presented or disclosed.

Performance Obligations

7.7.35 Refer to the section "Identifying Performance Obligations," in paragraphs 7.2.01–7.2.09 and the "Determining the Timing of Satisfaction of Performance Obligations" section in paragraphs 7.5.01–7.5.08 for discussion on accounting for performance obligations.

7.7.36 Paragraph 12 of FASB ASC 606-10-50 includes disclosure requirements regarding performance obligations. Those requirements and the considerations for a health care entity are as follows:

- a.* "When the entity typically satisfies its performance obligations (for example, upon shipment, upon delivery, as services are rendered, or upon completion of service) including when performance obligations are satisfied in a bill-and-hold arrangement." A health care entity may disclose that it satisfies some of its performance obligations at the time goods are provided (for example, retail sale of medical equipment or pharmaceuticals), while other performance obligations may be satisfied over time (for example, inpatient or outpatient services and certain services provided by continuing care retirement communities).
- b.* "The significant payment terms (for example, when payment typically is due, whether the contract has a significant financing component, whether the consideration amount is variable, and whether the estimate of variable consideration is typically constrained in

accordance with paragraphs 11–13 of FASB ASC 606-10-32.)" A health care entity may disclose that it typically enters into agreements with third-party payors (Medicare, Medicaid, commercial insurance, HMOs, and similar payors) that provide for payments at amounts different from its established charges and that the arrangement terms provide for subsequent settlement and cash flows that may occur well after the service is provided. Similarly, a health care entity may disclose that it offers uninsured patients certain discounts from charges and may include implicit price concessions in the estimate of the transaction price based on historical collection experience. Those amounts are estimated each reporting period. If applicable, FinREC believes that a health care entity should disclose how it estimates retroactive settlements with third-party payors and whether those amounts are constrained. A CCRC may disclose payment terms (for example, monthly and advance fees) and whether advance fees are refundable or not. A CCRC may also need to disclose whether there is a significant financing component included in its payment arrangements (see the section, "Application of FASB ASC 606 to Continuing Care Retirement Community Contracts" in paragraphs 7.6.109–7.6.162).

- c. "The nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (that is, if the entity is acting as an agent)." A health care entity may disclose the different services it provides (for example, inpatient, outpatient, long-term care, home health, and so on).
- d. "Obligations for returns, refunds, and other similar obligations." A hospital will disclose credit balances that represent refunds owed to patients and third-party payors and CCRCs will disclose whether it has advance fees that are refundable and the related terms.
- e. "Types of warranties and related obligations." A health care entity will need to determine whether it has provided warranties or has related obligations and disclose these, if applicable.

7.7.37 FASB ASC 606-10-50-12A states, "An entity shall disclose revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (for example, changes in transaction price)." If a health care entity determined a change in the implicit price concessions, discounts and contractual adjustments, or third-party settlements that it estimated in a previous reporting period, it will need to disclose the impact that this change in the estimate of the transaction price had on revenue in the reporting period.

Transaction Price Allocated to the Remaining Performance Obligations

7.7.38 An entity should disclose information about its remaining performance obligations in accordance with FASB ASC 606-10-50-13, subject to certain exceptions in paragraphs 14–14A of FASB ASC 606-10-50. Certain types of health care providers may have remaining performance obligations at the end of the reporting period, including hospitals with in-house patients, CCRCs, providers with multi-visit procedures, entities that offer prepaid services, and those with bundled payments. They are required to disclose a description of the following:

- a. The aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period
- b. An explanation of when the entity expects to recognize as revenue the amount disclosed in accordance with paragraph 606-10-50-13(a), which the entity should disclose in either of the following ways:
 1. On a quantitative basis using the time bands that would be most appropriate for the duration of the remaining performance obligations
 2. By using qualitative information.

7.7.39 FASB ASC 606-10-50-14 states that

[a]n entity need not disclose the information in paragraph 606-10-50-13 for a performance obligation if either of the following conditions is met:

- a. The performance obligation is part of a contract that has an original expected duration of one year or less.
- b. The entity recognizes revenue from the satisfaction of the performance obligation, in accordance with paragraph 606-10-55-18.

7.7.40 FASB ASC 606-10-55-18 states the following:

[I]f an entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date (for example, a service contract in which an entity bills a fixed amount for each hour of service provided), the entity may recognize revenue in the amount to which the entity has a right to invoice.

7.7.41 FASB ASC 606-10-50-14A states the following:

An entity need not disclose the information in paragraph 606-10-50-13 for variable consideration for which either of the following conditions is met:

- a. The variable consideration is a sales-based or usage-based royalty promised in exchange for a license of intellectual property accounted for in accordance with paragraphs 606-10-55-65 through 55-65B.
- b. The variable consideration is allocated entirely to a wholly unsatisfied performance obligation or to a wholly unsatisfied promise to transfer a distinct good or service that forms part of a single performance obligation in accordance with paragraph 606-10-25-14(b), for which the criteria in paragraph 606-10-32-40 have been met.

7.7.42 FASB ASC 606-10-50-14B states, "The optional exemptions in paragraphs 606-10-50-14(b) and 606-10-50-14A shall not be applied to fixed consideration."

7.7.43 In accordance with FASB ASC 606-10-50-15:

An entity shall disclose which optional exemptions in paragraphs 606-10-50-14 through 50-14A it is applying. In addition, an entity applying the optional exemptions in paragraphs 606-10-50-14 through 50-14A shall disclose the nature of the performance obligations, the remaining duration (see paragraph 606-10-25-3), and a description of the variable consideration (for example, the nature of the variability and how that variability will be resolved) that has been excluded from the information disclosed in accordance with paragraph 606-10-50-13. This information shall include sufficient detail to enable users of financial statements to understand the remaining performance obligations that the entity excluded from the information disclosed in accordance with paragraph 606-10-50-13. In addition, an entity shall explain whether any consideration from contracts with customers is not included in the transaction price and, therefore, not included in the information disclosed in accordance with paragraph 606-10-50-13. For example, an estimate of the transaction price would not include any estimated amounts of variable consideration that are constrained (see paragraphs 606-10-32-11 through 32-13).

For health care entities, an example of performance obligations that are recognized over time may relate to those services provided to acute care patients in a hospital at period end (in-house patients) that have not yet been billed. However, because the in-house patient is typically discharged within the following fiscal year, a health care entity may elect to apply the optional exemption in FASB ASC 606-10-50-14a and would only make the required qualitative disclosures. Other health care entities may have other types of performance obligations remaining at the end of the reporting period and they would need to determine whether they meet the other optional exceptions provided in paragraphs 14b and 14A of FASB ASC 606-10-50 and, if not, make the disclosures required in FASB ASC 606-10-50-13.

7.7.44 The descriptive disclosures of an entity's performance obligations of FASB ASC 606-10-50-12 are required for all entities, but FASB ASC 606-10-50-16 indicates that the disclosure requirements in paragraphs 13–15 of FASB ASC 606-10-50 related to remaining performance obligations are not required for entities that are neither a public business entity nor a not-for-profit entity that 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.

Significant Judgments in the Application of the Guidance

7.7.45 FASB ASC 606-10-50-17 states the following:

An entity shall disclose the judgments, and changes in the judgments, made in applying the guidance in this Topic that significantly affect the determination of the amount and timing of revenue from contracts with customers. In particular, an entity shall explain the judgments, and changes in the judgments, used in determining both of the following:

- a. The timing of satisfaction of performance obligations (see paragraphs 606-10-50-18 through 50-19)
- b. The transaction price and the amounts allocated to performance obligations (see paragraph 606-10-50-20)

7.7.46 A health care entity will provide disclosure of the judgments, and any significant changes, that it makes in the determination of the amount and

timing of revenue recognized. This might include how the entity determines explicit and implicit price concessions for uninsured self-pay patients and insured patients with co-payments and deductibles, and any constraints on revenue. A hospital may describe when it satisfies performance obligations for the services it provides (for example, inpatient and outpatient services). A CCRC may describe when it satisfies its performance obligations, how the transaction price is determined, including entrance fees and monthly fees, and how the transaction price is allocated. A medical practice that performs multi-visit procedures may describe when it satisfies its performance obligations, how it determines the transaction price, and how it allocates the transaction price to each performance obligation or visit.

7.7.47 Determining the amount of implicit price concessions for contracts to provide health care services to uninsured and insured patients with co-payments and deductibles will likely involve significant judgments for many health care entities (refer to the "Arrangements for Health Care Services Provided to Uninsured and Insured Patients With Self-Pay Balances, Including Co-Payments and Deductibles" section in paragraphs 7.6.01–7.6.43). Although not required by FASB ASC 606, a health care entity may consider disclosing the amount of implicit price concessions included in estimating the transaction price each reporting period. This disclosure may provide meaningful information to users of financial statements in evaluating the judgments made by management in estimating the transaction price.

Determining the Timing of Satisfaction of Performance Obligations

7.7.48 If a health care entity has performance obligations that are satisfied over time, the health care entity should disclose both of the following, in accordance with FASB ASC 606-10-50-18:

- a. The methods used to recognize revenue (for example, a description of the output methods or input methods used and how those methods are applied). For example, a health care entity might measure progress toward the complete satisfaction of the performance obligation by measuring costs incurred relative to the total expected costs, or charges incurred relative to the total expected charges.
- b. An explanation of why the methods used provide a faithful depiction of the transfer of goods or services. For example, a health care entity might indicate that costs or charges incurred to date are a faithful depiction of the entity's performance (that is, transfer of goods or services to the patient).

7.7.49 For performance obligations satisfied at a point in time, a health care entity should disclose, in accordance with FASB ASC 606-10-50-19, the significant judgments made in evaluating when a customer obtains control of promised goods or services. A health care entity might consider the indicators of transfer of control from FASB ASC 606-10-25-30 in determining its disclosure.

Determining the Transaction Price and Amounts Allocated to Performance Obligations

7.7.50 Refer to the "Arrangements for Health Care Services Provided to Uninsured and Insured Patients With Self-Pay Balances, Including Co-Payments and Deductibles" section in paragraphs 7.6.01–7.6.43, and the "Application of FASB ASC 606 to Continuing Care Retirement Community

Contracts" section in paragraphs 7.6.109–7.6.162 for discussion on determining the transaction price.

7.7.51 Paragraph 20 of FASB ASC 606-10-50 requires health care entities to disclose information about the methods, inputs, and assumptions used for all of the following:

- a. "Determining the transaction price, which includes, but is not limited to, estimating variable consideration, adjusting the consideration for the effects of the time value of money, and measuring noncash consideration." A health care entity may disclose that implicit price concessions included in the estimate of the transaction price are based on historical collection experience. A health care entity also may disclose how it estimates retroactive settlements with third-party payors. If applicable, a CCRC may disclose how it estimates the significant financing component included in its payment arrangements (see the "Application of FASB ASC 606 to Continuing Care Retirement Community Contracts" section in paragraphs 7.6.109–7.6.162).
- b. "Assessing whether an estimate of variable consideration is constrained." A health care entity may disclose that its historical experience and range of potential outcomes take into account the constraint in the estimate of variable consideration or the factors considered in constraining the transaction price.
- c. "Allocating the transaction price, including estimating standalone selling prices of promised goods or services and allocating discounts and variable consideration to a specific part of the contract (if applicable)."
- d. "Measuring obligations for returns, refunds, and other similar obligations." A CCRC may disclose that it estimates its refundable advance fee each reporting period based on its historical experience.

7.7.52 FASB ASC 606-10-50-21 indicates that the following disclosure requirements are not required for entities that are neither a public business entity nor a not-for-profit entity that 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:

- a. FASB ASC 606-10-50-18b, which states that an entity should disclose, for performance obligations satisfied over time, an explanation of why the methods used to recognize revenue provide a faithful depiction of the transfer of goods or services to a customer
- b. FASB ASC 606-10-50-19, which states that an entity should disclose, for performance obligations satisfied at a point in time, the significant judgments made in evaluating when a customer obtains control of promised goods or services
- c. FASB ASC 606-10-50-20, which states that an entity should disclose the methods, inputs, and assumptions used to determine the transaction price and to allocate the transaction price. However, if an entity that is neither a public business entity nor a not-for-profit entity that 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 elects not to provide these disclosures, the entity should provide the disclosure in FASB ASC 606-10-50-20b, which

states that an entity should disclose the methods, inputs, and assumptions used to assess whether an estimate of variable consideration is constrained.

Practical Expedients

7.7.53 Based on the guidance in FASB ASC 606-10-50-22, a health care entity should disclose its policy for electing either of the following:

- a. The practical expedient provided by FASB ASC 606-10-32-18 about the existence of a significant financing component
- b. The practical expedient provided by FASB ASC 340-40-25-4 about incremental costs of obtaining a contract

7.7.54 FASB ASC 606-10-50-23 indicates that the disclosure requirements of FASB ASC 606-10-50-22 related to election of the practical expedients for existence of a significant financing component and incremental costs of obtaining a contract, respectively, are not required for an entity that is neither a public business entity nor a not-for-profit entity that 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.

Assets Recognized From the Costs to Obtain or Fulfill a Contract With a Customer

7.7.55 Refer to the "Accounting for Contract Costs" section in paragraphs 7.7.61–7.7.73 for discussion on assets recognized from the costs to obtain or fulfill a contract with a customer.

7.7.56 If a health care entity capitalized costs to obtain or fulfill a contract with a customer in accordance with paragraphs 1 or 5 of FASB ASC 340-40-25, it is required to make the following disclosures:

- a. A health care entity should describe both of the following in accordance with FASB ASC 340-40-50-2:
 - i. The judgments made in determining the amount of the costs incurred to obtain or fulfill a contract with a customer in accordance with FASB ASC 340-40-25-1 or 25-5
 - ii. The method it uses to determine the amortization for each reporting period.
- b. A health care entity should disclose all of the following in accordance with FASB ASC 340-40-50-3:
 - i. The closing balances of assets recognized from the costs incurred to obtain or fulfill a contract with a customer (in accordance with paragraphs 1 or 5 of FASB ASC 340-40-25), by main category of asset (for example, costs to obtain contracts with customers, precontract costs, and set-up costs)
 - ii. The amount of amortization and any impairment losses recognized in the reporting period
- c. Health care entities may apply the practical expedient provided in FASB ASC 340-40-25-4, which allows the health care entity to recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less. In accordance with FASB ASC 340-40-50-5, health care entities that have elected

the practical expedient provided in FASB ASC 340-40-25-4 should disclose that fact. Certain other health care entities (for example, CCRCs) may incur material costs to obtain customer contracts and if so they should provide the disclosures described previously (see the "Accounting for Contract Costs" section in paragraphs 7.7.61–7.7.73).

7.7.57 FASB ASC 340-40-50-6 indicates that an entity that is neither a public business entity nor a not-for-profit entity that 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 may elect not to provide the disclosures in paragraphs 3 and 5 of FASB ASC 340-40-50.

7.7.58 The following examples are illustrative only and only include disclosures related to FASB ASC 606. For instance, these examples do not include the disclosures that might be required by FASB ASC 275-10-50, *Risks and Uncertainties*; FASB ASC 954-280-45, *Health Care Entities—Segment Reporting* (regarding major customers); and FASB ASC 954-605-50-3, *Health Care Entities—Charity Care*. It is important that the actual determination of the appropriate disclosures be based on materiality and a health care entity's specific facts and circumstances. These examples illustrate how the disclosure guidance in FASB ASC 606 might be applied to certain health care entities. Other presentations also may be appropriate depending on the nature of the entity, how the entity manages its business, and the conclusions it makes about revenue recognition.

7.7.59 The following example is applicable to a health care entity that is either a public business entity or a not-for-profit health care entity that 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. This example assumes that the opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers are separately presented or disclosed on the health care entity's financial statements.

Example 7-7-1 — Public Entity or Entity With Public Debt

Patient Care Service Revenue

Patient care service revenue is reported at the amount that reflects the consideration to which the Organization expects to be entitled in exchange for providing patient care. These amounts are due from patients, third-party payors (including health insurers and government programs), and others and includes variable consideration for retroactive revenue adjustments due to settlement of audits, reviews, and investigations. Generally, the Organization bills the patients and third-party payors several days after the services are performed or the patient is discharged from the facility. Revenue is recognized as performance obligations are satisfied.

Performance obligations are determined based on the nature of the services provided by the Organization. Revenue for performance obligations satisfied over time is recognized based on actual charges incurred in relation to total expected (or actual) charges. The Organization believes that this method provides a faithful depiction of the transfer of services over the term of the performance obligation based on the inputs needed to satisfy the obligation. Generally, performance obligations satisfied over time relate to patients in our hospital(s) receiving inpatient acute care services or patients receiving services in our outpatient centers or in their homes (home care). The Organization measures the

performance obligation from admission into the hospital, or the commencement of an outpatient service, to the point when it is no longer required to provide services to that patient, which is generally at the time of discharge or completion of the outpatient services. Revenue for performance obligations satisfied at a point in time is generally recognized when goods are provided to our patients and customers in a retail setting (for example, pharmaceuticals and medical equipment) and the Organization does not believe it is required to provide additional goods or services related to that sale.

Because all of its performance obligations relate to contracts with a duration of less than one year, the Organization has elected to apply the optional exemption provided in FASB ASC 606-10-50-14a and, therefore, is not required to disclose the aggregate amount of the transaction price allocated to performance obligations that are unsatisfied or partially unsatisfied at the end of the reporting period. The unsatisfied or partially unsatisfied performance obligations referred to previously are primarily related to inpatient acute care services at the end of the reporting period. The performance obligations for these contracts are generally completed when the patients are discharged, which generally occurs within days or weeks of the end of the reporting period.

The Organization determines the transaction price based on standard charges for goods and services provided, reduced by contractual adjustments provided to third-party payors, discounts provided to uninsured patients in accordance with the Organization's policy, and implicit price concessions provided to uninsured patients. The Organization determines its estimates of contractual adjustments and discounts based on contractual agreements, its discount policies, and historical experience. The Organization determines its estimate of implicit price concessions based on its historical collection experience with this class of patients.

Agreements with third-party payors typically provide for payments at amounts less than established charges. A summary of the payment arrangements with major third-party payors follows:

- **Medicare.** Certain inpatient acute care services are paid at prospectively determined rates per discharge based on clinical, diagnostic, and other factors. Certain services are paid based on cost-reimbursement methodologies subject to certain limits. Physician services are paid based upon established fee schedules. Outpatient services are paid using prospectively determined rates.
- **Medicaid.** Reimbursements for Medicaid services are generally paid at prospectively determined rates per discharge, per occasion of service, or per covered member.
- **Other.** Payment agreements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations provide for payment using prospectively determined rates per discharge, discounts from established charges, and prospectively determined daily rates.

Laws and regulations concerning government programs, including Medicare and Medicaid, are complex and subject to varying interpretation. As a result of investigations by governmental agencies, various health care organizations have received requests for information and notices regarding alleged noncompliance with those laws and regulations, which, in some instances, have resulted in organizations entering into significant settlement agreements. Com-

pliance with such laws and regulations may also be subject to future government review and interpretation, as well as significant regulatory action, including fines, penalties, and potential exclusion from the related programs. There can be no assurance that regulatory authorities will not challenge the Organization's compliance with these laws and regulations, and it is not possible to determine the impact (if any) such claims or penalties would have upon the Organization. In addition, the contracts the Organization has with commercial payors also provide for retroactive audit and review of claims.

Settlements with third-party payors for retroactive adjustments due to audits, reviews, or investigations are considered variable consideration and are included in the determination of the estimated transaction price for providing patient care. These settlements are estimated based on the terms of the payment agreement with the payor, correspondence from the payor, and the Organization's historical settlement activity, including an assessment to ensure that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the retroactive adjustment is subsequently resolved. Estimated settlements are adjusted in future periods as adjustments become known (that is, new information becomes available), or as years are settled or are no longer subject to such audits, reviews, and investigations. Adjustments arising from a change in the transaction price were not significant in 20X2 or 20X1. [Or, disclose the amounts and explain significant adjustments.]

Generally, patients who are covered by third-party payors are responsible for related deductibles and coinsurance, which vary in amount. The Organization also provides services to uninsured patients, and offers those uninsured patients a discount, either by policy or law, from standard charges. The Organization estimates the transaction price for patients with deductibles and coinsurance and from those who are uninsured based on historical experience and current market conditions. The initial estimate of the transaction price is determined by reducing the standard charge by any contractual adjustments, discounts, and implicit price concessions. Subsequent changes to the estimate of the transaction price are generally recorded as adjustments to patient service revenue in the period of the change. For the years ended December 31, 20X2 and 20X1, additional revenue of \$XXX and \$XXX, respectively, was recognized due to changes in its estimates of implicit price concessions, discounts, and contractual adjustments for performance obligations satisfied in prior years. Subsequent changes that are determined to be the result of an adverse change in the patient's ability to pay are recorded as bad debt expense.

Consistent with the Organization's mission, care is provided to patients regardless of their ability to pay. Therefore, the Organization has determined it has provided implicit price concessions to uninsured patients and patients with other uninsured balances (for example, copays and deductibles). The implicit price concessions included in estimating the transaction price represent the difference between amounts billed to patients and the amounts the Organization expects to collect based on its collection history with those patients.

Patients who meet the Organization's criteria for charity care are provided care without charge or at amounts less than established rates. Such amounts determined to qualify as charity care are not reported as revenue.

The Organization has determined that the nature, amount, timing, and uncertainty of revenue and cash flows are affected by the following factors: payors,

geography, service lines, method of reimbursement, and timing of when revenue is recognized. The following tables provide details of these factors.

The composition of patient care service revenue by primary payor for the years ended December 31 is as follows:

	20X2	20X1
Medicare	\$ 16,000	\$ 15,000
Medicaid	6,000	5,000
Managed care	11,000	10,500
Commercial insurers	4,000	3,500
Uninsured	1,800	1,900
Other	1,000	1,000
	39,800	36,900

Revenue from patient's deductibles and coinsurance are included in the preceding categories based on the primary payor.

The composition of patient care service revenue based on the regions of the country the Organization operates in, its lines of business, method of reimbursement, and timing of revenue recognition for the years ended December 31, 20X2 and 20X1 are as follows:

	20X2			
	Northeast	Central	Southeast	Total
Services lines:				
Hospital-inpatient	\$ 3,500	\$ 1,000	\$ 3,000	\$ 7,500
Hospital-outpatient	4,500	2,000	2,000	8,500
Physician services	3,000	3,000	5,000	11,000
Home health and hospice	1,000	800	2,000	3,800
Retail sales	2,000	2,000	4,000	8,000
Other	400	200	400	1,000
	14,400	9,000	16,400	39,800
Method of reimbursement:				
Fee for service	8,900	5,300	6,000	20,200
Capitation and risk sharing	3,100	1,500	6,000	10,600
Other	2,400	2,200	4,400	9,000
	14,400	9,000	16,400	39,800

	20X2			
	Northeast	Central	Southeast	Total
Timing of revenue and recognition:				
Health care services transferred over time	12,400	7,000	12,400	31,800
Retail pharmacy and equipment sales at point in time	2,000	2,000	4,000	8,000
	14,400	9,000	16,400	39,800

[Notes: 1. Although not included in this example, a similar table would be required for 20X1 for comparative purposes. 2. FASB ASC 606-10-50-6 would require a reconciliation of this information to the segment disclosures for a public business entity.]

Financing component

Example A

The Organization has elected the practical expedient allowed under FASB ASC 606-10-32-18 and does not adjust the promised amount of consideration from patients and third-party payors for the effects of a significant financing component due to the Organization's expectation that the period between the time the service is provided to a patient and the time that the patient or a third-party payor pays for that service will be one year or less. However, the Organization does, in certain instances, enter into payment agreements with patients that allow payments in excess of one year. For those cases, the financing component is not deemed to be significant to the contract.

Example B

The Organization has entered into contracts with patients that provide for payments ratably over two years with no stated interest rate. The Organization adjusts the promised amount of consideration due from these patients using discount rates ranging from X% to XX% to account for the effects of the financing component. For the years ended December 31, 20X2 and 20X1, interest income of \$XX and \$XX, respectively, was recognized. At December 31, 20X2 and 20X1, the unamortized discount was \$XX and \$XX, respectively.

Contract costs

Example A

The Organization has applied the practical expedient provided by FASB ASC 340-40-25-4 and all incremental customer contract acquisition costs are expensed as they are incurred, as the amortization period of the asset that the Organization otherwise would have recognized is one year or less in duration.

Example B

The Organization has elected to apply the practical expedient provided by FASB ASC 340-40-25-4, and expense as incurred the incremental customer contract acquisition costs for contracts in which the amortization period of the asset that the Organization otherwise would have recognized is one year or less.

However, incremental costs incurred to obtain customer contracts for which the amortization period of the asset that the Organization otherwise would have recognized is longer than one year are capitalized and amortized over the life of the contract based on the pattern of revenue recognition from these contracts. The Organization regularly considers whether the unamortized contract acquisition costs are impaired if they are not recoverable under the contract. During the year ended December 31, 20X2, \$XX of unamortized costs were expensed as a result of the impairment analysis. During the years ended December 31, 20X2 and 20X1, the Organization recognized amortization expense of \$XX and \$XX, respectively. At December 31, 20X2 and 20X1, the unamortized customer contract acquisition costs are \$XXX and \$XXX, respectively, and are presented in other assets on the accompanying balance sheets.

7.7.60 The following example is applicable to a health care entity that is other than a public business entity or a not-for-profit health care entity that 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, that elected the disclosure exclusions of paragraphs 7, 11, 16, 21, and 23 of FASB ASC 606-10-50, and FASB ASC 340-40-50-6. This example assumes that the opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers are separately presented or disclosed on the health care entity's financial statements.

Example 7-7-2 — Entity that is neither a public business entity nor a not-for-profit entity that 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

Patient Care Service Revenue

Patient care service revenue is reported at the amount that reflects the consideration to which the Organization expects to be entitled in exchange for providing patient care. These amounts are due from patients, third-party payors (including health insurers and government payors), and others and includes variable consideration for retroactive revenue adjustments due to settlement of audits, reviews, and investigations. Generally, the Organization bills the patients and third-party payors several days after the services are performed or the patient is discharged from the facility. Revenue is recognized as the performance obligations are satisfied.

Performance obligations are determined based on the nature of the services provided by the Organization. Revenue for performance obligations satisfied over time is recognized based on actual charges incurred in relation to total expected (or actual) charges. The Organization believes that this method provides a faithful depiction of the transfer of services over the term of the performance obligation based on the inputs needed to satisfy the obligation. Generally, performance obligations satisfied over time relate to patients in our hospitals receiving inpatient acute care services or patients receiving services in our outpatient centers or in their homes (home care). The Organization measures the performance obligation from admission into the hospital, or the commencement of an outpatient service, to the point when it is no longer required to provide services to that patient, which is generally at the time of discharge or completion of the outpatient services. Revenue for performance obligations satisfied at a point in time is generally recognized when goods are provided to our patients and customers in a retail setting (for example, pharmaceuticals and medical

equipment), and the Organization does not believe it is required to provide additional goods or services related to that sale.

The Organization determines the transaction price based on standard charges for goods and services provided, reduced by contractual adjustments provided to third-party payors, discounts provided to uninsured patients in accordance with the Organization's policy, or implicit price concessions provided to uninsured patients. The Organization determines its estimates of contractual adjustments and discounts based on contractual agreements, its discount policies, and historical experience. The Organization determines its estimate of implicit price concessions based on its historical collection experience with this class of patients.

Agreements with third-party payors provide for payments at amounts less than established charges. A summary of the payment arrangements with major third-party payors follows:

- **Medicare.** Certain inpatient acute care services are paid at prospectively determined rates per discharge based on clinical, diagnostic, and other factors. Certain services are paid based on cost-reimbursement methodologies subject to certain limits. Physician services are paid based upon established fee schedules. Outpatient services are paid using prospectively determined rates.
- **Medicaid.** Reimbursements for Medicaid services are generally paid at prospectively determined rates per discharge, per occasion of service, or per covered member.
- **Other.** Payment agreements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations provide for payment using prospectively determined rates per discharge, discounts from established charges, and prospectively determined daily rates.

Laws and regulations concerning government programs, including Medicare and Medicaid, are complex and subject to varying interpretation. As a result of investigations by governmental agencies, various health care organizations have received requests for information and notices regarding alleged noncompliance with those laws and regulations, which, in some instances, have resulted in organizations entering into significant settlement agreements. Compliance with such laws and regulations may also be subject to future government review and interpretation as well as significant regulatory action, including fines, penalties, and potential exclusion from the related programs. There can be no assurance that regulatory authorities will not challenge the Organization's compliance with these laws and regulations, and it is not possible to determine the impact (if any) such claims or penalties would have upon the Organization. In addition, the contracts the Organization has with commercial payors also provide for retroactive audit and review of claims.

Settlements with third-party payors for retroactive revenue adjustments due to audits, reviews or investigations are considered variable consideration and are included in the determination of the estimated transaction price for providing patient care. These settlements are estimated based on the terms of the payment agreement with the payor, correspondence from the payor and the Organization's historical settlement activity, including an assessment to ensure that it is probable that a significant reversal in the amount of cumulative revenue

recognized will not occur when the uncertainty associated with the retroactive adjustment is subsequently resolved. Estimated settlements are adjusted in future periods as adjustments become known (that is, new information becomes available), or as years are settled or are no longer subject to such audits, reviews, and investigations.

Consistent with the Organization's mission, care is provided to patients regardless of their ability to pay. Therefore, the Organization has determined it has provided implicit price concessions to uninsured patients and other uninsured balances (for example, copays and deductibles). The implicit price concessions included in estimating the transaction price represents the difference between amounts billed to patients and the amounts the Organization expects to collect based on its collection history with those patients.

Patients who meet the Organization's criteria for charity care are provided care without charge or at amounts less than established rates. Such amounts determined to qualify as charity care are not reported as revenue.

Generally, patients who are covered by third-party payors are responsible for related deductibles and coinsurance, which vary in amount. The Organization also provides services to uninsured patients and offers those uninsured patients a discount, either by policy or law, from standard charges. The Organization estimates the transaction price for patients with deductibles and coinsurance and from those who are uninsured based on historical experience and current market conditions. The initial estimate of the transaction price is determined by reducing the standard charge by any contractual adjustments, discounts, and implicit price concessions based on historical collection experience. Subsequent changes to the estimate of the transaction price are generally recorded as adjustments to patient service revenue in the period of the change. Subsequent changes that are determined to be the result of an adverse change in the patient's ability to pay are recorded as bad debt expense.

The Organization has determined that the nature, amount, timing, and uncertainty of revenue and cash flows are affected by the following factors:

- Payors (for example, Medicare, Medicaid, managed care or other insurance, patient) have different reimbursement and payment methodologies
- Length of the patient's service or episode of care
- Geography of the service location
- Method of reimbursement (fee for service or capitation)
- Organization's line of business that provided the service (for example, hospital inpatient, hospital outpatient, nursing home, and so on)

For the years ended December 31, 20X2 and 20X1, the Organization recognized revenue of \$XX and \$XX, respectively, from goods and services that transfer to the customer over time and \$XX and \$XX, respectively, from goods and services that transfer to the customer at a point in time.

Accounting for Contract Costs

This Accounting Implementation Issue Is Relevant for Accounting for Contract Costs Under FASB ASC 340-40.

Background

7.7.61 Health care entities may enter into various contracts in which they incur incremental costs of obtaining a contract or costs to fulfill a contract. Examples of these arrangements are CCRC contracts, prepaid health plans, risk-sharing contracts, or other contracts in which a health care entity incurs costs to acquire or fulfill a contract that are not in the scope of existing cost guidance (for example, fixed assets).

Incremental Costs to Obtain a Contract

7.7.62 Health care service providers incur costs that are related to securing a contract with customers (for example, patients, residents, or members). Examples of these costs are marketing, advertising, costs to enroll members, commissions, incentive compensation, salaries and benefits, processing costs, actuarial, and legal expenses. Health care entities should evaluate costs associated with acquiring new contracts to determine if these costs meet the requirements for capitalization as an asset under paragraphs 1–3 of FASB ASC 340-40-25 or should be expensed as incurred. In accordance with FASB ASC 340-40-25-1, "an entity shall recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs." To determine if the costs are recoverable, a health care entity may consider the pricing of the contract and whether the incremental costs could be recovered through direct reimbursement under the contract or recovered through the margin inherent in a contract. If a health care entity determines that its contract acquisition costs are not recoverable, then the health care entity should expense those costs in accordance with FASB ASC 340-40-25-1.

7.7.63 FASB ASC 340-40-25-2 indicates that "[t]he incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract that the entity would not have incurred had the contract not been obtained..." Identifying if costs are incremental to the contract likely will require analysis of how the various contracts are obtained, which costs are directly associated with the contracts, and if those costs would have been incurred regardless of the outcome of securing the contract. Examples of costs that may qualify to be capitalized as incremental costs include the following:

- a. Sales commissions
- b. Contingent legal fees (fees that are payable only if there is a successful negotiation of a contract)
- c. Other costs incurred only as a result of obtaining the contract

7.7.64 Paragraphs 2–4 of FASB ASC 340-40-55 provide an example of incremental costs of obtaining a contract and note that sales commissions to employees may be considered incremental. CCRCs often enter into sales commission arrangements related to obtaining new entrance fee contracts. In accordance with FASB ASC 340-40-25-3, sales commissions that are directly related to sales achieved during a time period typically represent incremental costs that would require capitalization. FinREC believes some bonuses and other compensation that is based on other quantitative or qualitative metrics (that is, profitability or performance evaluations not tied to the sales of

contracts) typically do not meet the criteria for capitalization because they are not directly related to obtaining a contract.⁴

7.7.65 As FASB ASC 340-40-25-3 describes, those "costs to obtain a contract that would have been incurred regardless of whether the contract was obtained shall be recognized as an expense when incurred, unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained." For example, travel costs to deliver a proposal, external legal fees to perform due diligence, and salaries related to personnel working on a specific contract proposal would likely have been incurred regardless of whether the contract was obtained and, therefore, would not be considered incremental. As discussed in FASB ASC 340-40-25-8a, general and administrative costs are expensed as incurred unless they are explicitly charged to the contract, in which case, the entity would apply FASB ASC 340-40-25-7.

7.7.66 Historically, CCRCs were allowed to capitalize the initial costs of acquiring a contract under FASB ASC 954-340-25. These costs included the costs of acquiring initial continuing care contracts that had the following characteristics:

- a. Costs incurred to originate a contract.
- b. Costs resulting from and that are essential to the acquisition of the initial contract.
- c. The costs are incurred through the date of substantial occupancy but no later than one year from the date of completion construction.

These costs typically reflected costs of processing the contract, such as evaluating the prospective resident's financial condition, negotiating contract terms, processing contract documents, and marketing salaries to solicit potential initial residents. However, FASB ASC 954-340-25 has been superseded and, therefore, costs of acquiring a contract need to be evaluated under FASB ASC 340-40-25, as noted in paragraph 7.7.62. In most cases, the salary costs and other costs to originate a contract are paid even if the contract is ultimately not executed. FinREC believes that generally the initial costs incurred to market a facility and process the contract are not incremental to obtaining a specific contract and, therefore, should be expensed as incurred.⁵

7.7.67 At the date of initial application, an organization should evaluate if there are any unamortized costs that no longer qualify for capitalization under FASB ASC 340-40. FASB ASC 606-10-65-1 allows entities two options when transitioning to the guidance under FASB ASC 606. The first option is full retrospective application of FASB ASC 606, which requires reflecting the cumulative effect of the change on the opening equity balance of the earliest period presented and adjusting the financial statements for each prior period presented to reflect the effect of applying FASB ASC 606, as described in FASB ASC 606-10-65-1d1. As an alternative, under FASB ASC 606-10-65-1d2, entities may apply the amendments to FASB ASC 606 retrospectively with the cumulative effect recognized at the date of initial application. Under this transition method, an entity may elect to apply this guidance retrospectively either to all contracts at

⁴ For further consideration regarding potential implementation issues related to commission arrangements, health care entities are encouraged to refer to paragraphs 13–15 of the FASB/IASB Joint Transition Resource Group for Revenue Recognition (TRG) Agenda Ref. No. 25, *January 2015 Meeting — Summary of Issues Discussed and Next Steps*.

⁵ Paragraphs 14–28 of TRG Agenda Ref. No. 57, *Capitalization and Amortization of Incremental Costs of Obtaining a Contract*, provide examples of salary costs that are incremental to a contract.

the date of initial application or only to contracts that are not completed at the date of initial application. Under either method, the unamortized costs that no longer qualify for capitalization would be derecognized through a cumulative effect adjustment, either as of the beginning of the earliest period presented under FASB ASC 606-10-65-1d1 or as of the beginning of the period of adoption under FASB ASC 606-10-65-1d2.

7.7.68 As a practical expedient, FASB ASC 340-40-25-4 notes that an entity may recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less. For example, in a prepaid health contract situation, an organization may have incremental costs of a contract, but the contract period is often for a one-year period, in which case, the practical expedient could be applied. In determining the contract period, an organization should evaluate the time period that services are provided to the customer and not the overall relationship with the payor, who is acting as a third party to pay for some or all of the services on the patient's behalf. For further discussion of the payor relationship, refer to paragraph 7.6.46 of the section, "Third-Party Settlement Estimates." If an organization incurs additional incremental costs of obtaining a contract for a subsequent renewal period, those costs should be evaluated for capitalization under FASB ASC 340-40 and the practical expedient under FASB ASC 340-40-25-4. (See further discussion in paragraph 7.7.70 related to the amortization period for capitalized costs to obtain the initial contract.) A CCRC entrance fee contract typically spans the life of the resident which, in most cases, is greater than a year, and so the practical expedient would not apply.

Costs to Fulfill a Contract

7.7.69 In accordance with FASB ASC 340-40-25-6 for costs to fulfill a contract, a health care entity should first determine if the cost is within the scope of other FASB ASC guidance (such as FASB ASC 330, *Inventory*; FASB ASC 360, *Property, Plant, and Equipment*; and FASB 720-35 on advertising costs). In order for a health care entity to capitalize costs of fulfilling a contract that is not within the scope of existing FASB ASC cost guidance, all the criteria in FASB ASC 340-40-25-5 are required to be met, including the criterion in FASB ASC 340-40-25-5b that "the costs generate or enhance resources of the entity that will be used by the entity in satisfying (or in continuing to satisfy) performance obligations in the future." For example, most costs of labor and supplies do not solely generate or enhance resources to be used to satisfy performance obligations in the future.

Amortization and Impairment

7.7.70 As described in FASB ASC 340-40-35-1, an asset recognized either for incremental costs of obtaining a contract with a customer or for costs incurred to fulfill a contract "shall be amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates" (periods of expected contract renewals would be included, unless a commission paid on a contract renewal is commensurate with the commission paid on the initial contract).⁶ In addition, FASB ASC 340-40-35-2 states

⁶ Paragraphs 8–18 of TRG Agenda Ref. No. 23, *Incremental Costs of Obtaining a Contract*, and paragraph BC309 of FASB Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, discuss considerations related to contract renewals and the impact on the amortization period.

that, "an entity shall update the amortization to reflect a significant change in the entity's expected timing of transfer to the customer of the goods or services to which the asset relates." FASB ASC 250-10 requires such a change to be accounted for as a change in accounting estimate. Such a change could be indicative of impairment of the related assets, and entities should evaluate the facts and circumstances to determine the appropriate conclusions.

7.7.71 In accordance with FASB ASC 340-40-35-1, the asset recognized for contract acquisition costs capitalized in accordance with FASB ASC 340-40-25-1 related to a CCRC entrance fee contract should be amortized on a systematic basis that is consistent with the transfer to the customer of the services or goods to which the asset relates. As discussed in paragraphs 7.6.149–7.6.152 of the section, "Application of FASB ASC 606 to Continuing Care Retirement Community Contracts," there are various appropriate methods for a CCRC to measure progress that are generally categorized as output methods and input methods. For a CCRC entrance fee contract, FinREC believes that the amortization of related contract acquisition costs capitalized in accordance with FASB ASC 340-40-25-1 should mirror the pattern of transfer of the goods and services.

7.7.72 For other contracts that have multiple performance obligations, it is important that health care entities apply judgment to determine how to amortize the asset consistent with the pattern of performance for the underlying performance obligation or obligations. For example, an organization could allocate the asset to the individual performance obligations on a relative basis and amortize each respective portion of the asset based on the pattern of the performance for that individual underlying performance obligation. An alternative method would be to amortize the single asset using one measure of performance considering all the performance obligations in the contract.⁷

7.7.73 FASB ASC 340-40-35-3 describes that "[a]n entity shall recognize an impairment loss in profit or loss to the extent that the carrying amount of an asset recognized..." for incremental costs of obtaining a contract with a customer or for costs incurred to fulfill a contract exceeds:

- a. The amount of consideration that the entity expects to receive in the future and that the entity has received but has not recognized as revenue, in exchange for the goods or services to which the asset relates ("the consideration"), less
- b. The costs that relate directly to providing those goods or services and that have not been recognized as expenses (see paragraphs 340-40-25-2 and 340-40-25-7).

⁷ Paragraphs 60–67 of TRG Agenda Ref. No. 23 discuss considerations related to the amortization of contract assets related to multiple performance obligations.

Chapter 11

Contributions Received and Made

Gray shaded text in this chapter reflects guidance issued but not yet effective as of the date of this guide, September 1, 2021, but becoming effective on or prior to June 30, 2022, 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.

11.01 Health care entities that receive contributions are subject to the requirements of the "Contributions Received" sections of FASB *Accounting Standards Codification* (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 AICPA 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 The "Pending Content" in FASB ASC 958-605-55-4 states that foundations, business entities, and other types of entities may provide resources to health care entities (both not-for-profit [NFP] or business entities) under programs referred to as grants, awards, or sponsorships. Those asset transfers are contributions if the resource providers do not receive commensurate 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. 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.

11.06 The "Pending Content" in FASB ASC 958-605-15-5A states that when determining whether a transfer of assets is an exchange transaction in which a resource provider (for example, a government agency, a foundation, a corporation, or other entity) receives commensurate value in return for the resources transferred or a contribution, the type of resource provider should not factor into the determination and an entity should evaluate the terms of an agreement and consider the following:

- a. The resource provider (including a foundation, a government agency, a corporation, or other entity) is not synonymous with the general public. A benefit received by the public as a result of the assets transferred is not equivalent to commensurate value received by the resource provider. Therefore, if the resource provider receives indirect value in exchange for the assets transferred or if the value received by the resource provider is incidental to the potential public benefit from using the assets transferred, the transaction shall not be considered commensurate value received in return.
- b. Execution of the resource provider's mission or the positive sentiment from acting as a donor shall not constitute commensurate value received by the resource provider for purposes of determining whether the transfer of assets is a contribution or an exchange.
- c. If the expressed intent asserted by both the recipient and the resource provider is to exchange resources for goods or services that are of commensurate value, the transaction shall be indicative of an exchange transaction. The transaction shall be indicative of a contribution if the recipient solicits assets from the resource provider without the intent of exchanging goods or services of commensurate value.
- d. If the resource provider has full discretion in determining the amount of the transferred assets, the transaction shall be indicative of a contribution. If both the recipient and the resource provider agree on the amount of assets transferred in exchange for goods and services that are of commensurate value, the transaction shall be indicative of an exchange transaction.
- e. If the penalties assessed on the recipient for failure to comply with the terms of the agreement are limited to the delivery of assets or services already provided and the return of the unspent amount, the transaction is generally indicative of a contribution. The existence of contractual provisions for economic forfeiture beyond the amount of assets transferred by the resource provider to penalize the recipient for nonperformance generally indicates that the transaction is an exchange of commensurate value.

Additional information about distinguishing a contribution from an exchange transaction is provided in chapter 5 of AICPA Audit and Accounting Guide *Not-for-Profit Entities*.

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 include 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 FASB ASC 958-605-45-3 requires that an NFP distinguish between contributions received with donor-imposed restrictions and those received without donor-imposed restrictions. The former should be reported as donor-restricted support that increases net assets with donor restrictions. The latter should be reported as support that increases net assets without donor restrictions. As noted in paragraph 3.17, items that reflect increases or decreases in net assets with donor restrictions 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 958-220-45-13 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 restrictions that are temporary in nature 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, in determining when the last of two or more donor-imposed restrictions that are

temporary in nature has expired, explicit donor stipulations generally carry more weight than implied restrictions. When the restriction expires, net assets with donor restrictions are reclassified to net assets without donor restrictions, and are reported in the statement of operations as "Net Assets Released From Restriction." In accordance with FASB ASC 958-220-45-3, reclassifications are presented as separate items. FASB ASC 954-220-45-8 provides guidance on the presentation of these items within or outside of the performance indicator.

11.13 The "Pending Content" in paragraphs 4A–4B of FASB ASC 958-605-45 states that an NFP may elect a policy to report donor-restricted contributions whose restrictions are met in the same reporting period as the revenue is recognized as support within net assets without donor restrictions provided that the NFP has a similar policy for reporting investment gains and income (see FASB ASC 958-220-45-24), reports consistently from period to period, and discloses its accounting policy. An NFP may elect that policy for donor-restricted contributions that were initially conditional contributions (the condition has been met) without also having to elect it for other donor-restricted contributions or investment gains and income provided that the NFP 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 9.17–.22 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 AICPA 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 In accordance with the "Pending Content" in FASB ASC 958-605-25-11, conditional promises to give, which contain donor-imposed conditions that represent a barrier that must be overcome as well as a right of release from obligation, should be recognized when the condition or conditions on which they depend are substantially met, that is, when a conditional promise becomes unconditional. Imposing a condition creates a barrier that must be overcome before the recipient is entitled to the assets promised. For example, a promise to contribute cash if a like amount of new gifts is raised from others within 30 days and a provision that the cash will not be transferred if the gifts are not raised impose a condition on which entitlement to a promised gift depends. The "Pending Content" in FASB ASC 958-605-25-5F states that 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

11.19 The "Pending Content" in FASB ASC 958-605-55-16 states that if a donor stipulation is not related to the purpose of the agreement (generally stipulations that are administrative or trivial), that stipulation is not indicative of a barrier. (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 barrier if the administrative requirement is not related to the purpose of the agreement.) The "Pending Content" in FASB ASC 958-605-55-17B notes that it is possible that some agreements that do not contain any barriers could contain either a right of return of assets transferred or a right of release from obligation. For example, some foundations include a right-of-return or a right-of-release-from-obligation clause in their agreements as a matter of policy and standard wording but impose no barriers that must be achieved before a recipient is entitled to the resources. If so, the resources would be considered unconditional and revenue would be recognized immediately. Additional information about distinguishing unconditional from conditional promises to give is provided in chapter 5 of AICPA Audit and Accounting Guide *Not-for-Profit Entities*.

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 donor-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 net assets with donor restrictions.

11.21 Technical Questions and Answers (Q&A) section 6140.03, "Lapsing of Time Restrictions on Receivables That Are Uncollected at Their Due Date,"² explains that time restrictions on contributions receivable lapse when the receivable is due. In some cases, the due date may be explicitly stated. In other cases, circumstances surrounding receipt of the contribution may make clear the implicit due date. In yet other cases, the due date may be unclear. NFPs should consider the facts and circumstances surrounding the promise to give to determine the due date, if any. At the due date, the time restriction expires and the net assets become available for the purpose specified by the donor. If the donor did not specify a purpose or otherwise restrict the contribution and the promise is to be paid in one future payment, the related net assets with

¹ According to FASB *Accounting Standards Codification* (ASC) 958-605-25-5E, in cases of ambiguous donor stipulations, a contribution containing stipulations that are not clearly unconditional shall be presumed to be a conditional contribution. Additional guidance on distinguishing conditional from unconditional promises is provided in the "Pending Content" in paragraphs 5A–5F of FASB ASC 958-605-25, FASB ASC 958-605-25-15, and the "Pending Content" in paragraphs 15–17F of FASB ASC 958-605-55.

² All Q&A sections can be found in *Technical Questions and Answers*. *Technical Questions and Answers* can be downloaded at <https://www.aicpa.org/resources/download/aicpa-technical-questions-and-answers-at-your-fingertips>.

donor restrictions will be reclassified to net assets without donor restrictions in the period in which that payment is due. If instead the donor sets forth a schedule of future payments, a reclassification from net assets with donor restrictions to net assets without donor restrictions is made in each period that a payment is due. In the period(s) in which the restrictions expire, net assets with donor restrictions or the portion of net assets with donor restrictions that relate to the particular payment installment are reclassified to net assets without donor restrictions 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 would be reasonable to conclude 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 collectibility. 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 Unless the entity elects to subsequently measure contributions receivable at fair value in conformity with the "Fair Value Option" sections of FASB ASC 825-10, the subsequent measurement of contributions receivable is discussed in paragraphs 4–13 of FASB ASC 958-310-35. 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 958-310-45-3.³ 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.

³ According to the "Pending Content" in FASB ASC 958-310-45-3, because all expenses are reported as decreases in the net assets without donor restrictions class, those decreases should be reported as losses if they are decreases in net assets with donor restrictions.

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.

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. Pursuant to FASB ASC 958-605-30-2, contributions of property and equipment (including unconditional promises to give property and equipment) should be recognized at fair value at the date of contribution. In accordance with FASB ASC 958-605-45-6, gifts of long-lived assets received without stipulations about how long the donated asset must be used should be reported as revenue without donor restrictions. Contributions of long-lived assets with explicit donor restrictions are reported as donor-restricted support.

11.26 Contributions of cash or other assets that must be used to acquire or construct long-lived assets are reported as donor-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 available for current use and without donor restrictions. 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 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 958-360-45-1 states that if property, plant, and equipment item being depreciated was contributed to the NFP with an explicit donor-imposed restriction on the length of time of the item's use, net assets with donor restrictions should be reclassified as net assets without donor restrictions in a statement of activities as those restrictions expire. The amount reclassified may or may not be equal to the amount of the related depreciation. The amount to be reclassified should be based on the length of time indicated by the donor-imposed restrictions, if restrictions exist, whereas the amount of depreciation should be based on the useful economic life of the asset. Absent donor stipulations specifying how long such donated assets or assets constructed or acquired with cash restricted for such acquisition or construction must be used, restrictions on long-lived assets, if any, expire when the assets are placed in service.

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 Master 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 Pursuant to FASB ASC 954-220-45-3, the increase in net assets associated with services received from personnel of an affiliate that directly benefit the recipient NFP health care entity and for which the affiliate does not charge the recipient entity should be reported as an equity transfer, regardless of whether those services are received from personnel of an NFP affiliate or any other affiliate. The corresponding decrease in net assets or the creation or enhancement of an asset resulting from the use of services received from personnel of an affiliate should be reported similar to how other such expenses or assets are reported.

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 958-220-45-19 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 958-220-55 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 acknowledgement 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 11-1 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 net asset classification of the contribution received. 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 11-1
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," discusses the classification of dividend, interest and other investment income, and gains and losses. Chapter 9, "Net Assets (Equity)," discusses the classification of the investment return 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.⁴

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 Master 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

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, 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.

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 (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 12.83), 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 958-20-25-1 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.⁵ Examples 1–3 in paragraphs 3–17 of FASB ASC 958-20-55 provide examples of this guidance. Q&A sections 6400.35–.42 provide 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 AICPA Audit and Accounting Guide *Not-for-Profit Entities*.

⁵ 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.

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. Conditional promises to give should be recognized when the condition or conditions on which they depend are substantially met; that is, when the conditional promise becomes unconditional, in accordance with the "Pending Content" in FASB ASC 958-605-25-11. The guidance in FASB ASC 958-605 on determining whether a contribution is conditional applies to both contributions made by a resource provider and contributions received by a recipient. (Paragraphs 11.17–20 discuss whether a promise to give is a conditional.) 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 ASC 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 AICPA 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. The following paragraphs assume that the entity has not elected the "Fair Value Option" sections of FASB ASC 825-10 to report contributions receivable at fair value in subsequent periods.

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 collectibility. After the date of initial measurement, bad debt expense should be reported for the amount of promises to give that are expected to be uncollectible.

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 contributions that increase net assets without donor restrictions, NFP health care entities should apply the standards in paragraphs 5–8 of FASB ASC 954-220-45 to determine whether contributions are reported within or outside the performance indicator in the statement of operations.

11.58 NFP health care entities often receive nonfinancial assets as contributions, such as materials and supplies, services, use of fixed assets or utilities, and intangible assets. FASB ASC 958-605-30-2 requires those contributions to be measured at their fair values. The "Pending Content" in FASB ASC 958-605-45-7A requires that contributed nonfinancial assets be presented as a separate line item in the statement of activities, apart from contributions of cash and other financial assets. Disclosures about contributed nonfinancial assets are required by the "Pending Content in FASB ASC 958-605-50-1."⁶

11.59 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.

⁶ FASB ASU No. 2020-07, *Not-for-Profit Entities (Topic 958): Presentation and Disclosures by Not-for-Profit Entities for Contributed Nonfinancial Assets*, issued in September 2020, is effective for annual periods beginning after June 15, 2021, and interim periods within annual periods beginning after June 15, 2022. Early adoption is permitted.

Auditing

© Update 11-1 *Auditing: Audit Evidence, Auditing Accounting Estimates, Use of Specialists, and Use of Pricing Information*

This edition of the guide has not been updated to reflect changes as a result of the issuance of the following Statements on Auditing Standards (SAS):

- SAS No. 142, *Audit Evidence* (AU-C sec. 500)
- SAS No. 143, *Auditing Accounting Estimates and Related Disclosures* (AU-C sec. 540)
- SAS No. 144, *Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources*

SAS No. 142 is effective for audits of financial statements for periods ending on or after December 15, 2022. SAS Nos. 143 and 144 are effective for audits of financial statements for periods ending on or after December 15, 2023. Early implementation is permitted.

The following section will be updated in a future edition. Readers should refer to the preface for further details regarding these SASs. Readers are encouraged to consult the full text of the SASs at aicpa.org.

11.60 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.

11.61 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 controls in place. Paragraph .02 of AU-C section 265B, *Communicating Internal Control Related Matters Identified in an Audit*,⁷ 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.⁸ 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 265B, 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 265B, 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.

⁷ All AU-C sections can be found in AICPA *Professional Standards*.

⁸ Paragraphs .13 and .A61–.A67 of AU-C section 315B, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, provide guidance on obtaining an understanding of internal control relevant to the audit.

11.62 In order to have an effective system of internal control, an NFP health care entity that receives significant amounts of contributions should 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.

11.63 Contributions received are measured at fair value. AU-C section 540B, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*,⁹ 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.

11.64 Paragraph .20 of AU-C section 330B, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, 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 330B, 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 330B, the auditor may nevertheless decide to request confirmation of contributions receivable. If the auditor decides to confirm promises to give, the auditor may consider communicating this approach to the fund-raising or donor relations department of the auditee due to the potential sensitive nature of donor-donor relationships.

11.65 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 505B, *External Confirmations*, provides guidance concerning the confirmation process.

⁹ AU-C section 540A, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, reflects amendments made by SAS No. 134 to AU-C section 540B. Auditors that have implemented Statement on Auditing Standards (SAS) Nos. 134–140 and the amendments to other SASs made by SAS Nos. 134–140 will use AU-C section 540A until they implement SAS No. 143, *Auditing Accounting Estimates and Related Disclosures*.

11.66 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 330B, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, 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 315B, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. Various audit procedures and the purposes for which they may be performed are described in paragraphs .A10–.A26 of AU-C section 500B, *Audit Evidence*.

Audit Considerations

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives¹⁰</i>	<i>Substantive Audit Procedures¹¹</i>
Transactions			
<i>Contributions Received</i>			
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.

¹⁰ The auditor should consider a combination of preventative and detective controls responsive to the control objectives.

¹¹ 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			
<i>Contributions Receivable</i>			
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. Consider confirmation as discussed in paragraph 11.65.
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 collectibility.
		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.
<i>Promises to Give</i>			
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

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
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.
<i>Agency Transactions</i>			
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.

Exhibit 11-1¹²

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 330B, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, 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 315B, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. Various audit procedures and the purposes for which they may be performed are described in paragraphs .A10–.A26 of AU-C section 500A, *Audit Evidence*.

Audit Considerations

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives¹³</i>	<i>Substantive Audit Procedures¹⁴</i>
Account Balances			
Contributions Receivable (Promises to Give)			
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. Consider confirmation as discussed in paragraph 11.65.

(continued)

¹² SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the Auditing Standards Board (ASB) recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

¹³ The auditor should consider a combination of preventative and detective controls responsive to the control objectives.

¹⁴ 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>
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 fundraising function, and investigate reconciling items.
Accuracy/ valuation and allocation	Contributions receivable are appropriately valued.	Controls ensure the appropriate valuation of promises to give at the time of initial recognition. The valuation of promises to give is periodically reviewed by management.	Review and test the methods and assumptions used to measure promises to give at the time of initial recognition. Review promises to give for collectibility.
Completeness, Presentation	All disclosures related to contributions are complete, clear and understandable.	Controls ensure that contributions are appropriately presented and disclosed.	Determine the completeness, clarity, and understandability of disclosures for conditional and unconditional promises to give.
Contributions and Grants Payable (Promises to Give)			
Existence; Rights and Obligations	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.
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.

Audit Considerations — *continued*

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
Accuracy/ 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.
Presentation; Completeness	All disclosures related to contributions payable are complete, clear and understandable.	Controls ensure that contributions payable are appropriately presented and disclosed.	Determine the completeness, clarity, and understandability of disclosures for conditional and unconditional promises to give payable.
Agency Transactions			
Rights and Obligations, Existence	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. 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.
Completeness	All agency transactions are recognized.	Controls ensure that agency transactions are identified and reported only in the statement of financial position.	Review the documentation underlying the distribution of assets to others for propriety of classification and recognition.

(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	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.
Classes of 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 fundraising function, and determine whether a contribution should have been recognized and, if so, vouch it to a recognized contribution, investigating reconciling items.

Audit Considerations — continued

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
Accuracy/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. Write-offs of uncollectible promises to give are identified and approved in accordance with the entity's established policy.	Review and test the methods and assumptions used to measure contribution revenue at the time of initial recognition. Review write-offs and recoveries of uncollectible promises to give.
Cut-off	Contributions are reported in the period in which an unconditional promise was received.	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.
Classification	Restricted contributions are reported in the proper net asset class.	Contributions are reviewed for restrictions and other limitations.	Review the documentation underlying contributions, including donor correspondence and governing board minutes, for propriety of classification, including classification within or outside the performance indicator.
Contributed Services, Utilities, Facilities, and Use of Long-Lived Assets			
Occurrence, completeness, accuracy/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.

(continued)

Audit Considerations — *continued*

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
Completeness	All contributions received that meet the recognition criteria are recognized.	Controls ensure that contributions of nonfinancial assets are identified and recorded if they meet recognition criteria.	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.
Contributions Made			
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.
Accuracy/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.
Cut-off	All contributions made 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 fiscal period-end to ascertain that contributions made were recorded in the proper period.

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, 2021, but becoming effective on or prior to June 30, 2022, 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," 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 12.73–.74.

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 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

(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% 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–.37
The reporting entity owns 50% 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 321-10-35.	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. If the guidance in FASB ASC 970-810 is not used, use the guidance in FASB ASC 321-10-35.	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. If not consolidated, use the equity method.	Paragraphs 12.41–.42, 12.48

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 a limited 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 958-810-25 to determine if a limited partner has a controlling financial interest. If not consolidated, use the guidance in FASB ASC 321-10-35.	Paragraphs .41–.42, 12.48
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. If not consolidated, use the guidance in FASB ASC 321-10-35.	Paragraphs 12.29, 12.38
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 12.45–.47
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. If the equity method is not used, use the guidance in FASB ASC 321-10-35.	Paragraph 12.44

(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 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 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 12.51–.55
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 12.56–.58
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.

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 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 12.59
^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 Master 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 Master 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 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 membership¹ 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.² 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.

¹ 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.

² Additional information about the consolidation of entities controlled by contract can be found in paragraphs 12.29–32.

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

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.³ 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

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, 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 4.62–.64 and 12.80–.83 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.

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.⁴ 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 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 323-10.⁵

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 gifts without donor restrictions 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 net assets without donor restrictions, 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 gifts without donor restrictions would be distributed to affiliates in accordance with a specified formula, each affiliate would include its share of net assets without donor restrictions, 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.

⁴ Foundations that are not providers of health care services are not covered by this guide and should follow AICPA Audit and Accounting Guide *Not-for-Profit Entities*.

⁵ 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.

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 12.81), 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 discussion of variance power in paragraph 11.42). 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 Master 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).

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–.42⁶ and in chapter 5, "Contributions Received and Agency Transactions," of AICPA Audit and Accounting Guide *Not-for-Profit Entities*.

⁶ All Q&A sections can be found in *Technical Questions and Answers*. *Technical Questions and Answers* can be downloaded at <https://www.aicpa.org/resources/download/aicpa-technical-questions-and-answers-at-your-fingertips>.

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 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 810-10-17, 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.

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 in Entities Other Than Limited Partnerships or Similar Legal Entities

12.29 FASB ASC 958-810-15-4(a) states that an NFP with a controlling financial interest through direct or indirect ownership of a majority voting interest in a for-profit entity that is other than a limited partnership or similar legal entity should apply the guidance in the "General" subsections of FASB ASC 810-10. Per FASB ASC 810-10-15-8 and FASB ASC 810-10-25-1, 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% 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 generally not subject to the guidance for variable interest entities.

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 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

12.33 FASB ASC 958-810-15-4(c) states that an NFP that owns 50% 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% or less of the common stock or in-substance common stock (or both common stock and in-substance common stock). 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.

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% 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% 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% 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 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 12.30, 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 954-220-45-8(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 reports its interest in the for-profit business entity in conformity with FASB ASC 958-321-35-1, which requires NFPs to measure the interest using the guidance in FASB ASC 321-10-35 (paragraph 4.31).⁷ 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*. If the NFP does not analogize to the guidance in FASB ASC 970-810, the NFP reports its interest

⁷ Note that FASB ASC 321, *Investments — Equity Securities*, uses the term *equity securities* to include equity instruments that do not meet the definition of a security. Thus, ownership interests in all entities, including general partnerships, limited liability companies, limited liability partnerships, joint ventures, and so forth, are within the scope of FASB ASC 321, unless they are consolidated subsidiaries or accounted for using the equity method.

in the general partnership in conformity with FASB ASC 958-321-35-1, which requires NFPs to measure the interest using the guidance in FASB ASC 321-10-35 (paragraph 4.31).⁸ 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% ownership account and NFP B has a 30% 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. If the NFP does not analogize to the guidance in FASB ASC 970-810, the NFP reports its interest in the general partnership at fair value, or may elect the alternate measurement in FASB ASC 321-10-35-2. 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 3.146 of 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 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 12.29 for a limited liability company that is the functional equivalent of a regular corporation.

12.42 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. Paragraphs 14–19 of FASB ASC 958-810-25 provide guidance for purposes of assessing whether the limited partners' rights might preclude a general partner from controlling a limited partnership. 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 overcome and each of the general partners should account for its investment in the limited partnership using the equity method of accounting.

12.43 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

⁸ Note that FASB ASC 321 uses the term *equity securities* to include equity instruments that do not meet the definition of a security. Thus, ownership interests in all entities, including general partnerships, limited liability companies, limited liability partnerships, joint ventures, and so forth, are within the scope of FASB ASC 321, unless they are consolidated subsidiaries or accounted for using the equity method.

limited partnership. A limited partner is deemed to have a controlling financial interest if the limited partner directly or indirectly owns more than 50% 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.

12.44 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. If the NFP does not analogize to the guidance in FASB ASC 970-323, the NFP reports its interest in the general partnership in conformity with FASB ASC 958-321-35-1, which requires NFPs to measure the interest using the guidance in FASB ASC 321-10-35 (paragraph 4.31).⁹ 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.

12.45 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 12.49 provides additional information about distinguishing a minor interest from a more than a minor interest.

12.46 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.

⁹ Note that FASB ASC 321 uses the term *equity securities* to include equity instruments that do not meet the definition of a security. Thus, ownership interests in all entities, including general partnerships, limited liability companies, limited liability partnerships, joint ventures, and so forth, are within the scope of FASB ASC 321, unless they are consolidated subsidiaries or accounted for using the equity method.

12.47 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.

12.48 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, the limited partner should account for its investment in accordance with FASB ASC 321, *Investments — Equity Securities* (paragraph 4.31).

12.49 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% to 5% to be more than minor.

Special Entities

12.50 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

12.51 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.

12.52 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.

12.53 According to FASB ASC 958-810-25-9, to satisfy the at-risk requirement in FASB ASC 958-810-25-8(c) (see paragraph 12.52), 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.

12.54 FASB ASC 958-810-25-10 states that if all the conditions in FASB ASC 958-810-25-8 (see paragraph 12.52) 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 12.52). 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.

12.55 FinREC believes that 3% 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% 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

12.56 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.

12.57 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.

12.58 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 on principal versus agent considerations in paragraphs 36–40 of FASB ASC 606-10-55. An entity should not apply the equity method of accounting to activities of collaborative arrangements.

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*. An entity should not apply the equity method of accounting to activities of 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 on principal versus agent considerations in paragraphs 36–40 of FASB ASC 606-10-55. The "Pending Content" in paragraphs 5A–5C of FASB ASC 808-10-15 clarifies that transactions between collaborative arrangement participants should be accounted for as revenue under FASB ASC 606, *Revenue from Contracts with Customers*, when the collaborative arrangement participant is a customer in the context of a unit of account. In those situations, all the guidance in FASB ASC 606 should be applied, including recognition, measurement, presentation, and disclosure requirements. A unit of account is identified as a promised good or service (or bundle of goods or services) that is distinct within the collaborative arrangement using the guidance in FASB ASC 606-10-15-4 and paragraphs 19–22 of FASB ASC 606-10-25.

The "Pending Content" in FASB ASC 808-10-45-3 states that parts of a collaborative arrangement that are within the scope of other authoritative accounting literature, as described in the "Pending Content" in FASB ASC 808-10-15-5A, should be presented using the relevant provisions of that literature. If parts of the arrangement are outside the scope of other authoritative accounting literature, the presentation of those parts should be based on an analogy to authoritative accounting literature or if there is no appropriate analogy, a reasonable, rational, and consistently applied accounting policy election. An entity should evaluate the presentation of parts of a collaborative arrangement on the basis of the nature of the arrangement, the nature of its business operations, and the contractual terms of the arrangement. For example, if one party to an arrangement is required to make a payment to the other party to reimburse a portion of that party's research and development costs, that portion of the net payment may be classified as research and development expense in the payor's financial statements in accordance with FASB ASC 730,

Research and Development. An entity is precluded from presenting transactions in a collaborative arrangement together with revenue from contracts with customers unless the entity applies the guidance in FASB ASC 606 to a unit of account that is within the scope of that Topic in accordance with the "Pending Content" in FASB ASC 808-10-15-5B.¹⁰

Other Special-Purpose Entities

12.59 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

12.60 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. Paragraph 12.63 describes an accounting alternative for a private company for entities under common control.
- 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

¹⁰ FASB Accounting Standards Update (ASU) No. 2018-18, *Collaborative Arrangements (Topic 808): Clarifying the Interaction between Topic 808 and Topic 606*, issued in November 2018, is effective for public business entities for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Early adoption is permitted.

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.

- 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.

12.61 If application of the guidance in paragraph 12.60 does not result in a determination that there is a controlling financial interest (consolidation) or significant influence (equity method), the investor-owned health care entity reports its equity investment in conformity with FASB ASC 321 (paragraph 4.31).¹¹ 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). For investor-owned health care entities that are registrants, FASB ASC 323-30-S99-1 states that the SEC staff's position is that investments in all limited partnerships should be accounted for pursuant to FASB ASC 970-323-25-6, which requires the use of the equity method unless the investor's interest "is so minor that the limited partner may have virtually no influence over partnership operating and financial policies" (paragraphs 12.48–.49).

12.62 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.

12.63 *Alternatives Available to Private Companies*

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 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.

¹¹ Note that FASB ASC 321 uses the term *equity securities* to include equity instruments that do not meet the definition of a security. Thus, ownership interests in all entities, including general partnerships, limited liability companies, limited liability partnerships, joint ventures, and so forth, are within the scope of FASB ASC 321, unless they are consolidated subsidiaries or accounted for using the equity method.

- 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.

A private company (the reporting entity) may elect to not apply VIE guidance to a legal entity under common control when certain conditions are met. For entities that make this election, there are certain disclosure requirements per the "Pending Content" in paragraphs 2AG–2AI of FASB ASC 810-10-50 unless the legal entity is consolidated by the reporting entity through accounting guidance other than VIE guidance. Per the "Pending Content" in FASB ASC 810-10-15-17AD, a private company (reporting entity) need not evaluate legal entity by under the guidance in the VIE Subsections if all of the following criteria are met:

- a. The reporting entity and the legal entity are under common control.
- b. The reporting entity and the legal entity are not under common control of a public business entity.
- c. The legal entity under common control is not a public business entity.
- d. The reporting entity does not directly or indirectly have a controlling financial interest in the legal entity when considering the General Subsections of FASB ASC 810, *Consolidation*. The Variable Interest Entities Subsections should not be applied when making this determination.

If a private company elects to apply this accounting alternative, it should apply this alternative to all legal entities for which criteria *a–d* are met. A reporting entity that elects the accounting alternative and, thus, does not apply the guidance in the VIE Subsections should continue to apply other accounting guidance (including guidance in the General Subsections of FASB ASC 810-10) unless another scope exception from FASB ASC 810 applies.¹²

Presentation of Consolidated and Combined Financial Statements

12.64 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

¹² FASB ASU No. 2018-17, *Consolidation (Topic 810): Targeted Improvements to Related Party Guidance for Variable Interest Entities*, was issued October 2018. The amendments in this ASU are effective for a private company for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.

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 12.63 provides additional information about the alternative for private companies.

12.65 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.

12.66 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.

12.67 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 securities owned by the investor-owned entity are measured and reported using the standards in FASB ASC 320, rather than being remeasured using the standards in FASB ASC 958-320.

12.68 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 should 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 9.16 provides additional information about noncontrolling interests.

12.69 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.

12.70 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.

12.71 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.

12.72 However, neither generally accepted accounting principles (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.

12.73 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.

12.74 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 800B, *Special Considerations — Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*, establishes requirements and provides guidance regarding auditor's reports.

Accounting for Transfers Between Related Entities

12.75 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

12.76 The FASB ASC Master 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

¹³ Contractual agreements or regulatory provisions may require parent company-only financial statements. AU-C section 800B, *Special Considerations — Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*, provides guidance for reporting on financial presentations to comply with contractual agreements or regulatory provisions.

All AU-C sections can be found in AICPA *Professional Standards*.

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 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 954-220-45-2, 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. Paragraphs 11.31–32 discuss reporting an equity transfer if an NFP health care entities receive services from personnel of an affiliate that directly benefit the health care entity for which the affiliate does not charge the health care entity.

12.77 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.

12.78 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.

12.79 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

12.80 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.

12.81 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 Master 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 Master 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."

12.82 Per FASB ASC 958-20-55-2B, 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 as a counterparty in a transfer from an entity to itself. In addition, an equity transaction, unlike an equity transfer, is reciprocal; the NFP 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 Master 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 12.76–.79).

12.83 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 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 4.64) for each period for which a statement of financial position is presented.

Other Transfers

12.84 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, *Consolidation*.

12.85 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 12.77–79.

12.86 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.

12.87 Subsequent to the time that a receivable is recorded, the ability of the receiving entity to repay the receivable should be considered.

12.88 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 954-220-45-2, with the transferor reducing net assets and the transferee increasing net assets at the date such determination is made. See paragraphs 12.76–79 for additional discussion.

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.

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.

Disclosure

12.89 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 550B, *Related Parties*, establishes requirements and provides guidance for the auditor when determining the existence of transactions with related parties and identifying them.

12.90 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.

Mergers and Acquisitions

12.91 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 12.92–.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.

12.92 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.

12.93 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.

12.94 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.

12.95 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.

12.96 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

12.97 The FASB ASC Master 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.

12.98 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

12.99 The FASB ASC Master 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.

12.100 FASB ASC 958-805-15-4 requires that an NFP acquirer determine whether a transaction or other event is an acquisition by an NFP by determining whether the acquired assets and assumed liabilities constitute a business or nonprofit activity, as defined. If the acquired assets are not a business or a nonprofit activity, the reporting entity should account for the transaction or other event as an asset acquisition. For example, as described in paragraphs 5A–5C of FASB ASC 805-10-55, if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, the set is not considered a business. 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

12.101 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.

12.102 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.

12.103 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 If the accounting alternative in FASB ASC 805-20 is applied, an NFP acquirer should not 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.

¹⁷ Reporting noncontrolling interests in financial statements is discussed in chapter 11, "Net Assets and Reclassification of Net Assets" of AICPA Audit and Accounting Guide *Not-for-Profit Entities*.

12.104 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 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.

12.105 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

12.106 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).

12.107 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.

12.108 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 donor 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 donor-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, to net assets with donor restrictions acquired in an acquisition.

Performance Indicator

12.109 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

12.110 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 without donor restrictions or with donor restrictions. A contribution without donor restrictions should be presented within the performance indicator. A contribution with donor restrictions should be presented outside the performance indicator.

12.111 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

12.112 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. For example, as described in paragraphs 5A–5C of FASB ASC 805-10-55, if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, the set is not considered a business. An entity should account for each business combination by applying the acquisition method.

12.113 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

12.114 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.

12.115 *Alternatives Available to Private Companies*

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

12.116 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

12.117 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

© Update 12-1 **Auditing: Audit Evidence, Auditing Accounting Estimates, Use of Specialists, and Use of Pricing Information**

This edition of the guide has not been updated to reflect changes as a result of the issuance of the following Statements on Auditing Standards (SASs):

- SAS No. 142, *Audit Evidence* (AU-C sec. 500)
- SAS No. 143, *Auditing Accounting Estimates and Related Disclosures* (AU-C sec. 540)
- SAS No. 144, *Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources*

SAS No. 142 is effective for audits of financial statements for periods ending on or after December 15, 2022. SAS Nos. 143 and 144 are effective for audits of financial statements for periods ending on or after December 15, 2023. Early implementation is permitted.

The following section will be updated in a future edition. Readers should refer to the preface for further details regarding these SASs. Readers are encouraged to consult the full text of the SASs at aicpa.org.

12.118 The 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, "Audit Considerations."

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 330B, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, 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 315B, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. Various audit procedures and the purposes for which they may be performed are described in paragraphs .A10–.A26 of AU-C section 500B, *Audit Evidence*.

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			
<i>Transactions/Account Balances/Presentation and Disclosure</i>			
Existence and occurrence, completeness, and presentation and disclosure	The reporting entity is appropriate.	Procedures ensure that investees, affiliates, and other related entities are accounted for appropriately.	Review the articles of incorporation, bylaws, and minutes of directors' meetings; shareholder lists; and filings with regulatory authorities to determine the existence of related parties.
			Obtain representations from management 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.

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>
	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: • 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 as follows: • Consider previously identified transactions or relationships. • Review the minutes of directors' and other meetings. • Discuss related-party transactions with entity personnel. • Review unusual transactions. • Review 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.

Exhibit 12-2²⁰

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 330B, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, 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 315B, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. Various audit procedures and the purposes for which they may be performed are described in paragraphs .A10–.A26 of AU-C section 500A, *Audit Evidence*.

Audit Considerations

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i> ²¹	<i>Substantive Audit Procedures</i> ²²
Account Balances			
Reporting Entity and Related Entities			
Existence, Completeness, Presentation	The reporting entity is appropriate.	Procedures ensure that investees, affiliates, and other related entities are identified and accounted for appropriately.	Review the articles of incorporation, bylaws, and minutes of directors' meetings; shareholder lists; and filings with regulatory authorities to determine the existence of related parties. Obtain representations from management about whether all investees, affiliates, and related entities have been accounted for properly or disclosed.

²⁰ Statement on Auditing Standards (SAS) Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the Auditing Standards Board (ASB) recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

²¹ The auditor should consider a combination of preventative and detective controls responsive to the control objectives.

²² 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.

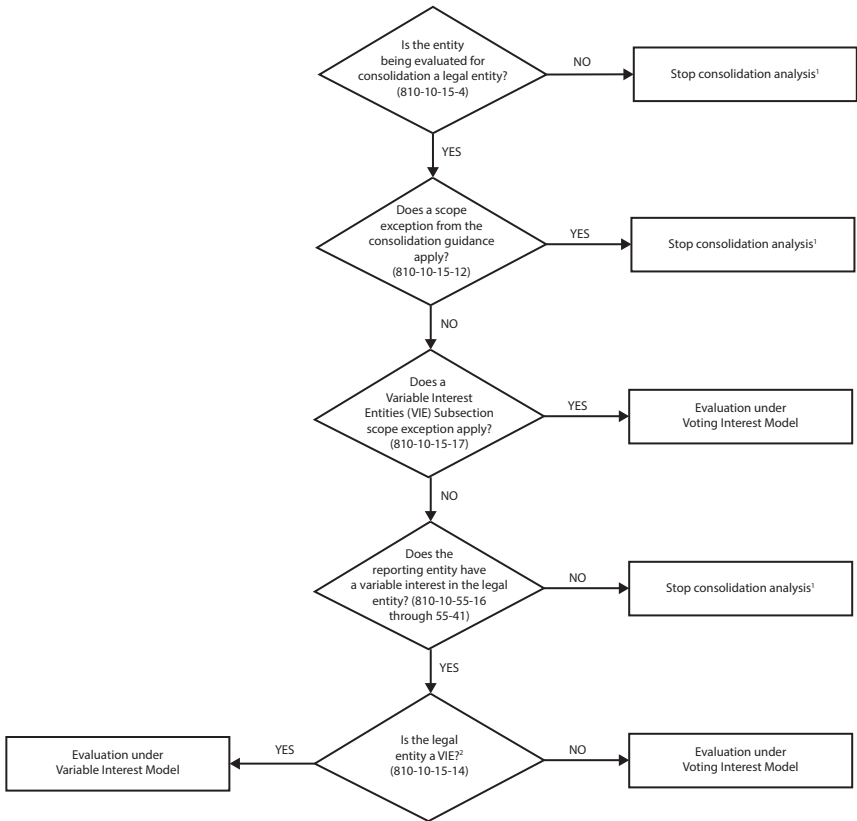
Audit Considerations — continued

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
<i>Classes of Transactions</i>			
Reporting Entity and Related Entities			
Presentation	Relationships and transactions with related entities are identified and disclosed, if appropriate.	Controls identify transactions with related parties for disclosure.	Review transactions with investees, affiliates, and other related entities to determine that they are properly reported and clearly expressed.
Completeness, Accuracy	Transactions with related entities are identified and disclosed, if appropriate.	Controls identify transactions with related parties for disclosure.	Test significant related-party transactions as follows: • Determine substance. • Examine documents (invoices, contracts, and agreements). • Determine the basis of pricing. • Determine the collectibility of receivables and advances.
Completeness	Transactions with related entities are identified and disclosed, if appropriate.	Controls identify transactions with related parties for disclosure.	Review related-party transactions for completeness as follows: • Consider previously identified transactions or relationships. • Review the minutes of directors' and other meetings. • Discuss related-party transactions with entity personnel. • Review unusual transactions. • Review the responses to related-party (conflict-of-interest) questionnaires.
Presentation; Completeness	All related-party transactions and entities are properly reported.	Controls identify transactions with related parties for disclosure.	Review the presentation and disclosure of related-party information for completeness and understandability.

Supplement — Flowcharts

Consolidation Analysis for an Investor-Owned
Health Care Entity

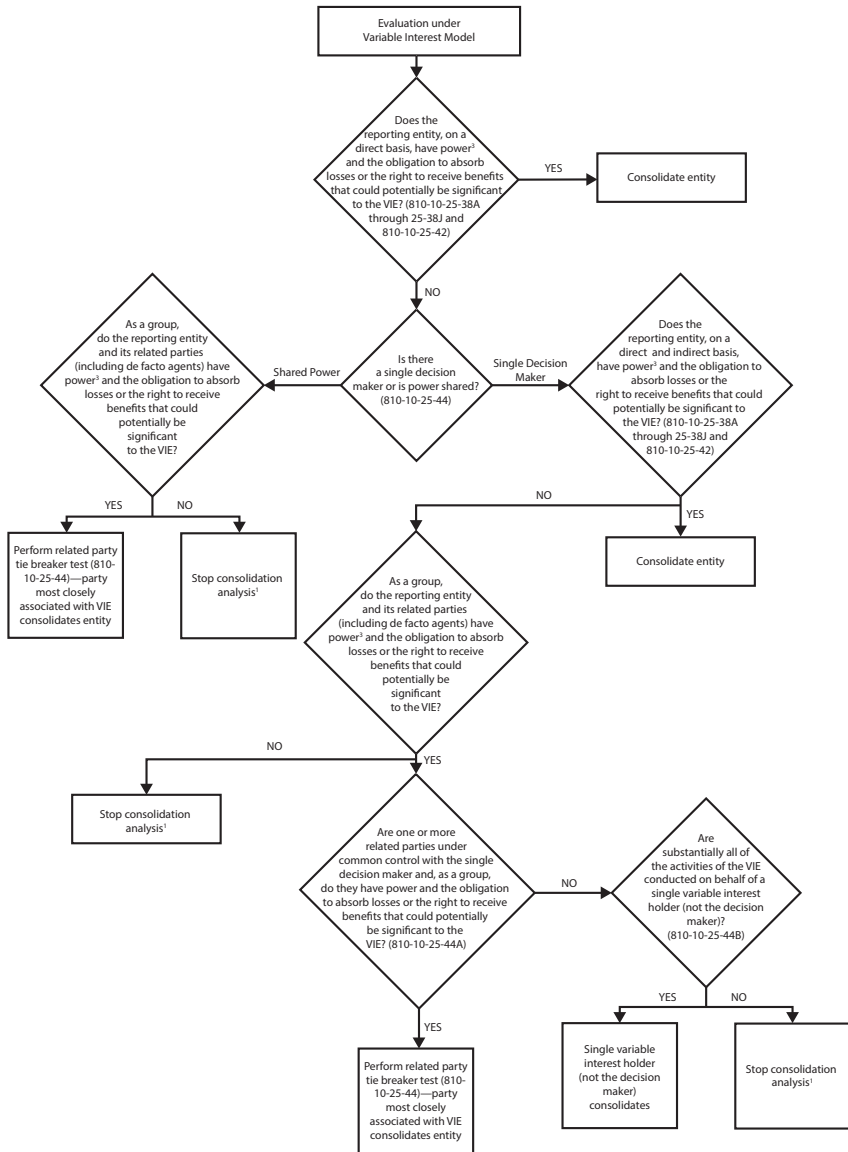
The following flowchart from FASB ASC 810-10-05-6 provides an overview of the guidance in FASB ASC 810-10 for evaluating whether an investor-owned health care reporting entity should consolidate another legal entity. The flowchart does not include all of the guidance in FASB ASC 810-10 and is not intended as a substitute for that guidance. For example, the flowchart does not illustrate the consolidation analysis for entities controlled by contract.



¹ Consolidation not required; however, evaluation of other generally accepted accounting principles (GAAP) may be relevant to determine recognition, measurement, or disclosure.

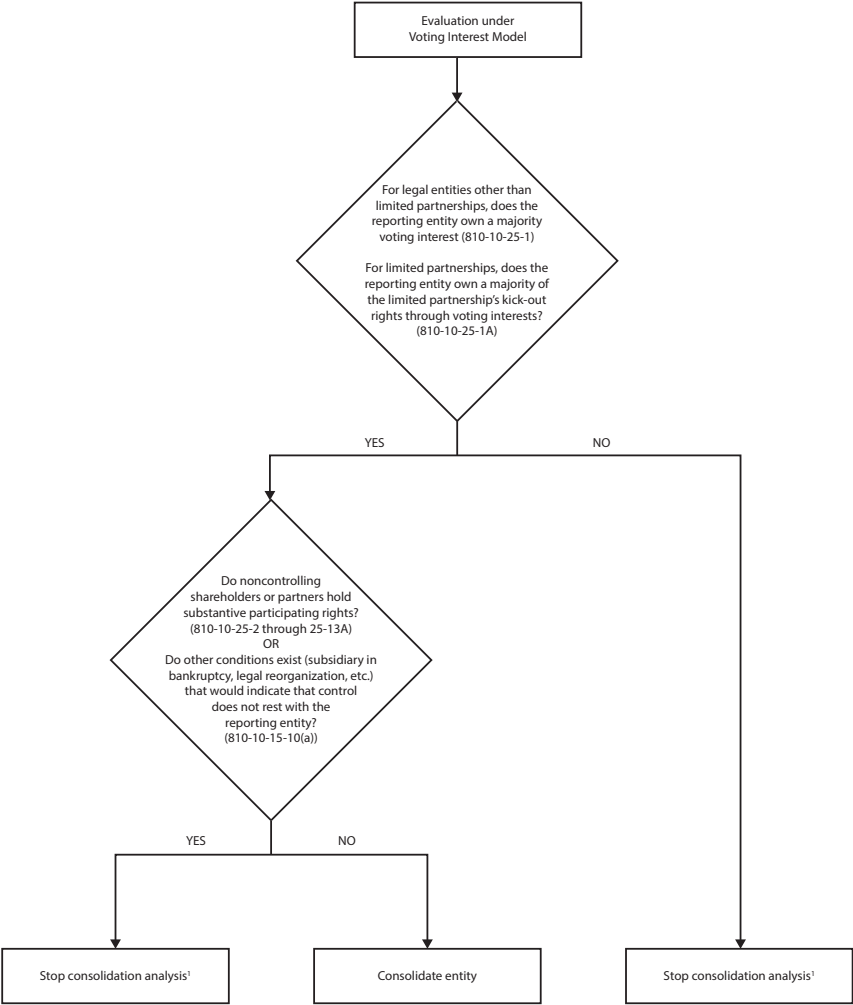
² A legal entity is a VIE if any of the following conditions exist:

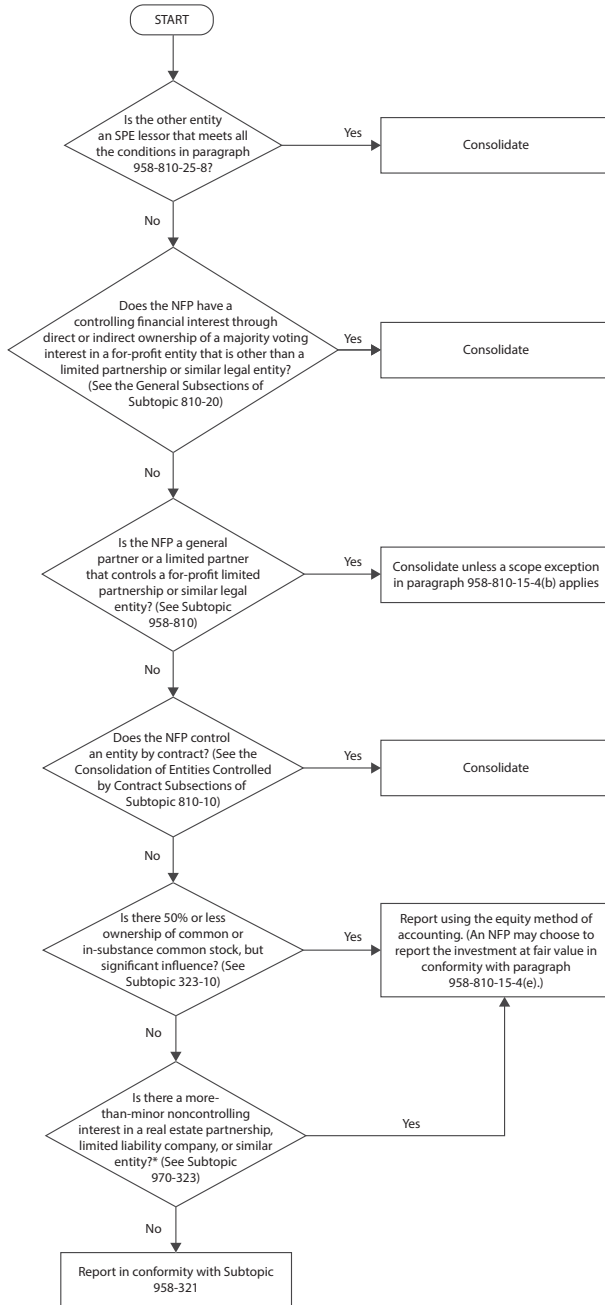
- a. The equity investment at risk is not sufficient to finance the activities of the entity without additional subordinated financial support provided by any parties.
- b. As a group, the holders of the equity investment at risk lack any of the following characteristics of a controlling financial interest:
 - 1. The power to direct the activities that most significantly impact the entity's economic performance:
 - i. For legal entities other than limited partnerships, investors lack that power through voting rights or similar rights if no owners hold voting rights or similar rights (such as those of a common shareholder in a corporation).
 - ii. For limited partnerships, partners lack that power if neither (01) nor (02) below exists:
 - 01. A simple majority or lower threshold of limited partners (including a single limited partner) with equity at risk is able to exercise substantive kick-out rights through voting interests over the general partner(s).
 - 02. Limited partners with equity at risk are able to exercise substantive participating rights over the general partner(s).
 - 2. The obligation to absorb expected losses.
 - 3. The right to receive expected residual returns.
- c. The equity investors' voting rights are not proportional to the economics, and substantially all of the activities of the entity either involve or are conducted on behalf of an investor that has disproportionately few voting rights.



¹ Power is defined as the power to direct the activities of a VIE that most significantly impact the VIE's economic performance.

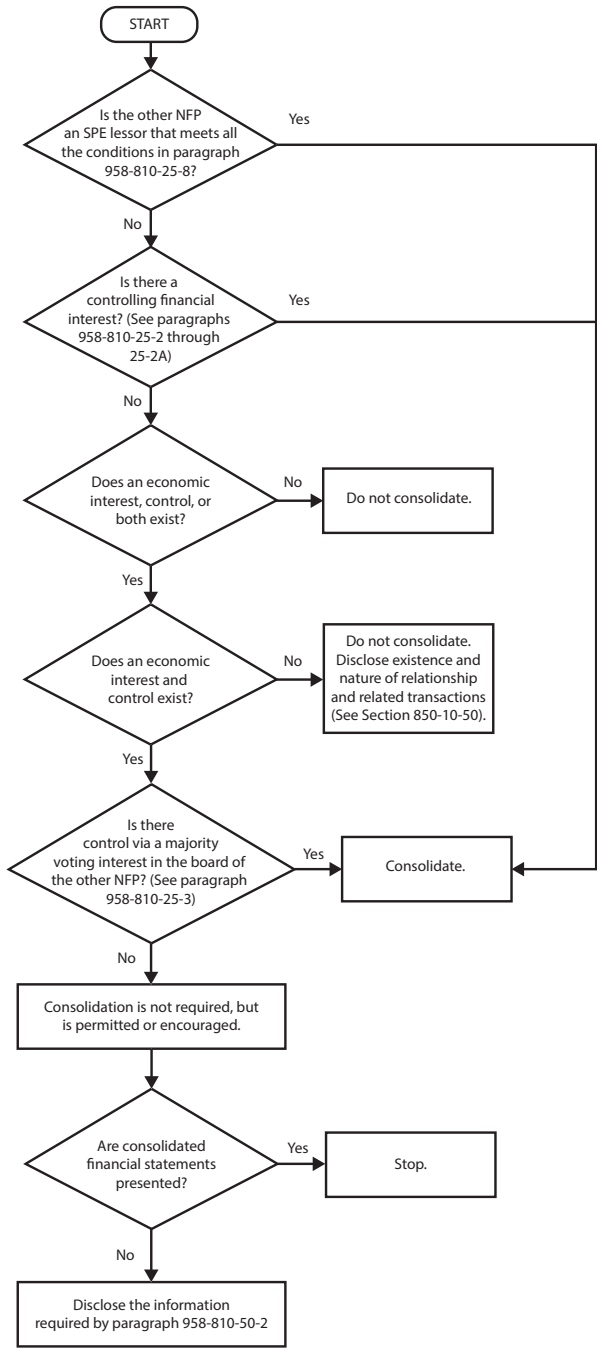
Health Care Entities



Ownership of a For-Profit Entity by a Not-for-Profit Entity

* According to paragraph 323-30-35-3, a limited liability company that maintains a specific ownership account for each investor—similar to a partnership capital account structure—should be viewed as similar to an investment in a limited partnership for purposes of determining whether a noncontrolling investment in a limited liability company should be accounted for in accordance with the guidance in Topic 321 or the equity method.

Relationship of a Not-for-Profit Entity With Another Not-for-Profit Entity



Chapter 13

Financial Accounting and Reporting for Managed Care Services

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 2.69–.79 provide additional guidance on statutory reporting and other regulatory considerations. Paragraph 4.65 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:

- If the nature of the entity's promise is to provide a good or service to the customer (that is, the entity is a principal), revenue received in exchange is recognized as premium revenue.
- If the nature of the entity's promise is to arrange for the good or service to be provided to the customer by the other party (that is, the entity is an agent), revenue received in exchange for performing administrative services is recognized as administrative fees. See paragraphs 13.23–.26.

13.04 FASB *Accounting Standards Codification* (ASC) 606-10-55-36 states that when another party is involved in providing goods or services to

a customer, the entity should determine whether the nature of its promise is a performance obligation to provide the specified goods or services itself (that is, the entity is a principal) or to arrange for those goods or services to be provided by the other party (that is, the entity is an agent). An entity determines whether it is a principal or an agent for each specified good or service promised to the customer. If a contract with a customer includes more than one specified good or service, an entity could be a principal for some specified goods or services and an agent for others. A specified good or service is a distinct good or service (or a distinct bundle of goods or services) to be provided to the customer (see paragraphs 15–22 of FASB ASC 606-10-25). The guidance in paragraphs 36–40 and paragraphs 316–334F of FASB ASC 606-10-55 should be considered when determining whether an entity is the principal or the agent for each specified good or service and how revenue should be recognized.

13.05 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

13.06 Costs of capitation arrangements are reported as health care expenses. The recognition of premium revenue from capitation arrangements is discussed in paragraphs 10.30–33.

Accounting for Health Care Costs

13.07 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.

13.08 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.

13.09 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.

13.10 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 8.119–.122 for additional discussion on the use of actuaries and actuarial methods. Paragraph 2.33 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.

13.11 The effects of reinsurance and stop-loss insurance recoveries are considered in calculating and recording those estimated costs. See paragraphs 13.16–.17 for additional information.

Accounting for Loss Contracts

13.12 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.

13.13 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. To determine the need to recognize a loss, 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.

13.14 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 noncancellable, 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 13.15 for additional discussion.

13.15 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

13.16 For purposes of determining whether a premium deficiency will occur and measuring that deficiency, the Financial Reporting Executive Committee (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

13.17 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.

13.18 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

13.19 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

13.20 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.

13.21 FASB ASC 340-40 provides guidance for providers of prepaid health care services when they account for the incremental costs of obtaining customers. Paragraphs 1–4 of FASB ASC 340-40-25 state that an entity should recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs. The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission). Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained should be recognized as an expense when incurred, unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained. Per FASB ASC 340-40-35-1, the asset recognized should be amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. As a practical expedient, an entity may recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less. Advertising costs should be accounted for in accordance with the guidance in FASB ASC 720-35.

Financial Statement Display Considerations

Balance Sheet

13.22 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.

13.23 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

13.24 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.

13.25 Paragraphs 36–40 and paragraphs 316–334F of FASB ASC 606-10-55 provides guidance about whether an entity should report revenue gross or net of certain amounts paid to others. FASB ASC 606-10-55-37B states that when (or as) an entity that is a principal satisfies a performance obligation, the entity recognizes revenue in the gross amount of consideration to which it

expects to be entitled in exchange for the specified good or service transferred. FASB ASC 606-10-55-38 states that when (or as) an entity that is an agent satisfies a performance obligation, the entity recognizes revenue in the amount of any fee or commission to which it expects to be entitled in exchange for arranging for the specified goods or services to be provided by the other party. An entity's fee or commission might be the net amount of consideration that the entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party. The indicators listed in paragraph 13.26 should be considered in that evaluation of whether an entity is a principal or an agent, but are not intended as a substitute for reading the cited paragraphs in FASB ASC 606-10-55.

13.26 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 guidance in FASB ASC 606-10-55. The indicators in paragraph 13.26 may be more or less relevant to the assessment of control depending on the nature of the specified good or service and the terms and conditions of the contract. In addition, different indicators may provide more persuasive evidence in different contracts.

Indicators of Gross Revenue Reporting

13.27 Per FASB ASC 606-10-55-39, indicators that an entity controls the specified good or service before it is transferred to the customer (and is therefore a principal) include, but are not limited to, the following:

- The entity is primarily responsible for fulfilling the promise to provide the specified good or service. This typically includes responsibility for the acceptability of the specified good or service (for example, primary responsibility for the good or service meeting customer specifications). If the entity is primarily responsible for fulfilling the promise to provide the specified good or service, this may indicate that the other party involved in providing the specified good or service is acting on the entity's behalf.
- The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer (for example, if the customer has a right of return). For example, if the entity obtains, or commits to obtain, the specified good or service before obtaining a contract with a customer, that may indicate that the entity has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service before it is transferred to the customer.
- The entity has discretion in establishing the price for the specified good or service. Establishing the price that the customer pays for the specified good or service may indicate that the entity has the ability to direct the use of that good or service and obtain substantially all of the remaining benefits. However, an agent can have discretion in establishing prices in some cases. For example, an agent may have some flexibility in setting prices in order to generate additional revenue from its service of arranging for goods or services to be provided by other parties to customers.

Disclosures

13.28 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.
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Chapter 14

Financial Accounting and Reporting by Continuing Care Retirement Communities

Gray shaded text in this chapter reflects guidance issued but not yet effective as of the date of this guide, September 1, 2021, but becoming effective on or prior to June 30, 2022, 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

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. Similar transactions can be found in assisted living facilities, and those facilities may also find this chapter useful.

14.02 The United States has over 2,000 CCRCs. Many CCRCs are operated by not-for-profit 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 *Accounting Standards Codification* (ASC) 954-440-05-3 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. They generally supply required continuous nursing service or appropriate assistance to residents who have a wide range of medical conditions and needs.

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. FASB ASC

954-440-05-4 states that continuing care retirement communities use the following three basic types of contracts:

- An all-inclusive continuing-care contract includes residential facilities, meals, and other amenities. It also provides long-term nursing care for little or no increase in periodic fees, except to cover normal operating costs and inflation. [These are typically referred to as "Lifecare" or "Type A" contracts.]
- A modified continuing-care contract also includes residential facilities, meals, and other amenities. However, only a specified amount of long-term nursing care is provided for little or no increase in periodic fees, except to cover normal operating costs and inflation. After the specified amount of nursing care is used, residents pay either a discounted rate or the full per diem rates for required nursing care. [These are typically referred to as "Modified Lifecare" or "Type B" contracts.]
- A fee-for-service continuing-care contract includes residential facilities, meals, and other amenities as well as emergency and infirmary nursing care. Access to long-term nursing care is guaranteed, but it may be required at full per diem rates. [These are typically referred to as "Type C contracts."]

14.07 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). Appendix A to this chapter, "Implementation Guidance for FASB ASC 606, *Revenue from Contracts with Customers*," (paragraph 14.54) includes excerpts from chapter 7, "Health Care Entities" of AICPA Audit and Accounting Guide *Revenue Recognition* about the application of FASB ASC 606 to continuing care retirement community contracts. Technical Questions and Answers (Q&A) sections 6400.55–.62¹ are useful in applying FASB ASC 842, *Leases*, to Type A contracts of CCRCs. Those questions discuss the following considerations:

- Q&A section 6400.55, "Background to Sections 6400.56–.62 — Accounting for Lease Components in Type A Life Care Contracts by Continuing Care Retirement Communities"
- Q&A section 6400.56, "Embedded Lease Component Within Type A Life Care Contracts"
- Q&A section 6400.57, "Determination of the Lease Term When an Embedded Lease Component for an Independent Living Unit Is Present Within Type A Life Care Contracts"
- Q&A section 6400.58, "Classification of an Embedded Lease Component Within Type A Life Care Contracts"
- Q&A section 6400.59, "Non-Lease Components Within the Resident Agreement of Type A Life Care Contracts"

¹ All Q&A sections can be found in *Technical Questions and Answers*. *Technical Questions and Answers* can be downloaded at <https://www.aicpa.org/resources/download/aicpa-technical-questions-and-answers-at-your-fingertips>.

- Q&A section 6400.60, "Measurement of Lease Payments if a Lease for an Independent Living Unit Exists in a Type A Life Care Contract"
- Q&A section 6400.61, "Reassessment of Lease Term Within the Resident Agreement of Type A Life Care Contracts"
- Q&A section 6400.62, "Impact on a Lease Component Within the Resident Agreement of Type A Life Care Contracts When a Resident Transitions to Assisted Living or Skilled Nursing"

14.08 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

14.09 *Advance fees* (one-time fee typically at the time of occupancy, sometimes referred to as *entrance fees*) 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

14.10 *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

14.11 *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 or other amenities, health

care services, excess meals or other services beyond those provided through the payment of advance or periodic fees.

Types of Living Accommodations

14.12 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.

14.13 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

14.14 FASB ASC 954-440-05-6 states that a continuing care retirement community may require several different payment methods for services and the use of facilities. The following are the three most prevalent methods:

- *Advance fee only.* Under this method, a resident pays an advance fee in return for future services and the use of facilities. Such services generally include continuing care retirement community housing-related services (for example, meals, laundry, housekeeping, and social services) and health care. These services usually are provided to the resident for the remainder of his or her life or until the contract is terminated. Additional periodic fees are not paid, regardless of how long a resident lives or if the resident requires more services than anticipated. Generally, the resident receives no ownership interest in the facility.
- *Advance fee with periodic fees.* Under this method, a resident pays an advance fee and periodic fees for services and the use of facilities. Such periodic fees may be fixed, or they may be subject to adjustment for increases in operating costs or inflation or for other economic reasons.
- *Periodic fees only.* Under this method, a resident pays a fee at periodic intervals for services and the use of the facilities provided by the continuing care retirement community. Such fees may be either fixed or adjustable.

14.15 According to FASB ASC 954-440-05-7, an advance fee may be met by transferring a resident's personal assets (which may include rights to future income) or by paying a lump sum of cash to the CCRC. Advance fees received for future services may be refunded at the occurrence of some future event, such as death, withdrawal from the CCRC, termination of the contract, or reoccupancy of a residential unit. The amount of the refund generally is based on contractual provisions or statutory requirements.

14.16 As explained in FASB ASC 954-440-05-5, 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 the life of the resident. In certain circumstances, this obligation continues regardless of whether advance fees or periodic fees are sufficient to meet the costs of providing services to a resident.

Accounting for Advance Fees

14.17 As explained in FASB ASC 954-440-05-8, payment of an advance fee generally is required before a resident acquires a right to reside in an apartment or residential unit for life. A portion of advance fees may be refundable by rescission within a legally set time period or if a certain future event occurs, such as the death or withdrawal of a resident or termination of the contract. Some refunds are paid only if a residential unit is reoccupied.

14.18 FASB ASC 954-440-05-9 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. Amounts refunded may be based on a fixed amount or percentage, an amount that declines to a fixed amount over time, an amount that declines to zero, or an amount based on the resale amount. Refunds may be contingent on vacating the unit, resale of the unit, or passage of a fixed period of time if the unit is not resold.

14.19 As explained in FASB ASC 954-440-05-10, some contracts between a CCRC and a resident stipulate that all or a portion of the advance fee may be refundable if the contract holder's unit is reoccupied by another person. The source of money for the payment is from the proceeds of the advance fees collected by the CCRC from the next resident of the reoccupied unit. The terms governing how the proceeds from the next resident are to be paid to the previous resident vary from contract to contract.

14.20 Nonrefundable entrance fees are those entrance fees that are either nonrefundable at contract inception or are refundable on a decreasing basis for a fixed period of time (for example, ratably over 48 months), at which point the entrance fees become nonrefundable. The accounting for nonrefundable advance fees is discussed in appendix A to this chapter. Refundable advance fees are those advance fees that are expected to be fully refunded regardless of when the contract is terminated, as well as the refundable portion of resident agreements that are partially refundable.

14.21 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 contract is accounted for in accordance with FASB ASC 606. FASB ASC 606-10-32-10 states that an entity should recognize a refund liability if the entity receives consideration from a customer and expects to refund some or all of that consideration to the customer. A refund liability is measured at the amount of consideration received (or receivable) for which the entity does not expect to be entitled (that is, amounts not included in the transaction price). The refund liability (and corresponding change in the transaction price and, therefore, the

contract liability) should be updated at the end of each reporting period for changes in circumstances. Paragraphs 7.6.129–7.6.130 in appendix A to this chapter provide additional information about refundable advance fees.²

Classification of Refundable Advance Fees

14.22 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.

14.23 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.

14.24 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 14.33).

14.25 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 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 and that some portion of that liability might be classified as current.

14.26 The Financial Reporting Executive Committee (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.

² As noted at paragraph 7.6.130 in the appendix to this chapter (paragraph 14.45), The Financial Reporting Executive Committee believes that the best estimate of the amount of refundable entrance fees received from residents, considering the constraint on variable consideration described in paragraphs 11–13 of FASB *Accounting Standards Codification* (ASC) 606-10-32, should be recorded as a liability at the inception of the resident agreement and not included in the transaction price because the continuing care retirement community (CCRC) expects to refund these amounts when the resident agreement is terminated.

Accounting for the Obligation to Provide Future Services and the Use of Facilities to Current Residents

14.27 FASB ASC 954-440 discusses the commitments of CCRCs to provide services. This paragraph and paragraphs 14.28–.30 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.

14.28 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 subsequently measured 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 deferred revenue (contract liability, as used in FASB ASC 606), plus depreciation of facilities to be charged related to the contracts, plus any unamortized incremental costs of obtaining a contract (see FASB ASC 340-40), if applicable. The calculation should be made by grouping contracts by type, such as all contracts with a limit on annual increases in fees, contracts with unlimited fee increases, and so forth.

14.29 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 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 be composed of operating expenses, including interest expense and excluding selling, and general and administrative expenses. Anticipated cost increases affecting these operating expenses should be considered in determining cash outflows. The expected inflation rate as well as other factors should be considered in determining the discount rate. In calculating the liability, the specific CCRC's historical experience or statistical data relating to the residents' life spans should be used. The life spans used should be the same as those used to recognize revenue. 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.

14.30 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.

14.31 The application of the conclusions in paragraph 14.29 is presented in exhibit 14-1.

Accounting for the Costs of Acquiring Continuing-Care Contracts

14.32 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, the incremental costs of acquiring both initial and subsequent new continuing-care contracts are within the scope of FASB ASC 340-40. (See paragraph 13.20.)

Financial Statements

14.33 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.

14.34 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

14.35 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 14.26 for the classification of refundable advance fees

14.36 Paragraphs 3.48–49 discuss locating example financial statements. Paragraphs 7.7.16–7.7.59 in the appendix to chapter 10, "Health Care Service

Revenue and Related Receivables," (paragraph 10.55) contain additional guidance on presentation and disclosure requirements.

Auditing

🔄 **Update 14-1 Auditing: Audit Evidence, Auditing Accounting Estimates, Use of Specialists, and Use of Pricing Information**

This edition of the guide has not been updated to reflect changes as a result of the issuance of the following Statements on Auditing Standards (SASs):

- SAS No. 142, *Audit Evidence* (AU-C sec. 500)³
- SAS No. 143, *Auditing Accounting Estimates and Related Disclosures* (AU-C sec. 540)
- SAS No. 144, *Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources*

SAS No. 142 is effective for audits of financial statements for periods ending on or after December 15, 2022. SAS Nos. 143 and 144 are effective for audits of financial statements for periods ending on or after December 15, 2023. Early implementation is permitted.

The following section will be updated in a future edition. Readers should refer to the preface for further details regarding these SASs. Readers are encouraged to consult the full text of the SASs at aicpa.org.

14.37 When auditing a CCRC, the auditor may need to consider the examples of specific audit objectives, specific control objectives, and substantive audit procedures that are presented in exhibit 14-2.

14.38 A CCRC ordinarily documents the terms of its arrangements with its residents using standardized residency contracts. It is common for a CCRC to use several different types of residency contracts, each with different terms. As discussed in paragraphs 14.14–.21, 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.

14.39 In determining which standardized contracts 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 contract

14.40 In determining which transactions to review, the auditor should select a sufficient number and type of contracts to reduce audit risk to an

³ All AU-C sections can be found in AICPA *Professional Standards*.

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 14.27–.31.

14.41 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

14.42 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.

14.43

Exhibit 14-1

The following example is reproduced from paragraphs 1–4 of FASB 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:

- a. All residents pay a \$50,000 fee, which is refundable less 2% 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.
- b. An additional periodic fee of \$1,000 is payable monthly with a 5% increase annually.
- c. The asset recognized for the incremental cost of obtaining the contract on 12/31/X6 is assumed to be \$17,000.
- d. The deferred revenue (contract liability) 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		\$48,000	\$48,300	\$29,768	\$2,315

<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		\$47,000	\$52,000	\$34,000	\$4,000

<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)
	\$1,000	\$(3,700)	\$(4,232)	\$(1,685)
Present value of net cash flows discounted at 10%				\$(7,137)

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		\$7,500	\$7,185	\$4,218	\$312
Total estimated depreciation of the use of facilities to be charged to the current residents					\$19,215

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:	
Deferred revenue (contract liability) on 12/31/X6	(27,027)
Plus:	
Depreciation to be charged to current residents	19,215
Asset recognized for the incremental cost of acquiring the 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	\$16,325

^(a) These numbers are for illustrative purposes only and no inference has been made as to the recoverability of the \$17,000.

14.44

Exhibit 14-2

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 330B, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, 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 315B, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. Various audit procedures and the purposes for which they may be performed are described in paragraphs .A10–.A26 of AU-C section 500B, *Audit Evidence*.

Audit Considerations

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives⁴</i>	<i>Substantive Audit Procedures⁵</i>
<i>Classes of Transactions, Account Balances, and Disclosures</i>			
Deferred Revenue (Contract Liability)			
<i>Classes of Transactions, Account Balances, and Disclosures</i>			
Completeness, rights and obligations, and presentation and disclosure	Amounts received from nonrefundable entrance fees for future services are properly deferred until future services or goods are transferred to residents.	Procedures and policies ensure that amounts received as advance fees are recognized in the proper period on a basis consistent with prior periods.	Test the procedures related to the recognition of nonrefundable advance fees, and determine whether revenue recognition is consistent with paragraphs 7.6.149–7.6.160 in appendix A to this chapter.

(continued)

⁴ The auditor should consider a combination of preventative 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>
	Deferred revenues are appropriately classified on the balance sheet.	Appropriate consideration is given to those factors influencing classification of deferred revenues and the method used to recognize revenue.	Recalculate the amounts classified as current liability (that is, the amount that will be recognized within the coming fiscal year) consistent with the method used to recognize revenue; remainder should be long term.
Refundable Fee Obligation			
<i>Classes of Transactions, Account Balances, and Disclosures</i>			
Existence, completeness, and presentation	Liabilities relating to refundable fee arrangements are accounted for and properly classified.	Written documentation is prepared for refundable fee arrangements.	Obtain a supporting rollforward schedule of the refundable fee obligations and compare the ending account balances to the prior periods' balances, Test new fees received and and refunds disbursed. Review and document any applicable state requirements relating to the timing and other factors relating to making refunds to residents.
	Liabilities are accounted for and properly reported.	All liabilities are classified, described, and properly disclosed in the financial statements.	Determine that such refundable amounts are properly classified and disclosed in the financial statements in accordance with contract terms.

Audit Considerations — continued

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Specific Control Objectives</i>	<i>Substantive Audit Procedures</i>
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.
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.

Exhibit 14-2⁶

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 330B, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, 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 315B, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. Various audit procedures and the purposes for which they may be performed are described in paragraphs .A10–.A26 of AU-C section 500A, *Audit Evidence*.

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			
Deferred Revenue (Contract Liability)			
Completeness, Rights and Obligations	Amounts received from nonrefundable entrance fees for future services are properly deferred until future services or goods are transferred to residents.	Procedures and policies ensure that amounts received as advance fees are recognized in the proper period on a basis consistent with prior periods.	Test the procedures related to the recognition of nonrefundable advance fees, and determine whether revenue recognition is consistent with paragraphs 7.6.149–7.6.160 in appendix A to this chapter.

⁶ Statement on Auditing Standards (SAS) Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the Auditing Standards Board (ASB) recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

⁷ The auditor should consider a combination of preventative 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>
Presentation	Deferred revenues are appropriately classified on the balance sheet.	Appropriate consideration is given to those factors influencing classification of deferred revenues and the method used to recognize revenue.	Recalculate the amounts classified as current liability (that is, the amount that will be recognized within the coming fiscal year) consistent with the method used to recognize revenue; remainder should be long term.
Refundable Fee Obligations			
Completeness, Accuracy	Liabilities relating to refundable fee arrangements are accounted for and properly reported.	Written documentation is prepared for refundable fee arrangements.	Obtain a supporting rollforward schedule of the refundable fee obligations and compare the ending account balances to the prior periods' balances, Test new fees received and and refunds disbursed. Review and document any applicable state requirements relating to the timing and other factors relating to making refunds to residents.
Presentation, Classification	Obligations are properly classified as short-term or long-term.	Appropriate consideration is given to those factors influencing classification of refundable fees.	Determine that such refundable amounts are properly classified and disclosed in the financial statements in accordance with contract terms.
Obligations to Provide Future Services			
Existence, Completeness	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>
<i>Classes of Transactions</i>			
Revenues From Periodic Service Fees			
Occurrence, Completeness	Revenue from periodic service fees is properly measured and reported.	Written documentation and monitoring of service fees established and charged to residents.	Review resident agreements and charges, including changes in charges to residents for payment terms, performance obligations, and satisfaction of performance obligations.

14.45

Appendix A — Implementation Guidance for FASB ASC 606, *Revenue from Contracts with Customers*

- A-1** This appendix includes excerpts from chapter 7, "Health Care Entities" of AICPA Audit and Accounting Guide *Revenue Recognition* (Revenue Recognition Guide). That guide has been developed by the AICPA Industry Revenue Recognition Task Forces, Revenue Recognition Working Group, and Auditing Revenue Task Force, to assist management in the preparation of their financial statements in accordance with U.S. generally accepted accounting principles (GAAP) and to assist practitioners in performing and reporting on their audit engagements. Specifically, that guide is intended to help entities and auditors prepare for changes related to revenue recognition as a result of FASB Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, and subsequent ASUs amending FASB *Accounting Standards Codification* (ASC) 606, *Revenue from Contracts with Customers*. Readers should note that the positions taken by the Financial Reporting Executive Committee are based on facts and circumstances stated in the guide and supported by guidance in effect at the time the industry implementation papers were finalized, from 2015–2018. Readers should consider individual facts and circumstances and subsequently issued guidance to determine an appropriate accounting position.
- A-2** The following implementation issues are discussed in chapter 7 of the Revenue Recognition Guide.

<i>Issue Description</i>	<i>Paragraph Reference</i>
Identifying performance obligations	7.2.01–7.2.09
Determining the timing of satisfaction of performance obligations	7.5.01–7.5.08
Arrangements for health care services provided to uninsured and insured patients with self-pay balances, including co-payments and deductibles	7.6.01–7.6.43
Third-party settlement estimates	7.6.44–7.6.72
Risk sharing arrangements	7.6.73–7.6.108
Application of FASB ASC 606 to continuing care retirement community contracts	7.6.109–7.6.162
Application of the portfolio approach	7.7.01–7.7.15
Presentation and disclosure	7.7.16–7.7.59
Accounting for contract costs	7.7.61–7.7.73

Only "Application of FASB ASC 606 to Continuing Care Retirement Community Contracts" is included in this appendix. The remaining implementation

issues are included in the appendix, "Implementation Guidance for FASB ASC 606, *Revenue from Contracts with Customers*," to chapter 10, "Health Care Service Revenue and Related Receivables" (paragraph 10.55). A discussion of sales commission arrangements related to obtaining new entrance fee contracts is included in "Accounting for Contract Costs" section in the appendix to chapter 10.

Application of FASB ASC 606 to Continuing Care Retirement Community Contracts

This Accounting Implementation Issue Is Relevant to the Application of FASB ASC 606 to Continuing Care Retirement Community Contracts.

Background

7.6.109 Continuing care retirement communities (CCRCs) provide residents with a diversity of residential, social, and health care services in accordance with a resident service agreement (resident agreement or contract) specifying the obligations of the CCRC to the resident. Generally, a resident entering a CCRC initially lives in an independent living unit designed for seniors, such as a cottage, duplex, townhome, or apartment. If and when the health of a resident declines, he or she may be permanently transferred to an assisted living facility or a nursing facility, both of which are generally located on the same campus as the independent living units. The health care services provided by CCRCs generally include nursing care and assisted living and may also include home health care, physician services, and other services related to health care. 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 these services to CCRC residents, certain services, predominantly assisted living and nursing services, may be provided to nonresidents. Most CCRCs require some type of entrance (or advance) fee, which may or may not be refundable, and a monthly fee. The entrance fee and monthly fee may vary depending on the type of contract selected by the resident.

7.6.110 This section is focused on Type A life care contracts that are all-inclusive continuing-care contracts that include residential facilities, other amenities, and access to health care services, primarily assisted living and nursing care, for little or no increase in periodic (or monthly) fees, other than increases as stipulated in the resident agreement, generally based on increases in operating costs or inflationary increases. CCRCs should separately assess other types of life care contracts to determine the appropriate accounting under FASB ASC 606, *Revenue from Contracts with Customers*.

Initial Recognition

7.6.111 At inception of a CCRC contract (that is, a contract between the CCRC and a new resident), the CCRC is required to apply the guidance in FASB ASC 606 to determine how revenue should be recognized over the term of the contract, based on allocating the contract's transaction price among the distinct goods or services (performance obligations) promised in the contract.

Identifying the Contract With a Resident

7.6.112 Generally, each resident enters into a written resident agreement with the CCRC. This agreement establishes the rights and obligations of both the CCRC and the resident. A potential resident must apply for entrance to the CCRC, with the application process generally considering, among other things,

health status and financial resources. Payment terms are clearly outlined in the resident agreement, with entrance fees paid at the inception of the contract, and periodic fees paid monthly. Given the financial screening process for residents, CCRCs generally do not have collectibility issues; however, collectibility is still required to be assessed in accordance with FASB ASC 606-10-25-1e. FinREC believes a resident agreement between the resident and the CCRC would generally meet the criteria in FASB ASC 606-10-25-1 to be considered a contract with a customer to be accounted for under FASB ASC 606.

7.6.113 Type A life care contracts (or resident agreements) generally contain two payment sources: the entrance fee and the monthly fees. The entrance fee is a fixed amount paid at the time the contract is signed and the resident takes occupancy. It may be fully refundable, fully nonrefundable, or a combination of both. Refundable entrance fees are those entrance fees that are guaranteed to be refunded regardless of when the contract is terminated. Nonrefundable entrance fees are those entrance fees that are either nonrefundable at contract inception or are refundable on a decreasing basis for a fixed period of time (for example, ratably over 48 months), at which point the entrance fees become nonrefundable.

7.6.114 Under a Type A life care contract, in exchange for an entrance fee and a monthly fee that will not increase as long as the resident resides at the CCRC (other than for potential inflationary increases), the resident has the right to initially occupy an independent living unit at the CCRC and continue to live in that unit or occupy an assisted living unit or skilled nursing bed at the CCRC when the resident needs health care services. The resident also has the right to move out and discontinue paying the monthly fee at any time; however, that resident would generally forfeit, and not receive future value for, at least a portion of the nonrefundable entrance fee paid at the inception of his or her contract upon vacating the CCRC.

7.6.115 Because a CCRC resident has the ability to move out and discontinue paying the monthly fee at any time, FinREC believes the resident agreement for a Type A life care CCRC resident is generally a monthly contract with the option to renew.

7.6.116 CCRCs should determine whether the Type A life care contract contains a lease in the scope of FASB ASC 840, *Leases* (or FASB ASC 842, *Leases*, after adoption of that topic).⁹ If it is determined that the Type A life care contract contains a lease, the guidance in FASB ASC 606-10-15-4 should be applied to separate the elements that should be accounted for under FASB ASC 840 (or FASB ASC 842 after adoption) and FASB ASC 606. This section addresses the application of FASB ASC 606 to CCRC Type A life care contracts that are determined not to include a lease and any elements that should be accounted for under FASB ASC 606 in a CCRC Type A life care contract that includes a lease.

Identifying the Performance Obligations in the Contract

7.6.117 Paragraphs 14–22 of FASB ASC 606-10-25 discuss how to determine whether promised goods and services in the contract represent performance obligations.

⁹ Q&A sections 6400.55–.62 are useful in applying FASB ASC 842, *Leases*, to Type A life care contracts of CCRCs.

7.6.118 FASB ASC 606-10-25-14 establishes that a CCRC should assess goods or services promised in a contract and identify as performance obligations each promise to transfer to the resident either of the following:

- a. A good or service (or bundle of goods or services) that is distinct
- b. A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer ...

7.6.119 FASB ASC 606-10-25-18 states the following:

Depending on the contract, promised goods or services may include, but are not limited to, the following:

...

- e. Providing a service of standing ready to provide goods or services (for example, unspecified updates to software that are provided on a when-and-if-available basis) or of making goods or services available for a customer to use as and when the customer decides

...

7.6.120 The typical resident agreement for a Type A life care resident provides that the resident can live in the CCRC and access health care as needed for little or no increase in periodic fees other than increases as stipulated in the resident agreement, generally based on increases in operating costs or inflationary increases. The goods and services a resident will receive under the resident agreement are dependent on the resident's health and life span, along with his or her decision to continue to reside at the CCRC.

7.6.121 FinREC believes that the promised good or service (that is, the performance obligation) in the resident agreement for a Type A life care resident is that the CCRC is standing ready each month to provide a service such that the resident can continue to live in the CCRC and access the appropriate level of care based on his or her needs. Other goods or services offered separately by the CCRC that are not included in the monthly fees should also be assessed to determine if any additional performance obligations exist.

7.6.122 Paragraphs 42–43 of FASB ASC 606-10-55 state the following:

If, in a contract, an entity grants a customer the option to acquire additional goods or services, that option gives rise to a performance obligation in the contract only if the option provides a material right to the customer that it would not receive without entering into that contract (for example, a discount that is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market). If the option provides a material right to the customer, the customer in effect pays the entity in advance for future goods or services, and the entity recognizes revenue when those future goods or services are transferred or when the option expires.

If a customer has the option to acquire an additional good or service at a price that would reflect the standalone selling price for that good or service, that option does not provide the customer with a material right even if the option can be exercised only by entering into a previous contract. In those cases, the entity has made a marketing offer that it should account for in accordance with the guidance in this Topic

only when the customer exercises the option to purchase the additional goods or services.

7.6.123 Paragraph 11 of TRG Agenda Ref. No. 54, *Considering Class of Customer When Evaluating Whether a Customer Option Gives Rise to a Material Right*, notes that paragraph BC386 of ASU No. 2014-09 explains that the purpose of the guidance in paragraphs 42–43 of FASB ASC 606-10-55 is to distinguish between

- a. an option that the customer pays for as part of an existing contract (that is, a customer pays in advance for future goods or services), and
- b. a marketing or promotional offer that the customer did not pay for and, although made at the time of entering into a contract, is not part of the contract (that is, an effort by an entity to obtain future contracts with a customer).

7.6.124 Paragraph 12 of TRG Agenda Ref. No. 54 also explains, "Stated differently, the guidance in paragraphs 606-10-55-42 through 55-43 is intended to make clear that customer options that would exist independently of an existing contract with a customer do not constitute performance obligations in that existing contract."

7.6.125 FinREC believes that the nonrefundable entrance fee paid by a resident under a Type A life care contract contains a material right because, in effect, the resident is paying the CCRC in advance for future goods or services as explained in FASB ASC 606-10-55-42.

7.6.126 CCRCs should also evaluate whether the monthly renewal options included in the resident agreement for a Type A life care resident provide a further material right to the resident. Consistent with the discussion in TRG Agenda Ref. No. 54, this evaluation will require judgment and should compare the monthly renewal option with what is offered to other new life care customers (that would be considered in the same class of customer), not what is offered to potential customers that would purchase services separately (on a fee-for-service basis). Generally, the monthly fees paid by a new life care customer would be comparable to the monthly fees paid by existing life care customers, but individual facts and circumstances should be evaluated. As such, FinREC believes that generally, the monthly renewal options included in the resident agreement for a Type A life care resident would not provide a material right to the resident, in addition to the material right provided by the nonrefundable entrance fee, when comparing renewal options available to other life care customers. However, the facts and circumstances of each arrangement should be considered.

Determining the Transaction Price

Monthly Fees

7.6.127 For Type A life care residents, monthly fees are specified in the resident agreement and are generally fixed with periodic changes based on increases for inflation or in operating costs. The monthly fees entitle the residents to the use of the residential facilities and other amenities, as well as access to health care services. As such, the monthly fees are included in the transaction price as the monthly options to extend the contract term are exercised.

Nonrefundable Entrance (Advance) Fees

7.6.128 Nonrefundable entrance fees are also specified in the resident agreement and are either nonrefundable at contract inception or are refundable on a decreasing basis for a fixed period of time, at which point the entrance fees become nonrefundable. For Type A life care residents, the nonrefundable entrance fee generally entitles the resident to the use of the residential facilities and other amenities, as well as access to health care services. As such, the nonrefundable entrance fees are a component of the transaction price.

Refundable Entrance (Advance) Fees

7.6.129 Refundable entrance fees are those entrance fees that are expected to be fully refunded regardless of when the contract is terminated, as well as the refundable portion of resident agreements that are partially refundable.

7.6.130 In accordance with FASB ASC 606-10-32-10, consideration received from a customer should be recognized as a liability if the entity expects to refund some or all of that consideration to the customer and is measured at the amount to which the entity does not expect to be entitled (that is, amounts not included in the transaction price). CCRCs are contractually obligated to return the refundable entrance fees received from residents. As such, in accordance with FASB ASC 606-10-32-10, FinREC believes that the best estimate of the amount of refundable entrance fees received from residents, considering the constraint on variable consideration described in paragraphs 11–13 of FASB ASC 606-10-32, should be recorded as a liability at the inception of the resident agreement and not included in the transaction price because the CCRC expects to refund these amounts when the resident agreement is terminated.

Significant Financing Component

7.6.131 *Assessing Significance.* FASB ASC 606 requires CCRCs to evaluate whether each of their contractual arrangements with residents provide a significant benefit of financing to either party of the contract. The financing component may be explicitly identified in the contract or, as frequently occurs in this industry, may be implied by payment terms of the contract.

7.6.132 FASB ASC 606-10-32-15 states

... an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer.

7.6.133 As a first step, it is important that the CCRC determine the level at which significance is required to be assessed. Paragraph BC234 of ASU No. 2014-09 states, in part

The Boards clarified that an entity should only consider the significance of a financing component at a contract level rather than consider whether the financing is material at a portfolio level. The Boards decided that it would have been unduly burdensome to require an entity to account for a financing component if the effects of the financing component were not material to the individual contract, but the combined effects for a portfolio of similar contracts were material to the entity as a whole.

7.6.134 The assessment of *significance* requires the CCRC to apply judgment. Paragraph BC234 of ASU No. 2014-09 states, "that for many contracts, an entity will not need to adjust the promised amount of customer consideration because the effects of the financing component will not materially change the amount of revenue that should be recognized in relation to a contract with a customer."

7.6.135 The assessment of significance is based upon individual facts and circumstances for each CCRC.

7.6.136 *Entrance (Advance) Fees.* Paragraphs BC237–BC238 of ASU No. 2014-09 explain that FASB ASC 606 does not include an exemption for advance payments because there may be situations when a significant financing component is present and to ignore the impact would likely skew the amount and pattern of revenue recognition. As such, an evaluation of whether entrance fees are deemed to have a significant financing component must be made. Such evaluations should be made based on the provisions of each resident contract.

7.6.137 CCRC contracts generally do not address the specific use of the entrance fees by the CCRC. As such, CCRCs use entrance fees for various purposes: working capital (that is, provision of services to residents), capital expenditures (including expenditures related to new buildings), refunds of entrance fee amounts due to prior residents, and so on.

7.6.138 As indicated in paragraph 7.6.130, FinREC believes that the refundable entrance fees received by a CCRC from residents are not part of the transaction price. As a result, refundable entrance fees do not need to be considered in a CCRCs significant financing component analysis.

7.6.139 A CCRC should consider all facts and circumstances in assessing whether the nonrefundable entrance fee payment from a resident results in a contract that is deemed to have a significant financing component, including the impact of pricing options (entrance fees vs. monthly fees) presented to potential residents.

7.6.140 Paragraph BC232(b) of ASU No. 2014-09 explains that

... An entity should consider the combined effect of: (1) the expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services; and (2) the prevailing interest rates in the relevant market. Although the Boards decided that the difference in timing between the transfer of goods and services and payment for those goods and services is not determinative, the combined effect of timing and the prevailing interest rates may provide a strong indication that a significant benefit of financing is being provided.

7.6.141 FASB ASC 606-10-32-17 states

[n]otwithstanding the assessment in paragraph 606-10-32-16, a contract with a customer would not have a significant financing component if any of the following factors exist:

- a. The customer paid for the goods or services in advance, and the timing of the transfer of those goods or services is at the discretion of the customer..."

A CCRC should determine whether the timing of the transfer of goods and services (for example, health care) under a CCRC contract are at the discretion

of the resident in determining whether the transaction price under the CCRC contract contains a significant financing component.

7.6.142 Paragraph BC233c of ASU No. 2014-09 states, in part

[i]n some circumstances, a payment in advance or in arrears in accordance with the typical payment terms of an industry or jurisdiction may have a primary purpose other than financing The primary purpose of those payment terms may be to provide the customer with assurance that the entity will complete its obligations satisfactorily under the contract, rather than to provide financing to the customer or the entity, respectively.

7.6.143 Seniors choose to move into a CCRC primarily for the security that a CCRC provides, which includes the availability of health care in the future, if needed. The payment of the entrance fee provides a resident with assurance that the CCRC will provide the goods and services that have been promised under the terms of the contract. The provision of this assurance by the CCRC should be considered when determining whether a nonrefundable entrance fee arrangement contains a significant financing component. The assessment of whether a nonrefundable entrance fee arrangement contains a significant financing component requires judgement and will be based upon individual facts and circumstances for each entity.

7.6.144 If a CCRC deems a nonrefundable entrance fee arrangement to contain a financing component, a CCRC should apply judgment to determine whether the financing component will materially change the amount of revenue that should be recognized in relation to a contract with a customer (that is, it is a significant financing component). The assessment of what constitutes "significant" will be based upon individual facts and circumstances for each entity. If an entity concludes that the financing component is not significant, the entity does not need to apply the provisions of paragraphs 15–30 of FASB ASC 606-10-32 and adjust the consideration promised in determining the transaction price.

7.6.145 *Discount Rate.* FASB ASC 606-10-32-19 states, "After contract inception, an entity shall not update the discount rate for changes in interest rates or other circumstances (such as a change in the assessment of the customer's credit risk)."

7.6.146 In accordance with FASB ASC 606-10-32-19, once a CCRC determines that a significant financing component is present and adjusts the promised consideration accordingly, the entity would continue to use the same assumed discount rate for the specific contract assessed unless there is a contract modification that results in the original contract being effectively terminated.

Recognize Revenue When (or as) the Entity Satisfies a Performance Obligation

Monthly Fee

7.6.147 As explained in paragraph 7.6.126, FinREC believes that the resident agreement for a Type A life care resident is a monthly contract with options to renew, and the options to renew generally would not provide a material right to the resident. In accordance with FASB ASC 606-10-55-43, the options to renew should be accounted for only when the resident exercises the options.

7.6.148 FinREC believes that generally, the CCRC should recognize monthly fees as revenue when the services for the month are performed (that is, the CCRC satisfies the performance obligation).

Nonrefundable Entrance Fee

7.6.149 In accordance with paragraphs 42 and 51 of FASB ASC 606-10-55, the CCRC should recognize revenue for the material right associated with access to future services, when those future goods or services are transferred. Judgment is required to determine how to account for the nonrefundable entrance fee. FinREC believes that the nonrefundable entrance fee that contains a material right associated with access to future services (calculated after consideration of any significant financing components as described in paragraphs 7.6.131–7.6.146) should be allocated to optional future periods covering a resident's life expectancy.

7.6.150 FinREC believes one appropriate method to allocate the nonrefundable upfront fees to the material rights is a method that results in an equal amount allocated to each month, given that the nature of the entity's performance is that of having the various residential, social, or health care services available to the customer on a when-and-if needed basis each month for as long as the customer remains in the facility. This is similar to an output method that uses a time-based measurement to measure progress toward complete satisfaction of a performance obligation in accordance with FASB ASC 606-10-55-17. A sample calculation using a time-based measure is included in example 7-6-12, "Example of Single Resident — Type A or 'Life Care' Contract — Time-Based."

7.6.151 FinREC believes that another acceptable approach to allocate the nonrefundable upfront fees to the material rights is an approach that is based on when the future estimated costs or services are transferred to a CCRC resident. This is similar to an input method using costs incurred relative to the expected costs to be incurred to measure progress toward complete satisfaction of a performance obligation in accordance with FASB ASC 606-10-55-20. A sample calculation using the cost-to-cost method is included in example 7-6-13, "Example of Single Resident — Type A or 'Life Care' Contract — Cost to Cost." In addition, a CCRC may want to consider the likelihood of a resident using the different levels of health care services when applying the cost-to-cost method.

7.6.152 FinREC believes that it would also be acceptable to apply the practical alternative to estimating the standalone selling price of the material right, as described in FASB ASC 606-10-55-45. Under this approach, the CCRC would allocate the transaction price to the optional periods by reference to the goods or services expected to be provided and the corresponding expected consideration for those future goods or services (for example, the monthly fees). This approach is illustrated in example 51, "Option That Provides the Customer With a Material Right (Renewal Option)," of FASB ASC 606.

Portfolio Approach

7.6.153 The guidance in FASB ASC 606 specifies the accounting for an individual contract with a customer. Entities may use a portfolio approach as a practical expedient to account for contracts with customers as a group, rather than individually, if as required in FASB ASC 606-10-10-4 the financial statement effects are not expected to materially differ from an individual contract approach.

7.6.154 If the CCRC reasonably expects that a portfolio approach would result in recognizing revenue that is not materially different than recognizing revenue on an individual contract basis, it is important for the CCRC to determine, based on the profile of its community, if it has one or multiple portfolios. If residents entering the CCRC are in a similar age cohort and health condition, then one portfolio may be considered. If there are variations in the age cohorts or other factors, then the CCRC might consider using multiple portfolios.

Subsequent to Initial Recognition

7.6.155 For Type A life care contracts, assuming the CCRC allocates and recognizes the nonrefundable entrance fee as each month's services are transferred using either a time-based or cost-to-cost (or other appropriate) allocation method, there will be a contract liability balance that will decrease each period based on the amount of the nonrefundable upfront fee allocated to that period.

7.6.156 A CCRC may need to consider updating relevant assumptions at the end of each reporting period if the updates would have a material effect on the determination of revenue recognized during each reporting period. For example, life expectancies may change or, for the cost-to-cost method described in paragraph 7.6.151, the amount of time to be spent by a resident in each level of care that was estimated at contract inception may change. CCRCs should apply judgment to determine the appropriate accounting for a change in an assumption that could affect the amortization of the contract liability balance (the nonrefundable entrance fees).

7.6.157 As documented in paragraph 11 of TRG Agenda Ref. No. 34, *March 2015 Meeting — Summary of Issues Discussed and Next Steps*, related to Issue 1 in TRG Agenda Ref. No. 32, *Accounting for a Customer's Exercise of a Material Right*, one acceptable approach is for the exercise of a material right to be accounted for as a contract modification as the additional consideration received or the additional goods or services provided, or both, when a customer exercises a material right to represent a change in the scope or price, or both, of a contract.

7.6.158 As discussed in paragraph 7.6.125, FinREC believes that the nonrefundable entrance fee paid by a resident under a Type A life care contract creates material rights for access to future services. In accordance with the discussion in TRG Agenda Ref. No. 34, one approach is to account for the exercise of the material rights by the customer as contract modifications. If the CCRC accounts for the exercise of the material rights as contract modifications, the guidance in FASB ASC 606-10-25-13a would apply and the changes in estimates, such as life expectancy or time spent at each level of care, would be accounted for prospectively.

7.6.159 A sample calculation reflecting a revised cost-to-cost methodology as a result of a resident transferring to another level of care earlier than projected at contract inception is included in example 7-6-14.

7.6.160 It is unlikely that the terms of the CCRC resident agreement would be modified after inception; therefore, the contract modification provisions in FASB ASC 606 are not discussed herein. However, if a contract were to be modified after inception, paragraphs 10–13 of FASB ASC 606-10-25 provide guidance for CCRCs to consider.

Calculation of Obligation to Provide Future Services and Use of Facilities

7.6.161 FASB ASC 606 does not change the guidance in sections 25 and 35 of FASB ASC 954-440 relating to the calculation of a CCRC onerous contract obligation to provide future services and use of facilities to current residents (the FSO Calculation). However, the determination of two components of the FSO Calculation may change as a result of applying FASB ASC 606. These two components are as follows:

- a. *Unamortized deferred revenue (contract liability)* — As discussed in paragraphs 7.6.149–7.6.152, there may be several acceptable approaches for recognizing the material right resulting from the non-refundable entrance fees. CCRCs should be aware that FASB ASC 606 has superseded the guidance in FASB ASC 954-605-25-2 and FASB ASC 954-430-35-1, which may result in a different unamortized deferred revenue (contract liability) to be included in the FSO Calculation.
- b. *Unamortized costs of acquiring initial contracts* — the "Accounting for Contract Costs" section, included in paragraphs 7.7.61–7.7.73, discusses application of the guidance in FASB ASC 340-40 to CCRCs. CCRCs should evaluate costs associated with acquiring new CCRC resident contracts to determine if these costs meet the requirements for capitalization as an asset under paragraphs 1–3 of FASB ASC 340-40-25. CCRCs should be aware that FASB ASC 340-40 has superseded the guidance in FASB ASC 954-720-25-7.

The illustrative example in FASB ASC 954-440-55-1 has been amended by FASB ASC 606 to reflect the change in terminology used to describe the two preceding components.

Examples

7.6.162 The following examples are illustrations of calculations for allocating the nonrefundable upfront fees to the material right provided to the Type A life resident. The actual pattern of revenue recognition should be based on the facts and circumstances of a CCRC's specific situation.

Example 7-6-12 — Single Resident — Type A or "Life Care" Contract — Time Based

Assumptions:

Nonrefundable entrance fee	\$200,000
Life expectancy at move-in	14
Resident expires in year 7	

Allocation of nonrefundable entrance fee

	Life Expectancy ^(a)	Revenue Recognized	Contract Liability
Inception			\$200,000
Year 1	14.0	\$14,290	185,710
Year 2	13.4	13,860	171,850
Year 3	12.7	13,530	158,320
Year 4	12.1	12,080	145,240

(continued)

Allocation of nonrefundable entrance fee — continued

	Life Expectancy ^(a)	Revenue Recognized	Contract Liability
Year 5	11.5	12,630	132,610
Year 6	10.9	12,170	120,440
Year 7	10.4	120,440	—
		\$200,000	

(a) Facility determines that it is appropriate to update life expectancies each reporting period based on actuarially determined life expectancies by using a prospective approach.

Example 7-6-13 — Single Resident — Type A or "Life Care" Contract — Cost to Cost

Assumptions:

Nonrefundable entrance fee	\$200,000
Inflation factor	3.00%
Expected years in independent living (IL)	10
Expected years in assisted living (AL)	2
Expected years in skilled nursing (SN)	2

Estimated annual costs by level of care at contract inception:

IL	\$20,000
AL	\$40,000
SN	\$100,000

Calculations at Contract Inception:

Projected Costs by Level of Care

	IL	AL	SN
Year 1	\$20,000	\$40,000	\$100,000
Year 2	20,600	41,200	103,000
Year 3	21,218	42,436	106,090
Year 4	21,855	43,709	109,273
Year 5	22,511	45,020	112,551
Year 6	23,186	46,371	115,928
Year 7	23,882	47,762	119,406
Year 8	24,598	49,195	122,988
Year 9	25,336	50,671	126,678
Year 10	26,096	52,191	130,478
Year 11	26,879	53,757	134,392
Year 12	27,685	55,370	138,424
Year 13	28,516	57,031	142,577
Year 14	29,371	58,742	146,854

Projected Costs by Level of Care for Sample Resident

	IL	AL	SN	Total
Year 1	\$20,000	\$—	\$—	\$20,000
Year 2	20,600	—	—	20,600
Year 3	21,218	—	—	21,218
Year 4	21,855	—	—	21,855
Year 5	22,511	—	—	22,511
Year 6	23,186	—	—	23,186
Year 7	23,882	—	—	23,882
Year 8	24,598	—	—	24,598
Year 9	25,336	—	—	25,336
Year 10	26,096	—	—	26,096
Year 11	—	53,757	—	53,757
Year 12	—	55,370	—	55,370
Year 13	—	—	142,577	142,577
Year 14	—	—	146,854	146,854
Totals	\$229,282	\$109,127	\$289,431	\$627,840
Relative values	36.52%	17.38%	46.10%	100.00%

Note: Inflation factor of 3% applied to costs in all levels of care.

Allocation of Nonrefundable Entrance Fee to Level of Care Based on Cost

	IL	AL	SN	Total
Nonrefundable entrance fee	\$200,000	\$200,000	\$200,000	\$200,000
Relative value	36.52%	17.38%	46.10%	100.00%
Allocation	\$73,040	\$34,760	\$92,200	\$200,000

Revenue Recognition Over Pattern of Transfer

	Revenue Recognized ^(a)	Contract Liability ^(b)
Inception		\$200,000
IL:		
Year 1	\$6,370	193,630
Year 2	6,560	187,070
Year 3	6,760	180,310
Year 4	6,960	173,350
Year 5	7,170	166,180
Year 6	7,390	158,790
Year 7	7,610	151,180
Year 8	7,840	143,340
Year 9	8,070	135,270
Year 10	8,310	126,960
	73,040	
AL:		
Year 11	17,120	109,840
Year 12	17,640	92,200
	34,760	
SN:		
Year 13	45,420	46,780
Year 14	46,780	—
	92,200	
Total	\$200,000	
(a) Nonrefundable entrance fee allocated to optional periods using cost-to-cost measurement approach.		
(b) Contract liability is equal to the nonrefundable entrance fee less revenue recognized.		

Example 7-6-14 — Single Resident — Type A or "Life Care" Contract — Cost to Cost

Resident Moves to AL at Beginning of Year 7

Contract liability at end of year 6	\$158,790
Inflation factor	3.00%
Expected years in assisted living (AL)	2
Expected years in skilled nursing (SN)	2

Estimated annual costs by level of care at contract inception:

AL	\$40,000
SN	\$100,000

Calculations at Beginning of Year 7***Projected Costs by Level of Care for Sample Resident***

	IL	AL	SN	Total
Year 7	\$—	\$47,762	\$—	\$47,762
Year 8	—	49,195	—	49,195
Year 9	—	—	126,678	126,678
Year 10	—	—	130,478	130,478
Totals	\$—	\$96,957	\$257,156	\$354,113
Relative values	0.00%	27.38%	72.62%	100.00%

Note: Inflation factor of 3% applied to costs in all levels of care.

Allocation of Nonrefundable Entrance Fee to Level of Care Based on Cost

	IL	AL	SN	Total
Transaction price	\$158,790	\$158,790	\$158,790	\$158,790
Relative value	0.00%	27.38%	72.62%	100.00%
Allocation	\$—	\$43,380	\$115,310	\$158,790

Revenue Recognition Over Pattern of Transfer

	Revenue Recognized^(a)	Contract Liability^(b)
End of year 6		\$158,790
AL:		
Year 7	\$21,420	137,370
Year 8	22,060	115,310
	43,480	
SN:		
Year 9	56,800	58,510
Year 10	58,510	—
	115,310	
Total	\$158,790	

(a) Contract liability allocated to remaining optional periods using cost-to-cost measurement approach.

(b) Contract liability is equal to beginning contract liability less revenue recognized.

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, 2021, but becoming effective on or prior to June 30, 2022, 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, 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 state and local governmental entities. This chapter references provisions of certain GASB pronouncements, as well as AICPA Audit and Accounting Guide *State and Local Governments*. However, not all guidance included in GASB pronouncements and that guide is incorporated, repeated, or summarized in this chapter. Accordingly, GASB pronouncements, 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) 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 or only in business-type activities and fiduciary activities (that is, whose financial statements are prepared using enterprise fund accounting

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.

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, a governmental entity should first consider accounting principles for similar transactions or other events

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, as amended, 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 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 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."

within a source of authoritative GAAP and then may consider nonauthoritative accounting literature from other sources that does not conflict with 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 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 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 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*, as amended, 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. 2015-1 (GASB IG 2015-1) as amended by Question 5.12 of GASB Implementation Guide No. 2016-1, *Implementation Guidance Update — 2016* (GASB IG 2016-1), 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 or in business-type activities and fiduciary 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 or in business-type activities and fiduciary activities:^{6,7}

⁶ Paragraph 138 of GASB Statement No. 34, as amended.

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 16.98 of 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

(continued)

- a. Statement of net position
- b. Statement of revenues, expenses, and changes in net position
- c. Statement of cash flows
- d. If applicable, a statement of fiduciary net position
- e. If applicable, a statement of changes in fiduciary net position
- f. Notes to financial statements
- g. Management's discussion and analysis (MD&A) as required supplementary information (RSI)
- h. If applicable, other RSI established by GAAP

The statements should be prepared using the accrual basis of accounting and economic resources measurement focus.⁸ In the absence of significant information to the contrary, financial statements are prepared using a going concern assumption. (Paragraphs 16–19 of GASB Statement No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards*, provide accounting and financial reporting standards for going concern considerations. In addition, paragraphs 2.80–.94 of this guide contain information about an auditor's responsibilities relating to an entity's ability to continue as a going concern.)

15.13 The statement of fiduciary net position and the statement of changes in fiduciary net position should include information about all fiduciary funds of the governmental health care entity, including fiduciary component units. The statements should provide a separate column for each type of fiduciary fund — pension (and other employee benefit) trust funds, investment trust funds, private-purpose trusts, and custodial funds. The statement of fiduciary net position and the statement of changes in fiduciary net position should be presented on separate pages from the other financial statements. For example, they might be included between the statement of cash flows and the notes to the financial statements. The requirement to present the fiduciary fund financial statements does not change the requirement in paragraph 106 of GASB Statement No. 34, as amended, to present financial statements for individual pension plans that are administered through trusts that meet the criteria in paragraph 3 of GASB Statement No. 67, *Financial Reporting for Pension Plans — an amendment of GASB Statement No. 25*, and other postemployment benefit (OPEB) plans that are administered through trusts that meet the criteria in paragraph 3 of GASB Statement No. 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, in the notes to the financial statements of the governmental health care entity if separate, GAAP financial reports have not been issued. If separate, GAAP financial reports have been issued, the notes should include information about how to obtain those separate reports.

(footnote continued)

relevant GAAP financial statements, note disclosures, management's discussion and analysis topics, and other required supplementary information (RSI). Paragraphs 15.226–.230 discuss the auditor's responsibility with respect to RSI.

⁸ See paragraphs 92 and 107 of GASB Statement No. 34, as amended. However, the recognition of certain liabilities of fiduciary funds (that is, liabilities of defined benefit pension and other postemployment benefit plans and liabilities to the beneficiaries of a fiduciary activity) are recognized in accordance with paragraphs 21–22 of GASB Statement No. 84, *Fiduciary Activities*.

The statement of fiduciary net position and the statement of changes in fiduciary net position should include information about all fiduciary funds of the governmental health care entity, including fiduciary component units. The statements should provide a separate column for each type of fiduciary fund — pension (and other employee benefit) trust funds, investment trust funds, private-purpose trusts, and custodial funds. The statement of fiduciary net position and the statement of changes in fiduciary net position should be presented on separate pages from the other financial statements. For example, they might be included between the statement of cash flows and the notes to the financial statements. The requirement to present the fiduciary fund financial statements does not change the requirement in paragraph 106 of GASB Statement No. 34, as amended, to present financial statements for individual pension plans that are administered through trusts that meet the criteria in paragraph 3 of GASB Statement No. 67, *Financial Reporting for Pension Plans — an amendment of GASB Statement No. 25*, and other postemployment benefit (OPEB) plans that are administered through trusts that meet the criteria in paragraph 3 of GASB Statement No. 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, in the notes to the financial statements of the governmental health care entity if separate, GAAP financial reports have not been issued. If separate, GAAP financial reports have been issued, the notes should include information about how to obtain those separate reports. Additional information about fiduciary activities is found in paragraphs 15.113–.114 (deferred compensation plans), paragraphs 15.131–.135 (pension trust funds and OPEB trust funds), and in paragraph 15.178 (fiduciary component units).⁹

Statement of Net Position

15.14 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.

⁹ As amended by GASB Statement No. 95, *Postponement of the Effective Dates of Certain Authoritative Guidance*, paragraph 9 of GASB Statement No. 92, *Omnibus 2020*, is effective for reporting periods beginning after June 15, 2021.

15.15 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.¹⁰ 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.

15.16 Balances of deferred outflows of resources and deferred inflows of resources reported in a statement of net position may be aggregations of different types of deferred amounts. If significant 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 deferred outflows of resources, those financial statement elements are not classified as current or noncurrent.

15.17 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, as amended.¹¹ Paragraph 99 of GASB Statement No. 34, as amended, states that restricted assets should be reported when *restrictions*, as defined in paragraph 34 of GASB Statement No. 34, as amended, on asset use change the nature or normal understanding of the availability of the asset. Restrictions¹² 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 of GASB Statement No. 62, as amended, 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

¹⁰ In certain cases, there are exceptions to the general rule that deferred inflows of resources and deferred outflows of resources 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 other post-employment benefit (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.

¹¹ 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.

¹² The term *restricted* is defined by paragraphs 34, as amended, and 99 of GASB Statement No. 34, as amended. As discussed in paragraph 15.149, 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.

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 (GASB IG 2015-1) discusses the reporting of restricted assets in a classified statement of net position. GASB Statement No. 34, as amended, does not otherwise require restricted assets to be displayed separately from unrestricted assets on the face of the statement of net position.

15.18 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, and deferred inflows of resources. 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.¹³ The individual components of net position are discussed in more detail in paragraphs 15.154–155.

15.19 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 interfund balances.

Statement of Revenues, Expenses, and Changes in Net Position

15.20 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 amended, 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

¹³ See paragraph 35 of GASB Statement No. 34.

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.

15.21 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 and changes in net assets with donor restrictions, 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.

15.22 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.¹⁴ 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.

15.23 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

¹⁴ See paragraph 102 of GASB Statement No. 34.

are beyond the control of management are not special items but should be disclosed in accordance with paragraph 56 of GASB Statement No. 34. GASB IG 2015-1 question 7.43.2 provides examples of extraordinary and special items.

15.24 As discussed in paragraph 15.19, 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 GASB 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.

15.25 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, as amended, 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.¹⁵ If a governmental health care entity must correct a prior-period's error, question 7.22.16 of GASB 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.

15.26 GASB Statement No. 69, *Government Combinations and Disposal of Government Operations*, as amended, 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 15.23 and illustrated in paragraph 15.20, 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 See footnote 13 to paragraph 17 of GASB Statement No. 34, as amended.

15.27 FASB ASC 220, *Comprehensive Income*, conflicts with the all-inclusive format required by GASB Statement No. 34, as amended, 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

15.28 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, as amended, 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,¹⁶ with a reconciliation provided of operating cash flows to operating income (loss).
- GASB Statement No. 9, as amended, 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.¹⁷
- Some transactions are classified differently by GASB and FASB. For example, under GASB Statement No. 9, as amended, 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 19 of GASB Statement No. 84, *Fiduciary Activities*, provides that a business-type activity that chooses to report assets with a corresponding liability in its statement of net position that would otherwise be reported as a custodial fund in fiduciary fund financial statements (as permitted in the circumstances discussed at paragraphs 15.138–.141) should separately report additions and deductions, if significant, as cash inflows and cash outflows, respectively, in the operating activities category of its statement of cash flows. For example, only if a governmental health care entity includes the cash and cash equivalent balances of an activity that otherwise would be a fiduciary activity with the

¹⁶ See paragraph 105 of GASB Statement No. 34.

¹⁷ 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.

cash and cash equivalents reported on the statement of net position, should the receipts and disbursements pertaining to those activities be included, if significant, as cash inflows and cash outflows, respectively, in the operating activities category of the statement of cash flows.

Paragraph 6 of GASB IG 2015-1 discusses implementation issues regarding GASB Statement No. 9, as amended.

Segment Reporting

15.29 If applicable, governmental health care entities should comply with the segment reporting requirements of GASB Statement No. 34, as amended.¹⁸ 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, as amended, 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.

15.30 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 AICPA Audit and Accounting Guide *State and Local Governments* and questions 7.86.1–7.86.6 of GASB IG 2015-1.

RSI, Including MD&A

15.31 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 15.32–.33) and certain information related to employer-sponsored benefit plans (paragraph 15.145). RSI other than MD&A should be presented immediately following the notes to the financial statements.¹⁹ Paragraphs 8–11 of GASB Statement No. 34, as amended, provide the standards for MD&A, which should precede the basic financial statements.

15.32 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

¹⁸ 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*.

¹⁹ See paragraph 6 and footnote 5 of GASB Statement No. 34.

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 specific requirements for MD&A for general-purpose governments. Because certain of those requirements would not apply to special-purpose governments engaged only in business-type activities or only in business-type activities and fiduciary activities, governmental health care entities should limit their MD&A to only those 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.

15.33 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 GASB 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 GASB IG 2015-1.

15.34 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

15.35 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 (that is, an exit price) 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*).
- *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.

15.36 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

15.37 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.

15.38 Cash and cash equivalents are considered to be restricted²⁰ 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 15.149 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

²⁰ The term *restricted* is defined by paragraphs 34 and 99 of GASB Statement No. 34, as amended. As discussed in paragraph 15.149, 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.

classified as noncurrent for financial reporting purposes, as discussed in paragraph 15.17.

15.39 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 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 15.63.

Investments and Certain Equity Interests

15.40 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*, as amended, and GASB Statement No. 72, as amended. Paragraphs 4–5 and paragraphs 11–12 of GASB IG 2015-1, as amended, and questions 4.1 to 4.8 and 4.25 to 4.53 of GASB 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 Derivative Instruments," of AICPA Audit and Accounting Guide *State and Local Governments*.

15.41 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 65–67 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 15.46 for equity interests, paragraph 15.62 for derivative instruments, paragraph 15.71 for capital assets, and paragraph 15.77 for intangible assets.)

15.42 If the governmental health care entity owns an equity interest that meets the definition of an investment in paragraph 64 of GASB Statement No. 72, as amended, it should report its equity interest as an investment, regardless of the extent of its ownership. The investment should be measured in conformity with the provisions of paragraph 77 of GASB Statement No. 72, as amended, which is discussed further in paragraphs 15.46–.47.

15.43 Paragraphs 15.173–.186 provide guidance for majority equity interests that do not meet the definition of an investment in paragraph 64 of GASB Statement No. 72. Paragraphs 15.187–.194 provide guidance for other equity interests that do not meet the definition of an investment in paragraph 64 of GASB Statement No. 72.

Measurement of Investments

15.44 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, as amended, 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.

15.45 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, as amended):

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>
A majority equity interest in a legally separate organization (for example, voting stock of a corporation or an interest in a partnership) ^a	The equity method as described in paragraphs 205–210 of GASB Statement No. 62, <i>Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements</i> , as amended, (see paragraph 5 of GASB Statement No. 90, <i>Majority Equity Interests — an amendment of GASB Statements No. 14 and No. 61</i> and paragraphs 15.46–.48). However, a majority equity interest that is held by a permanent or term endowment or a fiduciary fund is measured at fair value.
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 ^b	The equity method as described in paragraphs 202–210 of GASB Statement No. 62, as amended, (see paragraphs 77–78 of GASB Statement No. 72, <i>Fair Value Measurement and Application</i> , as amended, and paragraphs 15.46–.48). 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 71–74 and 82 of GASB Statement No. 72 and paragraph 15.49)
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> , as amended)

(continued)

**Investments Commonly Held by Governmental Health Care Entities
That are Measured at Other than Fair Value — *continued***

<i>Investment</i>	<i>Accounting</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, otherwise fair value)
Investments <i>in</i> qualified external investment pools	Amortized cost if the pool meets the criteria in paragraph 4 of GASB Statement No. 79, <i>Certain External Investment Pools and Pool Participants</i> , and measures its investments at amortized cost (see paragraph 41 of GASB Statement No. 79)
Investments in internal investment pools	The equity position in an internal investment pool is reported as an asset by the participant (paragraph 14 of GASB Statement No. 31, as amended). 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, as amended)
^a If a majority equity interest does not meet the definition of an investment, the holding of the majority equity interest results in the governmental health care entity being financially accountable for the organization and, therefore, the health care entity should report the organization as a component unit in accordance with paragraph 6 of GASB Statement No. 90. See additional discussion in paragraphs 15.171–.186. ^b 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, as amended), the equity interest should be measured using the cost method in paragraph 203 of GASB Statement No. 62, as amended. See additional discussion in paragraphs 15.187–.194.	

Equity Interests

15.46 Paragraphs 205–210 of GASB Statement No. 62, as amended, describe the equity method of accounting.²¹ The use of the equity method is required by paragraph 5 of GASB Statement No. 90 if a governmental health care entity's holding of a majority equity interest in a legally separate entity meets the definition of an investment in paragraph 64 of GASB Statement No. 72, unless the majority equity interest is held by a permanent or term endowment or a fiduciary fund (in which case the majority equity interest is measured at fair value).²² The use of the equity method is also required by paragraph 77 of GASB Statement No. 72, as amended, if an investment in voting stock gives the governmental health care entity the ability to exercise significant influence over operating and financial policies of an investee even though the governmental health care entity holds 50% or less of the voting stock. GASB Statement No. 72 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 15.49–.51
- Equity interest ownership in joint ventures, as discussed further in paragraphs 15.191–.193

15.47 As noted in paragraph 205 of GASB Statement No. 62, as amended, 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% or less of the voting stock of an investee, but more than 20%. 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.

15.48 Paragraph 209 of GASB Statement No. 62, as amended, describes the procedures that should be followed in applying the equity method of accounting.

²¹ The equity method is also used when a majority equity interest in an organization is reported as a component unit by the government that holds the equity interest; the asset is measured using the equity method. If a government's holding of a majority equity interest in a legally separate organization meets the definition of an investment, the legally separate organization should not be reported as a component unit.

²² Although less likely to occur at a governmental health care entity, a majority equity interest is also measured at fair value if held by a special-purpose government engaged only in fiduciary activities, a fiduciary fund, or permanent fund.

Investments in Certain Entities That Calculate the Net Asset Value per Share (or Its Equivalent)

15.49 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).

15.50 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.

15.51 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

15.52 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, as amended, 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. Question 4.36 of GASB Implementation Guide No. 2017-1, *Implementation Guidance Update — 2017* (GASB IG 2017-1), states that a government's investment position in an external investment pool is not categorized within the fair value hierarchy for purposes of the note disclosure requirement in paragraph 81a(2) of GASB Statement No. 72 regardless of how that external investment pool measures the pool's investments.

15.53 Paragraph 22 of GASB Statement No. 31, as amended, 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 GASB 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

15.54 GASB Statement No. 52, *Land and Other Real Estate Held as Investments by Endowments*, as amended, 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

15.55 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, as amended, 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.

15.56 Question 6.12.2 of GASB IG 2015-1 discusses impairment of investments covered by GASB Statement No. 31, as amended, 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, as amended, 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

15.57 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.²³ This differs significantly from the private-sector standards described in paragraphs 4.31–.37. GASB Statement No. 31, as amended, 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.

15.58 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.

²³ As discussed in questions 7.73.5 and 7.74.3 of GASB Implementation Guide No. 2015-1 (GASB 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.

Securities Lending and Reverse Repurchase Agreements

15.59 Governmental health care entities account for securities lending transactions in accordance with GASB Statement No. 28, *Accounting and Financial Reporting for Securities Lending Transactions*, as amended, and reverse repurchase agreements in accordance with GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements)*, and *Reverse Repurchase Agreements*, as amended, and GASB Interpretation No. 3, *Financial Reporting for Reverse Repurchase Agreements — an interpretation of GASB Statement No. 3*, as amended. That accounting differs from the private-sector standards of FASB ASC 860, *Transfers and Servicing*.

Financial Reporting and Disclosure

15.60 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, as amended. 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 4–17 of GASB Statement No. 40, as amended.
- 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, as amended. 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 NAV 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 NAV per share (or its equivalent) as a practical expedient for fair value have additional 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
 - For any investments in external investment pools that report their investments at amortized cost in accordance with paragraph 4 of GASB Statement No. 79, the presence of any limitations or restrictions on withdrawals (such as notice periods, maximum transaction amounts, and the qualifying external investment pool's authority to impose liquidity fees or redemption gates)
 - 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, as amended.
- 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, amount by which the value of the collateral provided is required to exceed the value of the securities lent, 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

Derivative Instruments

15.61 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.

15.62 GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, 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 instrument* and the scope of the statement are similar to that used by private-sector entities.

15.63 GASB Statement No. 53, as amended, 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 held primarily for the purpose of income or profit and have a present service capacity based solely on the ability to generate cash or to be sold to generate cash. 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 15.57 for further discussion.

15.64 GASB Statement No. 64, *Derivative Instruments: Application of Hedge Accounting Termination Provisions — An Amendment of GASB Statement No. 53*, provides additional guidance on determining whether a derivative instrument continues to meet the requirements for hedge accounting in the event that the swap counterparty or swap counterparty'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.²⁴
- 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.

15.65 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 AICPA Audit and Accounting Guide *State and Local Governments*, and paragraph 16 of GASB IG 2015-1 for additional guidance related to these methods.

15.66 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 GASB 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,

²⁴ 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.

hedging derivative instruments typically will not have a significant impact on the calculation of components of net position.

15.67 Question 4.6 of GASB Implementation Guide No. 2019-1 (GASB IG 2019-1) states that the government is released from the rights and obligations of an effective hedge against interest rate risk (an interest rate swap agreement) on the termination date, even if settlement occurs on a different date. At the termination date, in addition to reporting the balance of the deferred outflow of resources or deferred inflow of resources related to changes in fair value of the swap on the statement of revenues, expenses and changes in net position within the investment revenue classification, the government should report a receivable or payable for the amount to be received or paid at the settlement date.

15.68 A health care entity that holds derivative instruments should disclose the information required by paragraphs 69–79 of GASB Statement No. 53, as amended. 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 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, as amended, require disclosures related to fair value. Disclosures are also required for the companion instrument of any embedded derivative instruments and about synthetic guaranteed investment contracts.

Property and Equipment and Other Assets

15.69 The accounting requirements for capital assets and intangible assets of governmental health care entities are summarized in paragraphs 15.70–.88. 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."

Capital Assets — General

15.70 *Capital assets* are defined in paragraph 19 of GASB Statement No. 34, as amended, 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, as amended. Chapter 7, "Capital Assets," of AICPA Audit and Accounting Guide *State and Local Governments* contains additional information.

Capital assets are defined in paragraph 19 of GASB Statement No. 34, as amended, 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. Paragraph 4 of GASB Statement No. 89, *Accounting for Interest Cost Incurred before the End of a Construction Period*, requires that interest costs incurred before the end of a construction period be recognized as an expense in the period in which the cost is incurred, rather than being capitalized as part of the historical cost of a capital asset. 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, as amended. Chapter 7, "Capital Assets," of AICPA Audit and Accounting Guide *State and Local Governments* contains additional information.²⁵

15.71 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 15.41) 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.

15.72 Questions 4.36–4.41 of GASB 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.

15.73 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, as amended
- 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*, as amended. (Paragraphs 15.84–.87 provide more information about service concession arrangements.)

²⁵ GASB Statement No. 89, *Accounting for Interest Cost Incurred before the End of a Construction Period*, as amended by GASB Statement No. 95, is effective for reporting periods beginning after December 15, 2020. Changes adopted to conform to the provisions of this statement should be applied prospectively.

Capital Asset Impairment

15.74 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*, as amended. 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).

15.75 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, as amended, should not be reversed in future years, even if the events or circumstances causing the impairment have changed.

15.76 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, as amended, 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 section Z.42 of GASB IG 2015-1.

Intangible Assets

© Update 15-1 Accounting: Subscription-Based Information Technology Arrangements

GASB Statement No. 96, *Subscription-Based Information Technology Arrangements*, is effective for fiscal years beginning after June 15, 2022, and all reporting periods thereafter. Earlier application is encouraged.

A subscription-based information technology arrangement (SBITA) is a contract that conveys control of the right to use another party's (the SBITA vendor's) information technology (IT) software, alone or in combination with tangible capital assets (the underlying IT assets), as specified in the contract for a period of time in an exchange or exchange-like transaction. Common arrangements include provisions such as remote access to software applications or cloud data storage.

GASB Statement No. 96 (a) establishes that a SBITA results in a right-to-use subscription asset — an intangible asset — and a corresponding subscription liability; (b) provides the capitalization criteria for outlays other than subscription payments, including implementation costs of a SBITA; and (c) requires note disclosures regarding a SBITA.

This edition of the guide has not been updated to reflect changes that result from this statement; however, the following section will be updated in a future edition. Readers are encouraged to consult the full text of the statement at www.gasb.org.

15.77 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 15.71. 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 15.41–.60. Accounting for excess consideration provided in a governmental acquisition (known as goodwill in nongovernmental entities) is discussed in paragraphs 15.80–.82 and 15.210–.212.

15.78 Because the intangible assets within the scope of GASB Statement No. 51, as amended, 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 15.88 for further discussion.

15.79 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, as amended, 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)

15.80 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 15.208–212.

15.81 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

15.82 A government should periodically review and revise its estimate of the attribution period in subsequent reporting periods.

Leased Assets

15.83 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*, as amended, provides additional guidance for operating leases of governmental health care enterprises.

GASB Statement No. 87, *Leases*, as amended, establishes a single model for lease accounting based on the foundational principle that leases are financings of the right to use an underlying asset. Unlike FASB ASC 842, all leases (with certain exclusions as discussed in paragraphs 8, 19, and 41 of Statement No. 87) are reported in manner similar to finance leases of nongovernmental entities; that is, the lease liability is classified as long-term debt, the interest associated with the lease is classified as interest expense, and the right-to-use lease asset is amortized. (For nongovernmental entities, an operating lease does not have interest expense or amortization expense.) Similar to FASB

ASC 842, short-term leases are excluded from the general lease recognition requirements of GASB Statement No. 87.

Under GASB Statement No. 87, as amended, at commencement, 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 initial direct costs. A lessee should reduce the lease liability as payments are made and recognize an 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. However, if the lease contains a purchase option that the lessee has determined is reasonably certain of being exercised, the lease asset should be amortized over 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 revenue from the deferred inflow of resources in a systematic and rational manner over the term of the lease.²⁶

GASB Implementation Guide No. 2019-3, *Leases*, provides guidance that clarifies, explains, or elaborates on the requirements of Statement No. 87. Question 4.15 in GASB Implementation Guide No. 2020-1, *Implementation Guidance Update — 2020*, (GASB IG 2020-1) provides guidance to a lessor when determining the rate to be used to discount future lease payments to be received.²⁷ Additionally, appendix D, "GASB Statement No. 87, *Leases*," of the 2021 edition of AICPA Audit and Accounting Guide *State and Local Governments* (chapter 15 for the 2022 edition) provides guidance on accounting and financial reporting considerations.

²⁶ GASB Statement No. 87, *Leases*, as amended by GASB Statement No. 95, is effective for fiscal years beginning after June 15, 2021, and all reporting periods thereafter. Earlier application is encouraged.

²⁷ GASB Implementation Guide No. 2019-3, *Leases*, as amended by GASB Statement No. 95, is effective for fiscal years beginning after June 15, 2021, and all reporting periods thereafter. Earlier application is encouraged. Question 4.15 of GASB Implementation Guide No. 2020-1, *Implementation Guidance Update — 2020*, (GASB IG 2020-1) is effective for fiscal years beginning after December 15, 2021.

Service Concession Arrangements

© Update 15-2 Accounting: Public-Private and Public-Public Partnerships and Availability Payment Arrangements

GASB Statement No. 94, *Public-Private and Public-Public Partnerships and Availability Payment Arrangements*, is effective for fiscal years beginning after June 15, 2022 and all reporting periods thereafter. Earlier application is encouraged.

GASB Statement No. 94 supersedes GASB Statement No. 60 and related implementation guide questions. It amends several other pronouncements.

For purposes of applying GASB Statement No. 94, a public-private or public-public partnership (referred to as a PPP) is an arrangement in which a government (the transferor) contracts with an operator to provide public services by conveying control of the right to operate or use a nonfinancial asset, such as infrastructure or other capital asset (the underlying PPP asset), for a period of time in an exchange or exchange-like transaction. With some exceptions, the transferor should recognize an underlying PPP asset as an asset if financial statements are prepared using the economic resources measurement focus (which is used by most governmental health care entities) as well as a receivable for installment payments, if any, to be received from the operator in relation to the PPP. The transferor should also recognize a deferred inflow of resources for the consideration received or to be received as part of the PPP, which is recognized as revenue by the transferor in a systematic and rational manner over the PPP term.

For purposes of applying GASB Statement No. 94, an availability payment arrangement (APA) is an arrangement in which a government compensates an operator for activities that may include designing, constructing, financing, maintaining, or operating an underlying nonfinancial asset for a period of time in an exchange or exchange-like transaction. The payments by the government are based entirely on the asset's availability for use rather than on tolls, fees, or similar revenues or other measures of demand. An APA that is related to designing, constructing, and financing a nonfinancial asset in which ownership of the asset transfers by the end of the contract should be accounted for by a government as a financed purchase of the underlying nonfinancial asset.

This edition of the guide has not been updated to reflect changes that result from this statement; however, the following section will be updated in a future edition. Readers are encouraged to consult the full text of the statement at www.gasb.org.

15.84 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, as amended, 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, as amended, and paragraphs 211–271 of GASB Statement No. 62, as amended, should not be applied to SCAs.

15.85 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.²⁸

15.86 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.

15.87 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

15.88 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

²⁸ 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.

policies. See paragraph 115 of GASB Statement No. 34, as amended.

- 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, as amended, and 120 of GASB Statement No. 34 and question Z.51.29 of GASB IG 2015-1.
- If significant, capital assets that are not being depreciated, including construction in progress,²⁹ 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, as amended.
- 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*.
- Pertinent data regarding leases. See paragraphs 223, 231, 239, 255–256, and 270 of GASB Statement No. 62.
- Pertinent data regarding leases. See paragraphs 37–39 and 57–60 of GASB Statement No. 87, as amended.³⁰
- 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, as amended.
- 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 SCAs by transferors and governmental operators. (See paragraphs 16–18 of GASB Statement No. 60.)

Municipal Bond Financing and Other Long-Term Debt

15.89 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," will also apply to governmental health care entities, including its discussion of auditor involvement with municipal securities

²⁹ See question 7.11.1 of GASB IG 2015-1.

³⁰ GASB Statement No. 87, as amended by GASB Statement No. 95, is effective for fiscal years beginning after June 15, 2021, and all reporting periods thereafter. Earlier application is encouraged.

filings and letters for underwriters and certain other requesting parties.³¹ The primary differences arise with respect to measurement and disclosure; when they exist, such differences are highlighted in the discussion that follows.

15.90 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.**

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 lease. **If a health care entity has no obligation to make payments of principal and interest on the debt or 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.**³²

15.91 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 be used to pay debt principal and interest would be reported as restricted assets, as discussed in paragraph 15.38. 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, as amended, and 7.24.25 of GASB IG 2015-1 and paragraphs 15.146–153. 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

³¹ 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 945B, *Auditor Involvement With Exempt Offering Documents*, 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).

All AU-C sections can be found in *AICPA Professional Standards*.

³² GASB Statement No. 87, as amended by GASB Statement No. 95, is effective for fiscal years beginning after June 15, 2021, and all reporting periods thereafter. Earlier application is encouraged.

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

15.92 GASB Statement No. 7, *Advance Refundings Resulting in Defeasance of Debt*, as amended, 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.

15.93 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.³³ 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.

15.94 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.³⁴ If the source of

³³ See paragraph 4 of GASB Statement No. 7, *Advance Refundings Resulting in Defeasance of Debt*, and paragraph 4 of GASB Statement No. 86, *Certain Debt Extinguishment Issues*.

³⁴ 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, *Accounting and Financial Reporting for Refundings of Debt Reported by Proprietary Activities*, as amended.

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.³⁵ 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 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.

15.95 Paragraphs 124–127 of GASB Statement No. 62, as amended, apply if debt is extinguished by means other than defeasance in a current or an advanced refunding or a troubled debt restructuring.³⁶ Paragraph 126 of GASB Statement No. 62 requires that any gain or loss be recognized in the period of extinguishment and the gain or loss 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

15.96 Paragraph 187 of GASB Statement No. 62, as amended, 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 GASB IG 2016-1.

Disclosures

15.97 GASB standards require certain disclosures about debt, including the following:

For the purposes of disclosure in notes to financial statements, debt is defined as a liability that arises from a contractual obligation to pay cash (or other assets that may be used in lieu of cash) in one or more payments to settle an amount

³⁵ 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.

³⁶ 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.

that is fixed³⁷ at the date the contractual obligation is established. 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, as amended.
- 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, as amended.
- 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. See paragraph 10 of GASB Statement No. 38, as amended. Similar requirements apply to obligations under leases. See paragraph 37 of GASB Statement No. 87.³⁸
- When derivative instruments are entered into to achieve a synthetic interest rate, the hedging derivative instrument's net cash flows, in addition to the debt service requirements of the associated debt. See paragraph 74 of GASB Statement No. 53.
- 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, as amended.
- 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, as amended.
- 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

³⁷ For purposes of determining if an amount is fixed, interest to be accrued and subsequently paid (such as interest on variable-rate debt) or interest to be added to the principal amount of the obligation (such as interest on capital appreciation bonds) does not preclude the amount to be settled from being considered fixed at the date the contractual obligation is established.

³⁸ GASB Statement No. 87, as amended by GASB Statement No. 95, is effective for fiscal years beginning after June 15, 2021, and all reporting periods thereafter. Earlier application is encouraged.

private-sector entities. Paragraph 11 of GASB Statement No. 7, as amended, 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 8–9 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 10–11 of GASB Statement No. 86.
- Summarized information about the amount of unused lines of credit, assets pledged as collateral for debt, and terms specified in debt agreements related to significant (a) events of default with finance-related consequences, (b) termination events with finance-related consequences, and (c) subjective acceleration clauses. See paragraph 5 of GASB Statement No. 88.
- In all disclosures regarding debt, information about direct borrowings and direct placement of debt should be separated from information about other debt. See paragraph 6 of GASB Statement No. 88.

Contingencies and Other Liabilities

Insurance-Related Contingencies

15.98 Governmental health care entities are generally exposed to the same risks of loss that are described in chapter 8, "Contingencies and Other Liabilities." 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, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, 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 15.99
- 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 15.41–.68
- Participation in a public-entity risk pool (paragraphs 69–71), which is discussed in paragraph 15.102
- Claims-made policies (paragraph 72), which are discussed in paragraph 15.100
- Retrospectively-rated policies and contracts (paragraph 73–74), which are discussed in paragraph 15.101
- Disclosures (paragraphs 77–80)

General Principles for Recognition, Measurement, and Disclosure of Contingencies

15.99 The recognition and measurement requirements in paragraphs 53–56, as amended, 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 applies to governmental health care entities. However, recognition and measurement of claims liabilities differ because GASB Statement No. 10, as amended, 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

15.100 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, except that amounts recoverable through insurance reduce the liability, rather than being reported as a receivable.

Retrospectively-Rated Policies and Contracts

15.101 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

15.102 GASB Statement No. 10, as amended, 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, as amended. 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 amended, as discussed in paragraph 15.98. 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, as amended.

Irrevocable Self-Insurance Trusts

15.103 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, as amended. 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 15.150 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

15.104 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, as amended. 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

15.105 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.

15.106 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.

15.107 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

15.108 When evaluating pollution remediation obligations and asset retirement obligations, governmental health care entities should consider the guidance in GASB Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*, as amended, and GASB Statement No. 83, *Certain Asset Retirement Obligations*, respectively. 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). In contrast, GASB Statement No. 83 provides guidance for legally enforceable retirement obligations that result from normal operations of tangible capital assets, whether acquired or constructed.

15.109 The scope of GASB Statement No. 49, as amended, includes obligations to 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. 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. The amount should be estimated using the expected cash flow technique, which measures the liability as the sum of probability-weighted amounts in a range of possible estimated amounts — the estimated mean or average. 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 (which are within the scope of GASB Statement No. 18, *Accounting for Municipal Solid Waste Landfill Closure and Postclosure Care Costs*, as amended) and medical

equipment that requires decommissioning (which is within the scope of GASB Statement No. 83).

15.110 GASB Statement No. 83 addresses legally enforceable liabilities associated with the retirement of tangible capital assets (referred to as *asset retirement obligations* or *AROs*). A government health care entity 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 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 (an external obligating event), together with the occurrence of an internal event that obligates a government to perform asset retirement activities (an internal obligating event). For example, an x-ray machine is a health care-related example of an asset whose normal operation generates an ARO. The external obligating event is the law that requires x-ray machines to be disposed of in a certain way because of the presence of potentially hazardous materials. The internal obligating event is the occurrence of contamination which arises from putting the x-ray machine into operation. The measurement of an ARO should be based on the best estimate of the current value of outlays expected to be incurred. The best estimate should include probability weighting of all potential outcomes, when such information is available or can be obtained at reasonable cost. If probability weighting is not feasible at reasonable cost, the most likely amount in a range of potential outcomes should be used. A difference between the private-sector standards of FASB ASC 410, *Asset Retirement and Environmental Obligations*, and GASB Statement No. 83 is that the liability of a governmental health care entity is not projected and then discounted. The deferred outflow of resources should be amortized as an outflow of resources (for example, expense) in a systematic and rational manner over the estimated useful life of the tangible capital asset (or remaining useful life if the tangible capital asset is already in service when the ARO is recognized). At least annually the values of AROs are adjusted for the effects of general inflation or deflation. In addition, at least annually the health care entity should determine whether the effects of one or more of the relevant factors are expected to significantly change the estimated asset retirement outlays. If the result of the evaluation indicates there is a significant change in the estimated outlays, the health care entity should remeasure the ARO.

Other Contingencies

15.111 Governmental health care entities are also exposed to loss contingencies that are outside the scope of GASB Statement No. 10, as amended. The criteria in paragraphs 96–113 of GASB Statement No. 62, as amended, 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.³⁹ Those criteria are similar to the private-sector standards in FASB ASC 450-20.

³⁹ 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.

Compensation and Related Benefits

15.112 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 AICPA Audit and Accounting Guide *State and Local Governments* contains more expansive discussions of these standards.

Deferred Compensation Plans

15.113 GASB Statement No. 97, *Certain Component Unit Criteria, and Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans — an amendment of GASB Statements No. 14 and No. 84, and a supersession of GASB Statement No. 32*, requires that a Section 457 deferred compensation plan be classified as either a pension plan or an other employee benefit plan depending on whether the plan meets the definition of a pension plan. GASB Statement No. 84, as amended, should be applied to all arrangements organized under IRC Section 457 to determine whether those arrangements should be reported as fiduciary activities.⁴⁰

15.114 All accounting and financial reporting requirements that are relevant to pensions should be applied to benefits provided through a Section 457 plan that meets the definition of a pension plan. For example, an employer (or a nonemployer contributing entity) should apply the requirements of GASB Statement No. 68, *Accounting and Financial Reporting for Pensions — an Amendment of GASB Statement No. 27*, as amended, or 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*, as amended, to such benefits, as appropriate. The requirements that are applied should be based on the specific type of benefits that are provided through the Section 457 plan, for example, defined contribution pensions.⁴¹

Pensions

15.115 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 related to pensions (pension amounts) in their financial statements in accordance with GASB Statement No. 68, 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.

15.116 GASB Statement No. 68, as amended, requires that the net pension liability be reported on the face of the statement of net position and measured as the portion of the actuarial present value of projected benefit payments

⁴⁰ Paragraphs 6–9 of GASB Statement No. 97, *Certain Component Unit Criteria, and Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans — an amendment of GASB Statements No. 14 and No. 84, and a supersession of GASB Statement No. 32*, are effective for fiscal years beginning after June 15, 2021.

⁴¹ Paragraphs 6–9 of GASB Statement No. 97 are effective for fiscal years beginning after June 15, 2021.

that is attributed to past periods of employee service (total pension liability), net of the pension plan's fiduciary net position. Determining the total pension liability is a three step process: (1) projecting future benefit payments, (2) discounting projected future benefit payments to an actuarial present value, and (3) attributing the actuarial present value of projected future benefits to past and future periods using the entry age actuarial cost method with each period's service cost determined as a level percentage of pay. The pension plan's fiduciary net position component should be determined using the same valuation methods that are used by the pension plan for purposes of preparing its statement of fiduciary net position. The net pension liability should be measured as of a date (measurement date) no earlier than the end of the employer's prior fiscal year, consistently applied from period to period.

15.117 Most changes in the net pension liability during the measurement period are included in pension expense. For example, changes in the total pension liability during the measurement period resulting from current-period service cost, interest on the total pension liability, and changes of benefit terms are required to be recognized as pension expense in the current reporting period. Projected earnings on the pension plan's investments also are required to be included in the determination of pension expense in the current reporting period. Certain changes, including those pertaining to actual performance compared to assumptions and economic/demographic assumption changes, will be amortized over a closed period, commencing with the current period. Amounts that are not recognized as expense in the reporting period are recognized as deferred inflows of resources or deferred outflows of resources related to pensions, as appropriate. Employer contributions subsequent to the measurement date of the net pension liability are required to be reported as deferred outflows of resources.

15.118 Some governmental health care employers provide defined benefit pensions through a cost-sharing multiple-employer (cost-sharing) plan that is administered through a qualifying trust. Those employers are required to report their proportionate shares of the pension plan's collective 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, as amended. The liability to be recognized for the employer's proportionate share of the collective net pension liability is measured as of a date (measurement date) no earlier than the end of the employer's prior fiscal year, consistently applied from period to period. Paragraph 48 of GASB Statement No. 68, as amended, requires that the basis for the employer's proportion be consistent with the manner in which contributions to the plan are determined. Although GASB Statement No. 68 encourages an allocation method based on an employer's projected long-term contribution effort to the plan as compared to the total projected long-term contribution efforts of all employers contributing to the plan (that is, the actuarial method), other allocation methods may be used, including allocations based on historical measures, such as actual contributions or pensionable wages.

15.119 Paragraph 53 of GASB Statement No. 68 requires that pension expense, as well as deferred outflows of resources and deferred inflows of resources related to cost-sharing pension plans, be recognized for the governmental employer's proportionate share of collective pension expense and collective deferred outflows of resources and deferred inflows of resources related to pensions. The employer's proportionate share should be determined using the employer's proportion of the collective net pension liability.

15.120 GASB Statement No. 73, as amended, extends to all pensions the approach to accounting and financial reporting established in GASB Statement No. 68, as amended, 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.

15.121 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 RSI for pensions provided via certain multiple-employer defined benefit pension plans as defined by GASB Statement No. 78, such as certain labor union plans.

15.122 Further guidance is provided in GASB Implementation Guides, especially paragraph 10 of GASB IG 2015-1. Additionally, chapter 13, "Defined Benefit Pension Plans (Plan & Employer Considerations)," of AICPA Audit and Accounting Guide *State and Local Governments* contains extensive guidance on accounting, financial reporting, and auditing considerations related to pensions. GASB Statement No. 68, as amended, also provides accounting and financial reporting requirements for employers whose employees are provided with defined contribution pensions.

Postemployment Benefits Other Than Pensions — Employer Accounting

15.123 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. 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.

15.124 GASB Statement No. 75, as amended, has many parallels to the standards for pension accounting and financial reporting in GASB Statement No. 68, as amended. It 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 an actuarial present value and allocating the actuarial 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 may be used.)

15.125 Most changes in the net OPEB liability during the measurement period are included in OPEB expense. For example, changes in the total OPEB liability during the measurement period resulting from current-period service cost, interest on the total OPEB liability, and changes of benefit terms are required to be recognized as OPEB expense in the current reporting period. Projected earnings on the OPEB plan's investments also are required to be included in the determination of OPEB expense in the current reporting period. Certain changes, including those pertaining to actual performance compared to assumptions and economic/demographic assumption changes, will be amortized over a closed period, commencing with the current period. Amounts that are not recognized as expense in the reporting period are recognized as deferred inflows of resources or deferred outflows of resources related to OPEB, as appropriate. Employer contributions subsequent to the measurement date of the net OPEB liability are required to be reported as deferred outflows of resources.

15.126 Some governmental health care employers provide defined benefit OPEB through a cost-sharing multiple-employer (cost-sharing) plan that is administered through a qualifying trust. Those employers are required to report their proportionate shares of the plan's collective net OPEB liability, OPEB expense, and certain deferred outflows of resources and deferred inflows of resources (OPEB amounts) in their financial statements in accordance with GASB Statement No. 75, as amended. The liability to be recognized for the employer's proportionate share of the collective net OPEB liability is measured as of a date (measurement date) no earlier than the end of the employer's prior fiscal year, consistently applied from period to period. Paragraph 59 of GASB Statement No. 75 requires that the basis for the employer's proportion be consistent with the manner in which contributions to the plan are determined. Although GASB Statement No. 75 encourages an allocation method based on an employer's projected long-term contribution effort to the plan as compared to the total projected long-term contribution efforts of all employers contributing to the plan (that is, the actuarial method), other allocation methods may be used, including allocations based on historical measures, such as actual contributions.

15.127 Paragraph 63 of GASB Statement No. 75 requires that OPEB expense, as well as deferred outflows of resources and deferred inflows of resources related to cost-sharing OPEB plans, be recognized for the governmental employer's proportionate share of collective OPEB expense and collective deferred outflows of resources and deferred inflows of resources related to OPEB. The employer's proportionate share should be determined using the employer's proportion of the collective net OPEB liability.

15.128 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.

15.129 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.

15.130 Further guidance is provided in GASB Implementation Guide No. 2017-3, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions (and Certain Issues Related to OPEB Plan Reporting)*, (GASB IG 2017-3). Additionally, Chapter 14, "Defined Benefit Postemployment Benefits Other than Pensions (Plan & Employer Considerations)," of AICPA Audit and Accounting Guide *State and Local Governments* contains extensive guidance on accounting, financial reporting, and auditing considerations related to OPEB. GASB Statement No. 75, as amended, also provides accounting and financial reporting requirements for employers whose employees are provided with defined contribution OPEB.

Pension Trust Funds and OPEB Trust Funds

15.131 Governmental health care entities with pension plans or OPEB plans that are subject to the requirements of GASB Statements No. 67, as amended, and No. 74, as amended, respectively, have fiduciary fund reporting requirements for those pension or OPEB trusts if either (a) they are component units (as described in GASB Statement No. 14, *The Financial Reporting Entity*, as amended; see also paragraphs 15.173–.178) or (b) the health care entity controls the plan assets (as described in paragraph 12 of GASB Statement No. 84). Similarly, in circumstances in which assets from entities that are not part of the reporting entity are accumulated either for pensions (as described in paragraph 116 of GASB Statement No. 73, as amended) or for OPEB (as described in paragraph 59 of GASB Statement No. 74, as amended), governmental health care entities have fiduciary fund reporting requirements when those arrangements are component units or when the governmental health care entity controls the plan assets. However, pension or OPEB arrangements are not reported in fiduciary funds if they are neither component units nor controlled by the health care entity.

15.132 Appendix C of GASB Statement No. 84 provides flowcharts that are intended to aid in the application of the provisions of GASB Statement No. 84, as amended. (The flowcharts are nonauthoritative and do not cover all aspects of the requirement. They should not be used in place of the statement itself.)

15.133 If pension and OPEB arrangements meet the requirements for fiduciary fund reporting, governmental health care entities are required to include a statement of fiduciary net position and a statement of changes in fiduciary net position for the pension or OPEB trust in their financial statements. Pension (and other employee benefit) trust funds are used to report pension plans subject to the requirements of GASB Statement No. 67, as amended, and postemployment benefit plans subject to GASB Statement No. 74, as amended, as well as other employee benefit plan trusts if both (1) contributions to the trust and earnings on those contributions are irrevocable and (2) resources are held in a trust that meets all of the following criteria:

- a. The assets are administered through a trust in which the government itself is not a beneficiary
- b. The assets are dedicated to providing benefits to recipients in accordance with the benefit terms

- c. The assets are legally protected from the creditors of the government.

15.134 If pension and postemployment benefit arrangements are fiduciary activities (as defined in GASB Statement No. 84, as amended) but are not required to be reported in pension or other employee benefit trust funds, they are reported in custodial funds. Paragraphs 15.138–.141 provide additional information about reporting custodial funds.

15.135 GASB Implementation Guide No. 2019-2, *Fiduciary Activities*, as amended, (GASB IG 2019-2) provides guidance that clarifies, explains, or elaborates on the requirements of GASB Statement No. 84, as amended.

Questions 4.2 and 4.3 of GASB Implementation Guide No. 2021-1, *Implementation Guidance Update — 2021*, (IG 2021-1) provide guidance for determining if an employee benefit plan is a fiduciary activity.⁴²

Sabbaticals and Other Compensated Absences

15.136 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*, as amended. 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

15.137 GASB Statement No. 47, *Accounting for Termination Benefits*, as amended, establishes accounting standards for the measurement, recognition, and disclosures of voluntary and involuntary termination benefits. Section Z.47 of GASB IG 2015-1, as amended, provides additional helpful guidance. GASB Statement No. 69, as amended, provides guidance on costs included in and excluded from disposals of government operations and reporting thereof. Question 4.19 of GASB IG 2017-1 provides guidance when a government offers an early retirement incentive in the form of additional pension service credits.

⁴² Questions 4.2 and 4.3 of GASB Implementation Guide No. 2021-1, *Implementation Guidance Update — 2021*, are effective for reporting periods beginning after June 15, 2022.

Arrangements in Which the Health Care Entity Holds Assets for Others

15.138 Governmental health care entities may receive and hold assets owned by others under custodial relationships (referred to as fiduciary relationships). For example, they may perform billing and collection services for physicians. A governmental health care entity should apply paragraphs 6–9 of GASB Statement No. 84, as amended, to determine if those relationships are fiduciary component units and paragraphs 11–13 of GASB Statement No. 84 to determine if those relationships are other fiduciary activities. Fiduciary activities are required to be reported in a statement of fiduciary net position and a statement of changes in fiduciary net position.

15.139 Paragraphs 15–18 of GASB Statement No. 84 are used to determine the appropriate type of fiduciary fund(s) to use for reporting fiduciary activities in the fiduciary fund financial statements. If fiduciary activities are not required to be reported in pension (and other employee benefit) trust funds, investment trust funds, or private-purpose trust funds, they are required to be reported as custodial funds.

15.140 Paragraph 19 of GASB Statement No. 84 allows business-type activities to report custodial fund activity in the statement of net position as assets with a corresponding liability (rather than as a custodial fund in the fiduciary fund financial statements) if the assets, upon receipt, are normally expected to be held for three months or less. Paragraph 15.28 discusses the reporting of the cash inflows and outflows from the relationships if the health care entity uses this presentation option. If, however, the assets held are normally expected to be held for more than three months, they are required to be reported as custodial funds in fiduciary fund financial statements.

15.141 Appendix C of GASB Statement No. 84 provides flowcharts that are intended to aid in the application of the provisions of GASB Statement No. 84, as amended. (The flowcharts are nonauthoritative and do not cover all aspects of the requirements. They should not be used in place of the Statement itself.) GASB IG 2019-2, as amended, provides guidance that clarifies, explains, or elaborates on the requirements of GASB Statement No. 84, as amended.

Tax Considerations

15.142 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.

15.143 In some cases, state or local governmental entities will secure tax-exempt status as an IRC Section 501(c)(3) organization.⁴³ If such an exemption is secured, the entity may become subject to federal unrelated business income

⁴³ This is sometimes done to facilitate fundraising because IRC Section 501(c)(3) status assures potential donors that their contributions will be tax deductible.

tax and filing requirements on the same basis as other tax-exempt entities, as discussed in chapter 8.

Disclosures

15.144 Paragraph 3 of GASB Statement No. 10, as amended, and NCGA Statement 4, as amended, require various disclosures related to claims and judgments. Paragraphs 116 and 119–120 of GASB Statement No. 34, as amended, 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.

15.145 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, as amended.
- 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, as amended.
- 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, as amended, (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, as amended, (for pensions provided without using eligible trusts), or GASB Statement No. 78 (for certain multiple-employer defined benefit pension plans).
- Disclosures about OPEB, including certain multiyear actuarial data required to be presented as RSI. See GASB Statement No. 75, as amended, and GASB Statement No. 85, *Omnibus 2017* (for certain multiple-employer defined benefit OPEB plans).
- Disclosures about termination benefits. See paragraphs 18–21 of GASB Statement No. 47, as amended.
- Disclosure of actions taken to remedy significant violations of finance-related legal or contractual provisions. See paragraph 9 of GASB Statement No. 38.
- Disclosures about asset retirement obligations. See paragraphs 27–29 of GASB Statement No. 83.

Net Position

15.146 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

minority interest in a component unit exists, restricted net position should be displayed in two additional components: expendable and nonexpendable.⁴⁴

15.147 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.⁴⁵

15.148 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 GASB IG 2015-1. Paragraph 15.150 provides additional guidance about calculating the amount of the net investment in capital assets component of net position.

15.149 Restricted net position of governmental health care entities 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 governments⁴⁶ or (b) by law through constitutional provisions or enabling legislation.⁴⁷ Thus, in addition to resources restricted for purposes identified by donors and grantors, restricted net position includes restricted assets, as discussed in paragraph 15.38, 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, as amended, 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).

⁴⁴ See paragraph 35 of GASB Statement No. 34, as amended.

⁴⁵ However, these designations should not be displayed on the face of the statement of net position. See paragraph 15.155.

⁴⁶ See paragraphs 34–35 of GASB Statement No. 34.

⁴⁷ See GASB Statement No. 46, *Net Assets Restricted by Enabling Legislation — an amendment of GASB Statement No. 34*.

15.150 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. Question 7.24.7 of GASB IG 2015-1, as amended, 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.⁴⁸ 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.⁴⁹ 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.⁵⁰

15.151 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.⁵¹ 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.

15.152 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.⁵² In calculating net position balances associated with permanent endowments, care should be exercised to appropriately reflect the expendable and nonexpendable components if endowment assets include both corpus and spendable

⁴⁸ See question 7.23.2 of GASB IG 2015-1.

⁴⁹ See question 7.24.25 of GASB IG 2015-1.

⁵⁰ See question 7.24.2 of GASB IG 2015-1.

⁵¹ See question 7.24.13 of GASB IG 2015-1.

⁵² See questions 7.24.29 and 7.24.30 of GASB IG 2015-1.

accumulated net appreciation (for example, nonexpendable restricted assets are commingled with spendable restricted assets).

15.153 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 of resources to specific restricted or capital assets for purposes of calculating the components. Paragraph 13 of GASB IG 2015-1 contains guidance for applying the standards in various scenarios.

Financial Reporting of Net Position

15.154 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.⁵³ 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.

15.155 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

15.156 As discussed in chapter 10, "Health Care Service Revenue and Related Receivables," 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.⁵⁴ 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.**

15.157 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

⁵³ See question 7.22.8 of GASB IG 2015-1.

⁵⁴ Although the description of the economic and regulatory environment in Chapter 10, "Health Care Service Revenue and Related Receivables," generally applies to governmental health care entities, FASB standards for revenue recognition and measurement of receivables do not apply, including the standards in FASB ASC 606, *Revenue from Contracts with Customers*.

statement or in a note to the financial statements. Alternatively, revenues may be 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. The netting of discounts and allowances against revenue by governmental health care entities is similar to private-sector entities reducing revenue for implicit and explicit price concessions. 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 impairment of receivables as bad debt expense.

15.158 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*, as amended, 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.

15.159 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, as amended, 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, as amended.
- 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, as amended.
- 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 10.27.

Chapter 6, "Revenues and Receivables," of 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

15.160 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, *Accounting and Financial Reporting for Nonexchange Transactions*, as amended, which establishes accounting and financial reporting standards for the recognition of nonexchange transactions involving financial or capital resources.⁵⁵

15.161 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, as amended.

15.162 Voluntary nonexchange transactions may be received with associated time or purpose restrictions. As discussed in paragraph 14 of GASB Statement No. 33, as amended, 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.

⁵⁵ To date, GASB has not issued any guidance related to noncapital gifts-in-kind or contributed services.

15.163 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 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.

15.164 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.⁵⁶ As noted in question Z.33.19 of GASB 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, as amended, 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.⁵⁷

15.165 In some cases, it may become apparent after revenue has been recognized in the financial statements that 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.

15.166 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.⁵⁸ GASB Statement No. 81,

⁵⁶ See paragraph 25 and examples 21 and 21(a) in appendix D of GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*.

⁵⁷ See examples 24–25 in appendix D of GASB Statement No. 33.

⁵⁸ These and other types of split-interest agreements are described in chapter 6, "Split-Interest Agreements and Beneficial Interests in Trusts," of AICPA Audit and Accounting Guide *Not-for-Profit*

(continued)

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 qualifying 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. Question 4.13 of GASB IG 2019-1 discusses the situation in which the remainder interest of an irrevocable split-interest agreement is required to be used to establish a permanent endowment. Initially, the remainder interest benefit is recognized as a deferred inflow of resources. At the termination of the irrevocable split-interest agreement, revenue is recognized for the second transaction — the establishment of the permanent endowment.

15.167 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.⁵⁹ Question Z.33.1 in GASB IG 2015-1 also discusses considerations related to determining whether a grant is an exchange or a nonexchange transaction.

15.168 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* (ACC sec. 10),⁶⁰ provides guidance for state and local governmental entities, including health care entities, that conduct fundraising activities with activities related to other functions, such as program activities or supporting services (joint activities). FASB ASC 958-720 superseded SOP 98-2 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."

(footnote continued)

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.)

⁵⁹ See example 22 in appendix D of GASB Statement No. 33.

⁶⁰ All ACC sections can be found in AICPA *Professional Standards*.

15.169 GASB Statement No. 34, as amended, 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 15.19. 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 15.20, 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.

15.170 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, as amended, does not require that restricted resources be used first when an expenditure is made for a purpose for which both net assets subject to a temporary donor restriction and net assets without donor restrictions 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.⁶¹

The Reporting Entity and Related Entities

15.171 Governmental health care entities and private-sector health care entities use different definitions of the *financial reporting entity*. GASB Statement No. 14, 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.⁶²

15.172 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,⁶³ and legally separate organizations for which the primary government (or nucleus) is *financially accountable* (as discussed in paragraphs 15.174–175). 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 GASB IG 2015-1 provide guidance for making the "misleading to include" determination.

⁶¹ See paragraph 115 of GASB Statement No. 34.

⁶² See paragraphs 10–11 and 21 of GASB Statement No. 14, *The Financial Reporting Entity*.

⁶³ 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.

Identifying Component Units

15.173 *Component units* are legally separate organizations for which the elected officials of the primary government (or nucleus) 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.

15.174 Financial accountability can be demonstrated in several ways, as described in 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 for that organization to provide specific financial benefits to, or impose specific financial burdens on, the governmental health care entity.

Financial accountability can be demonstrated in several ways, as described in 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 for that organization to provide specific financial benefits to, or impose specific financial burdens on, the governmental health care entity.

In certain instances, a legally separate organization does not have a governing board. For purposes of determining whether a primary government (or nucleus) is financially accountable, if the governmental health care entity performs the duties that a governing board typically would perform, the absence of a governing board should be treated the same as the appointment of a voting majority of a governing board, except for situations in which the potential component unit is a defined contribution pension plan, a defined contribution OPEB plan, or an other employee benefit plan (for example, certain Section 457 plans).⁶⁴

15.175 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

- a. a separately elected governing board,

⁶⁴ Paragraph 4 of GASB Statement No. 97 is effective as follows: As it applies to defined contribution pension plans, defined contribution OPEB plans, and other employee benefit plans, is effective immediately (that is, as of June 23, 2020). For other potential component units, paragraph 4 is effective for reporting periods beginning after June 15, 2021.

- b. a governing board appointed by a higher level of government, or
- c. a jointly appointed board.

15.176 A governmental health care entity is also financially accountable if it owns a majority of the equity interest in a legally separate organization (for example, through acquisition of its voting stock) and the majority equity interest does not meet the definition of an investment. Because the holding of the majority equity interest results in the government being financially accountable for the organization, the government should report the legally separate organization as a component unit. For purposes of applying this guidance, an equity interest is a financial interest in a legally separate organization evidenced by the ownership of shares of the organization's stock or by otherwise having an explicit, measurable right to the net resources of the organization that is usually based on an investment of financial or capital resources. An equity interest is explicit and measurable if the government has a present or future claim to the net resources of the entity and the method for measuring the government's share of the entity's net resources is determinable. If the majority equity interest meets the definition of an investment in paragraph 64 of GASB Statement No. 72, it should be reported as an investment regardless of whether the legally separate organization also meets the criteria to be reported as a component unit. Paragraphs 15.41–.42 further discuss the definition of an investment.

15.177 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 15.195–.200.

15.178 Defined benefit and defined contribution pension and OPEB arrangements should be evaluated to determine if they are fiduciary component units by first determining if they are component units and then determining if they meet one of the criteria in paragraph 6 of GASB Statement No. 84. The determination of whether they are component units is made as follows:

- Defined benefit and defined contribution pension plans and OPEB plans should be reported as component units if they are legally separate entities for which the elected officials of the primary

government (or nucleus) are financially accountable. Financial accountability can be demonstrated in several ways, as described in paragraph 21 of GASB Statement No. 14, as amended (see paragraphs 15.174–175). Paragraph 7 of GASB Statement No. 84, as amended, and paragraphs 4–5 of GASB Statement No. 97 provide additional guidance for determining financial accountability. Generally, a pension trust that meets the criteria in paragraph 3 of GASB Statement No. 67 or an OPEB trust that meets the criteria in paragraph 3 of GASB Statement No. 74 is a legally separate entity.

- Relative to a defined benefit pension plan or defined benefit OPEB plan, a primary government (or nucleus) is considered to have a financial burden if it is legally obligated or has otherwise assumed the obligation to make contributions to the defined benefit pension plan or defined benefit OPEB plan. Further, as explained in paragraph 4 of GASB Statement No. 97, if the primary government (nucleus) performs the duties that a governing board typically would perform for a defined benefit pension plan or a defined benefit OPEB plan, the absence of a governing board should be treated the same as the appointment of a voting majority of a governing board. Questions 4.1 and 4.2 of GASB IG 2020-1 provide guidance about fiscal dependency if the governmental healthcare entity has the ability to change the required contribution amount to the defined benefit plan.⁶⁵
- Relative to defined contribution pension or defined contribution OPEB plans, generally a plan should be reported as a component unit in accordance with paragraphs 20–21 of GASB Statement No. 14 if the plan (a) is legally separate, (b) has a governing board and the primary government (or nucleus) appoints the voting majority of that board, and (c) the primary government (or nucleus) can impose its will on the plan.

Presentation of Component Units

15.179 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 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. Question 4.2 of GASB 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

⁶⁵ Questions 4.1 and 4.2 of GASB IG 2020-1 are effective for reporting periods beginning after June 15, 2021.

services to patients. The LLC should be included in the hospital's financial statements using the blending method because, in the absence of a separate governing board of the LLC, the government hospital being the sole member of the LLC is tantamount to the component unit having the same governing board as the primary government, and the government hospital management has operational responsibility for the LLC.

- 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.

15.180 For governments engaged only in business-type activities or only in business-type and fiduciary 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 (or nucleus) and presenting condensed combining information in the notes to the financial statements. GASB Statement No. 85 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 GASB Statement No. 14, as amended. If a component unit is blended, the asset and net position associated with the equity interest held by the primary government (or the entity that serves as the nucleus of the reporting entity) should be eliminated in the blending process. Fiduciary component units should be reported only in the statements of fiduciary net position and changes in fiduciary net position (which is discussed further at paragraph 15.20); fiduciary component units are never blended with the primary government (or nucleus).⁶⁶

15.181 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 column for the entity as a whole may be presented but is not required).⁶⁷

⁶⁶ Question 4.52 in GASB IG 2019-2 provides an example of a university that is a stand-alone business-type activity that uses a single-column for presenting its financial statements. It states that the university is required to include fiduciary fund financial statements as part of its basic financial statements, but it may choose to apply the exception in paragraph 19 of GASB Statement No. 84 to the extent that fiduciary assets upon receipt are normally expected to be held for three months or less. It also states that the government-wide financial statements that include a single column presentation for a business-type activity should not include fiduciary activities.

⁶⁷ 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).

(continued)

Component units included as a result of meeting the criteria in GASB Statement No. 39 (included in paragraph 15.177) should always be discretely presented. In accordance with paragraph 55 of GASB Statement No. 14, as amended, when a component unit is discretely presented, in addition to the separate column or separate page, the majority 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) and measured using the equity method in accordance with paragraphs 205–209 of GASB Statement No. 62, as amended by GASB Statement No. 90.

15.182 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.

15.183 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 of revenues, expense, and changes in net position,
- 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.

15.184 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 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

(footnote continued)

Question 4.28.10 of GASB IG 2015-1 discusses various financial statement display options for discretely-presented component units of governments engaged only in business-type activities.

year of the component units included in the reporting entity should be consistent from year to year.⁶⁸ 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.⁶⁹

15.185 Because of the separate nature of discretely-presented component units, GASB Statement No. 34, as amended, 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.⁷⁰ However, paragraph 15 of GASB Statement No. 48, as amended, requires that intra-entity transfers of capital and financial assets should be reported based on the carrying value of the transferor.⁷¹ 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 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 in paragraph 17 of GASB IG 2015-1, as amended, provides implementation guidance for GASB Statement No. 48.

15.186 Additional guidance is provided in chapter 3, "The Financial Reporting Entity," of AICPA Audit and Accounting Guide *State and Local Governments* and Appendix B4 of GASB IG 2015-1, which provide nonauthoritative illustrations, examples, disclosures, and financial statement presentations.

Equity Interests

15.187 Paragraph 3 of GASB Statement No. 90 defines an equity interest as a financial interest in a legally separate organization evidenced by the ownership of shares of the organization's stock or by otherwise having an explicit, measurable right to the net resources of the organization that is usually based on an investment of financial or capital resources by the government. An equity interest is explicit and measurable if the government has a present or future claim to the net resources of the entity and the method for measuring the government's share of the entity's net resources is determinable. The

⁶⁸ See paragraphs 59–60 of GASB Statement No. 14.

⁶⁹ See paragraph 60 of GASB Statement No. 14.

⁷⁰ See paragraph 61 of GASB Statement No. 34.

⁷¹ Paragraph 15 of GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*, requires that a difference between the amount paid (exclusive of amounts that may be refundable) and the carrying value of the assets transferred should be reported as a gain or loss by the transferor and as a revenue or expenditure/expense by the transferee in their separately issued statements, but reclassified as transfers or subsidies, as appropriate, in the financial statements of the reporting entity. However, paragraph 6 of GASB Statement No. 92 requires that the difference instead be reported as an employer contribution or a nonemployer contributing entity contribution for transfers of capital or financial assets between a governmental employer or nonemployer contributing entity and a defined benefit pension plan or a defined benefit other postemployment benefit (OPEB) plan that are within the same financial reporting entity. That guidance is effective for fiscal years beginning after June 15, 2021, with earlier application encouraged.

definition of equity interest is not intended to include a government's residual interest in assets that may (on dissolution) revert to the government for lack of another equitable claimant. (That type of interest is, in substance, the same as escheatage, that is, the reversion of property to a state resulting from the absence of any known, rightful inheritors to the property.)

15.188 When an equity ownership interest does not meet the definition of an investment in paragraph 64 of GASB Statement No. 72, as amended, the investee should be evaluated for inclusion as a potential component unit, as described in paragraphs 15.171–.177. If the investee meets the criteria for reporting as a component unit because the governmental health care entity owns a majority equity interest in the investee, the majority equity interest is reported as an asset of the entity, and the equity method of accounting is used. (That accounting is described in paragraphs 205–209 of GASB Statement No. 62, as amended.) The component unit is presented as described in paragraphs 15.180–.181.

15.189 When an equity interest does not meet the definition of an investment in paragraph 64 of GASB Statement No. 72, as amended, and the investee does not meet the criteria for reporting as a component unit, the governmental health care entity should report an asset for its equity interest. The equity interest should be measured using the equity method of accounting if it meets the criteria in paragraphs 205–208 of GASB Statement No. 62, as amended, and it is not specifically excluded in paragraph .202 of GASB Statement No. 62, as amended. (For additional discussion of the equity method, see paragraphs 15.46–.48.) If an 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, as amended), the equity interest should be measured using the cost method in paragraph 203 of GASB Statement No. 62, as amended.

15.190 However, if the governmental health care 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 15.41–.42.

Equity Interest in Joint Ventures

15.191 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 GASB 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 venture'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 70–71 of GASB Statement No. 14, it is a jointly governed organization, rather than a joint venture.⁷²

15.192 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.

15.193 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 the joint venture's change in net position should be reported in the health care entity's statement of revenues, expenses, and changes in net position as a single amount.

15.194 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

15.195 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 15.171–178.

15.196 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 15.177, the governmental health care entity is required to report the fundraising foundation as a discretely-presented component unit. Distributions

⁷² 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.

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.

15.197 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 15.172 (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 15.179). If none of the criteria for blending is met, the fundraising foundation is discretely presented.

15.198 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, as amended.

15.199 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 15.172. 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, as amended.⁷³

15.200 Section 4.33 of GASB 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

15.201 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 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, as amended, to a government combination.

15.202 GASB Statement No. 69, as amended, 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 15.171–186.)

15.203 GASB Statement No. 69, as amended, 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

⁷³ 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.

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.

15.204 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 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, as amended. Paragraph 9 of GASB Statement No. 90 provides guidance if a governmental health care entity acquires a 100% equity interest in a legally separate organization that retains its separate legal status and is reported as a component unit (as discussed in paragraphs 15.171–.186). At the date on which the governmental health care entity acquires the 100% equity interest, the component unit should measure its assets, deferred outflows of resources, liabilities, and deferred inflows of resources in accordance with the provisions of paragraphs 29–42, 44, and 45 of GASB Statement No. 69. In applying those measurement provisions, the consideration provided should include the net resources exchanged to complete the acquisition of the 100% equity interest plus the balances of any equity interest asset and deferred outflow of resources recognized prior to the completion of the acquisition. In addition, the net position acquired should be equal to the net position of the component unit after measuring assets, deferred outflows of resources, liabilities, and deferred inflows of resources in accordance with the provisions of paragraphs 29–36 of GASB Statement No. 69. The statement of revenues, expenses, and other changes in net position (or other flows statements) of the component unit should include only those transactions that occurred subsequent to the acquisition of the 100% equity interest.

Mergers

15.205 Paragraphs 13–19, 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.

15.206 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.

15.207 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

15.208 Paragraphs 29–44, 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.

15.209 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, as amended, 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.

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 and paragraph 10 of GASB Statement No. 92) at acquisition value as of the acquisition date. For purposes of GASB Statement No. 69, as amended, 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.⁷⁴

15.210 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). 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.

15.211 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.

15.212 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 15.80–.82.) 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.

15.213 GASB Statement No. 69, as amended, 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.

15.214 The acquiring government should recognize an expense for acquisition costs in the periods in which the costs are incurred and the services are received.

Transfers of Operations

15.215 Paragraphs 46, 49, 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. If the transferor entity did not recognize or measure those elements in conformity with

⁷⁴ Paragraph 10 of GASB Statement No. 92, as amended by GASB Statement No. 95, is effective for government acquisitions occurring in reporting periods beginning after June 15, 2021.

authoritative guidance for state and local governments, those elements should be adjusted to bring them into conformity with that guidance before the transferee government reports them. 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

🔄 Update 15-3 *Auditing: Audit Evidence, Auditing Accounting Estimates, Use of Specialists, and Use of Pricing Information*

This edition of the guide has not been updated to reflect changes as a result of the issuance of the following Statements on Auditing Standards (SASs):

- SAS No. 142, *Audit Evidence* (AU-C sec. 500)
- SAS No. 143, *Auditing Accounting Estimates and Related Disclosures* (AU-C sec. 540)
- SAS No. 144, *Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources*

SAS No. 142 is effective for audits of financial statements for periods ending on or after December 15, 2022. SAS Nos. 143 and 144 are effective for audits of financial statements for periods ending on or after December 15, 2023. Early implementation is permitted.

The following section will be updated in a future edition. Readers should refer to the preface for further details regarding these SASs. Readers are encouraged to consult the full text of the SASs at aicpa.org.

15.216 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. 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 AICPA Audit and Accounting Guide *State and Local Governments* and this guide will be useful.

15.217 Chapter 4, "General Auditing Considerations," of 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, 15, "Concluding the Audit," and 16, "Audit Reporting," of 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.

15.218 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 funds,⁷⁵ (b) has any discretely-presented component units (see paragraphs 15.171–.186), and (c) has any fiduciary funds. A governmental health care entity that reports its activities in a single enterprise fund and has no discretely-presented component units or fiduciary funds 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 or one or more fiduciary funds will have more than one opinion unit: one for the primary government (the health care entity), one for the discretely-presented component units in aggregate, and one for the fiduciary funds in aggregate. Chapter 4 of AICPA Audit and Accounting Guide *State and Local Governments* provides additional guidance for determining the number of opinion units.

15.219 Nonauthoritative Technical Questions and Answers (Q&A) section 6950.24, "Auditor Assessment of a Special-Purpose Government's Only Immaterial Fiduciary Fund,"⁷⁶ discusses the question of how an auditor should assess the appropriateness of the omission of a fiduciary fund by a special-purpose government engaged only in business-type activities if the government determines that it has an activity that meets the criteria to be reported as a fiduciary

⁷⁵ 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).

⁷⁶ A Technical Questions and Answers (Q&A) section is an other auditing publication. AU-C section 200B, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, indicates that in applying the auditing guidance included in an other auditing publication, the auditor should, exercising professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. Other auditing publications have no authoritative status; however, they may help the auditor understand and apply GAAS. The auditor is not expected to be aware of the full body of other auditing publications. Although the auditor determines the relevance of these publications in accordance with paragraph .28 of AU-C section 200B, the auditor may presume that other auditing publications published by the AICPA that have been reviewed by the AICPA Audit and Attest Standards staff are appropriate. These other auditing publications are listed in AU-C appendix F, *Other Auditing Publications*.

All Q&A sections can be found in *Technical Questions and Answers*. *Technical Questions and Answers* can be downloaded at <https://www.aicpa.org/resources/download/aicpa-technical-questions-and-answers-at-your-fingertips>.

fund in its financial statements, but the government elects not to present the only identified fiduciary fund in the financial statements because it considers it to be immaterial based on the guidance in question 7.4.1 in GASB IG 2015-1, as amended. Nonauthoritative Q&A section 6950.24 states that the auditor should first assess management's assertion that the omission of the fiduciary fund is appropriate (that is, the fiduciary fund is both quantitatively and qualitatively immaterial based on relevant GAAP). Based on the guidance in question 7.4.1, as amended, the government can assess quantitative materiality of the fiduciary fund type based on the significance of those funds to all funds of the government. In all cases, qualitative materiality aspects should be appropriately considered. If the auditor agrees with management's assessment of materiality (quantitative and qualitative) relevant to the omission, the auditor does not need to perform any further audit procedures related to this omitted fund. The auditor also does not need to reference the fiduciary fund omission in the auditor's report. The guidance in chapters 4 and 16 of AICPA Audit and Accounting Guide *State and Local Governments* on the auditor's materiality considerations at the opinion-unit level is not applicable because there is no aggregate remaining fund information opinion unit in this scenario.

15.220 Paragraphs 2.15–.18 of this guide provide general guidance on the concept of materiality. In accordance with paragraph .10 of AU-C section 320B, *Materiality in Planning and Performing an Audit*, 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 320B,⁷⁷ 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 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.

15.221 Paragraphs 2.79–.87 of this guide discuss management's representations for financial statements. Paragraphs 15.13–.14 of AICPA 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 730B, *Required Supplementary Information*, states that the auditor should obtain written representations from management (a) that it acknowledges its responsibility for the RSI; (b) about whether the RSI

⁷⁷ Paragraph renumbered as .A5 by Statement on Auditing Standards (SAS) No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*. SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the ASB recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

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.

15.222 Paragraphs 7.86–.123 discuss AU-C section 945B, *Auditor Involvement With Exempt Offering Documents*. When applying that guidance, paragraph .A35 of AU-C section 945B states that in determining the extent of subsequent event procedures to perform in connection with a governmental debt offering, and the related management representations to request, 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.

15.223 Governmental health care entities are subject to various legal and contractual provisions (compliance requirements) that may affect their financial statements. As discussed in paragraph 12.11 of 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

15.224 Paragraph .19 of AU-C section 700B, *Forming an Opinion and Reporting on Financial Statements*,⁷⁸ 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 700B⁷⁹ requires the auditor to modify the opinion in the auditor's report, in accordance with AU-C section 705B, *Modifications to the Opinion in the Independent Auditor's Report*, 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 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

⁷⁸ Paragraph renumbered to .18 by SAS No. 134. SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the ASB recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

⁷⁹ Paragraph renumbered to .19 by SAS No. 134. SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the ASB recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

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 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).⁸⁰

15.225 The auditor's primary responsibility is to report on the results of the audit of the basic financial statements. The auditor has additional responsibilities related to RSI and, if applicable, SI and OI under AU-C section 730B, AU-C section 725B, *Supplementary Information in Relation to the Financial Statements as a Whole*, and AU-C section 720B, *Other Information in Documents Containing Audited Financial Statements*, respectively. Those responsibilities, which are discussed in detail in chapter 16 of AICPA Audit and Accounting Guide *State and Local Governments*, are briefly described in paragraphs 15.226–.235.

Supplementary Information and Supporting Information, Including RSI

15.226 There are similarities, but important differences, between how GASB defines supporting information and how the AICPA auditing standards refer to the same information. The following is intended to clarify the two standard-setters' descriptions of the information, and how the information is referred to in this chapter.

15.227 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 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, [b] and [c] 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.

15.228 In contrast to GASB standards, the AICPA auditing standards refer to such supporting information as either RSI, other information (OI), or SI. AU-C section 730B defines RSI consistently with GASB literature. Therefore, references to such information in this chapter are to RSI. AU-C section 720B considers OI in documents containing audited financial statements as OI except

⁸⁰ The 2021 edition of AICPA Audit and Accounting Guide *State and Local Governments* (as of April 1, 2021) has been updated to reflect changes as a result of SAS Nos. 134–141. If auditors have not implemented SAS Nos. 134–140, it will be necessary to look back to the 2020 AICPA Audit and Accounting Guide *State and Local Governments* (as of April 1, 2020) for the auditing guidance and illustrative auditor reporting in effect prior to SAS Nos. 134–140. The 2020 editions of those guides remain available in all formats in the AICPA store through <https://www.aicpa.org/cpe-learning>.

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 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.

In contrast to GASB standards, the AICPA auditing standards refer to such supporting information as either RSI, other information (OI), or SI. AU-C section 730 defines RSI consistently with GASB literature. Therefore, references to such information in this guide are to RSI. AU-C section 720 defines OI as financial or nonfinancial information (other than the financial statements and the auditor's report thereon) that is included in an entity's annual report. AU-C section 725 defines SI as information presented outside the basic financial statements, excluding RSI that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. This chapter uses SI to describe information for which (1) the required conditions in AU-C section 725 have been met and (2) the auditor has been engaged to provide an "in relation to" opinion and OI for situations where the limited procedures in AU-C section 720 are required.⁸¹

15.229 As discussed in paragraph 15.31, 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 730B. If the deficiencies described in paragraph .07 of AU-C section 730B 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 706B, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*. Illustration 1 in the exhibit of AU-C section 730B 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:⁸²

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

⁸¹ SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the ASB recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

⁸² Unless the auditor is engaged to audit the RSI as described in AU-C section 730B, *Required Supplementary Information*, 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.

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.

As discussed in paragraph 15.31, GASB requires that certain information accompany the basic financial statements and be presented as RSI. Paragraph .A2 of AU-C section 730 states that because the RSI accompanies the basic financial statements, the auditor's report on the financial statements includes a discussion of the responsibility taken by the auditor on that information. However, because the RSI is not part of the basic financial statements, the auditor's opinion on the fairness of presentation of such financial statements in accordance with the applicable financial reporting framework is not affected by the presentation by the entity of the RSI or the failure to present some or all of such RSI. Furthermore, if the RSI is omitted by the entity, the auditor does not have a responsibility to present that information.

Paragraph .03 of AU-C section 730 states that when a designated accounting standard setter requires information to accompany an entity's basic financial statements, the auditor performs specified procedures in order to

- a. describe, in the auditor's report, whether RSI is presented and
- b. communicate therein when some or all of the RSI has not been presented in accordance with guidelines established by a designated accounting standard setter or when the auditor has identified material modifications that should be made to the RSI for it to be in accordance with guidelines established by the designated accounting standard setter.

In accordance with paragraph .07 of AU-C section 730, the auditor should include a separate section in the auditor's report on the financial statements with the heading "Required Supplementary Information," or other appropriate heading. The exhibit of AU-C section 730 provides examples of that section for various circumstances, including deficiencies in the RSI. The following example, based on illustration 1 of that exhibit, might be used to report on RSI when RSI is included, the auditor has applied the specified procedures, and no material departures from prescribed guidelines have been identified.⁸³

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the [identify the required supplementary

⁸³ Unless the auditor is engaged to audit the RSI as described in AU-C section 730, *Required Supplementary Information*, 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.

information] on page XX be presented to supplement the basic financial statements. Such information is the responsibility of management and, 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.⁸⁴

15.230 If any of the deficiencies described in paragraph .07 of AU-C section 730B 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 730B provides examples for other circumstances, including those in which the RSI is omitted, or there are material departures from prescribed guidelines.

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 should include a separate section in the auditor's report on the financial statements discussing the deficiency, with the heading "Required Supplementary Information," or other appropriate heading. The exhibit of AU-C section 730 provides examples for such circumstances, including those in which the RSI is omitted, or there are material departures from prescribed guidelines.⁸⁵

15.231 The auditor may be engaged to audit RSI, "GASB defined" SI, or a combination thereof — that is, express an opinion whether the information is

⁸⁴ SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the ASB recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

⁸⁵ SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the ASB recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

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 700B. 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 805B, *Special Considerations — Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*, applies. Chapter 4 of AICPA Audit and Accounting Guide *State and Local Governments* discusses auditor considerations in accepting such an engagement.

SI and OI

15.232 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 725B as well as certain required procedures on SI (see paragraphs .05–.08 of AU-C section 725B). 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 725B. Illustration 1 in the exhibit of AU-C section 725B 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 opinion⁸⁶ 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 725B 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.

⁸⁶ If multiple opinion units exist, this would instead refer to *opinions*.

AU-C section 725 addresses the auditor's responsibility when engaged to report on whether SI is fairly stated, in all material respects, in relation to the financial statements as a whole. SI is presented outside the basic financial statements and is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. 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.

Paragraph .03 of AU-C section 725 states that an auditor, when engaged to report on SI in relation to the financial statements as a whole,

- a. evaluates the presentation of the supplementary information in relation to the financial statements as a whole, and
- b. reports on whether the supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole

Paragraphs .05–.08 of AU-C section 725 describe the procedures to determine whether SI is fairly stated, in all material respects, in relation to the financial statements as a whole. Paragraphs .09–.13 of AU-C section 725 describe the requirements for the auditor's report. When the entity presents the SI with the financial statements, the auditor should report on the SI in either (a) a separate section in the auditor's report on the financial statements with the heading "Supplementary Information," or other appropriate heading, or (b) in a separate report on the SI. If SI is presented separately from the financial statements, a separate report, prepared in accordance with paragraph .10 of AU-C section 725, is used. The exhibit of AU-C section 725 provides examples for various circumstances. The following example, based on illustration 1 of that exhibit, might be used to report on SI in a separate section in the auditor's report when the auditor is issuing an unmodified opinion on the financial statements and an unmodified opinion on the SI:

Supplementary Information

Our audit was conducted for the purpose of forming an opinion on the financial statements that collectively comprise the Governmental Hospital's basic financial statements. The *[identify accompanying supplementary information]* is presented for purposes of additional analysis and is not a required part of the 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 information has been subjected to the auditing procedures applied in the audit of the basic financial statements 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 information is fairly stated in all material respects in relation to the financial statements as a whole.⁸⁷

⁸⁷ SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the ASB recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

15.233 The auditor's reporting on OI is described in AU-C section 720B. 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 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 720B 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.

AU-C section 720 addresses the auditor's responsibilities relating to OI, whether financial or nonfinancial information (other than financial statements and the auditor's report thereon), included in an entity's annual report. In accordance with paragraph .13 of AU-C section 720, the auditor, through discussion with management, should determine and obtain management's written acknowledgment regarding which document or documents comprise the annual report and the entity's planned manner and timing of the issuance of such documents. Although OI is not a part of the basic financial statements, auditors are required to perform certain procedures on OI. The auditor should read the OI and consider whether a material inconsistency exists between the OI and the financial statements. As the basis for this consideration, to evaluate their consistency, the auditor should compare selected amounts or other items in the OI (that are intended to be the same as, to summarize, or to provide greater detail about the amounts or other items in the financial statements) with such amounts or other items in the financial statements. While reading the OI, the auditor should remain alert for indications that

- a. a material inconsistency exists between the OI and the auditor's knowledge obtained in the audit.
- b. a material misstatement of fact exists or the OI is otherwise misleading.

The following example is based on illustration 1 of the exhibit to AU-C section 720, which illustrates a separate section in the auditor's report with the heading an "other information," as required by paragraph .24 of AU-C section 720, if the auditor has not identified an uncorrected material misstatement of the OI:

Other Information [Included in the Annual Report]

Management is responsible for the other information [included in the annual report]. The other information comprises the [information included in the annual report] but does not include the financial statements and our auditor's report thereon. Our opinion on the financial statements does not cover the other information, and we do not express an opinion or any form of assurance thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and consider whether a material inconsistency exists between the other information and the financial statements, or the other information otherwise appears to be materially misstated. If, based on the work performed, we conclude that an uncorrected material misstatement of the other information exists, we are required to describe it in our report.⁸⁸

Paragraphs .19–.23 of AU-C section 720 provide guidance if the auditor identifies that a material inconsistency appears to exist or the auditor becomes aware that the other information appears to be materially misstated.

15.234 Examples 15-1 and 15-2 illustrate auditor's reports for two specific situations commonly encountered by governmental health care entities. For additional examples of auditor's reports for governmental financial statements, see chapter 16 of AICPA Audit and Accounting Guide *State and Local Governments* (which includes among its examples one for a group audit that refers to component auditors). If the audit is also performed under *Government Auditing Standards* or a single audit is being performed, see chapter 13, "Auditor Reporting Requirements and Other Communication Considerations in a Single Audit," of AICPA Audit Guide Government Auditing Standards and *Single Audits* for illustrative report examples.⁸⁹

⁸⁸ SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the ASB recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

⁸⁹ The 2021 edition of the AICPA Audit and Accounting Guide *State and Local Governments* (as of April 1, 2021) and the 2021 edition of the AICPA Audit Guide Government Auditing Standards and *Single Audits* (as of April 1, 2021) have been updated to reflect changes as a result of SAS Nos. 134–141. If auditors have not implemented SAS Nos. 134–140, it will be necessary to look back to the 2020 AICPA Audit and Accounting Guide *State and Local Governments* (as of April 1, 2020) and the 2020 AICPA Audit Guide Government Auditing Standards and *Single Audits* (as of April 1, 2020) for the auditing guidance and illustrative auditor reporting in effect prior to SAS Nos. 134–140. The 2020 editions of those guides remain available in all formats in the AICPA store through <https://www.aicpa.org/cpe-learning>.

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 Statements⁹⁰

We have audited the accompanying financial statements of the Sample Governmental Hospital Authority (the Authority), a component unit of Feeling County, State of Union,⁹¹ 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.⁹²

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.⁹³ 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

⁹⁰ According to footnote 1 to illustration 1 in the exhibit of AU-C section 700B, *Forming an Opinion and Reporting on Financial Statements*, 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.

⁹¹ 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 16.69 of AICPA Audit and Accounting Guide *State and Local Governments*.

⁹² As noted in paragraph .A23 of AU-C section 700B, the identification of the title for each statement that the financial statements comprise may be achieved by referencing the table of contents.

⁹³ Because the report is covering audits for two years, the reference is to *audits*, rather than *audit*.

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 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 15-1⁹⁴

**Unmodified Opinions on Basic Financial Statements of a
Governmental Hospital That is a Component Unit of Another
Government and That Has One Opinion Unit for Business-Type
Activities and Another Opinion Unit for Its Fiduciary Activities
and Presents RSI**

Independent Auditor's Report

[Appropriate Addressee] of Governmental Hospital

Report on the Audit of the Financial Statements⁹⁵

Opinions

We have audited the financial statements of the business-type activities and fiduciary activities⁹⁶ of Governmental Hospital (Hospital), a component unit of [Name of Primary Government]⁹⁷ as of and for the year ended June 30, 20X1, and the related notes to the financial statements, which collectively comprise the Hospital's basic financial statements as listed in the table of contents.

In our opinion, the accompanying financial statements referred to above present fairly, in all material respects, the respective financial position of the business-type activities and fiduciary activities of the Governmental Hospital as of June 30, 20X1, 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.

Basis for Opinions

We conducted our audits⁹⁸ in accordance with auditing standards generally accepted in the United States of America (GAAS).⁹⁹ Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are required to be independent of the Hospital, and to meet our other ethical responsibilities, in

⁹⁴ The grey-shaded example 15-1 is a different fact set than the extant text. SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the ASB recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

⁹⁵ The "Report on the Audit of the Financial Statements" heading is only necessary if the auditor's report contains a separate section that addresses other reporting responsibilities.

⁹⁶ The example assumes that the governmental health care entity is engaged only in business-type activities and fiduciary activities. If the governmental health care entity is engaged in only business-type activities, see example 15-2. If the governmental health care entity also has nonmajor funds, the "Opinion" section would refer to fiduciary activities and aggregate remaining fund information.

⁹⁷ As discussed in paragraph 16.69 of the of AICPA Audit and Accounting Guide *State and Local Governments*, the auditor's report should disclose when an entity is a component unit of another financial reporting entity. If the governmental health care entity is not a component unit of another government, this reference to being a component unit should be removed.

⁹⁸ Because the report is covering audits for two years, the reference is to *audits*, rather than *audit*.

⁹⁹ When the audit is also performed under *Government Auditing Standards*, issued by the Comptroller General of the United States, see AICPA Audit Guide *Government Auditing Standards and Single Audits* for illustrations of the additional reporting required by *Government Auditing Standards* and other information on planning, performing and reporting on the audit in accordance with *Government Auditing Standards*.

accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

Responsibilities of Management for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and 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.

In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the Hospital's ability to continue as a going concern for twelve months beyond the financial statement date, including any currently known information that may raise substantial doubt shortly thereafter.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinions. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.

In performing an audit in accordance with GAAS, we

- exercise professional judgment and maintain professional skepticism throughout the audit.
- identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- obtain an understanding of internal control relevant to the audit 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, no such opinion is expressed.
- evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
- conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about the [Entity]'s ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control-related matters that we identified during the audit.

Required Supplementary Information¹⁰⁰

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 is the responsibility of management and, 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 audits 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.

Supplementary Information

[If required, see illustrative wording in paragraph 15.232.]

Other Information

[If required, see illustrative wording in paragraph 15.233.]

Report on Other Legal and Regulatory Requirements¹⁰¹

[The form and content of this section of the auditor's report would 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]

¹⁰⁰ This RSI section of the report illustrates a situation where RSI is included, the auditor has applied the specified procedures, and no material departures from prescribed guidelines have been identified.

¹⁰¹ In some circumstances, the auditor may have other reporting responsibilities in addition to the auditor's responsibility under GAAS. When there are such other reporting responsibilities, they should be addressed in a separate section in the auditor's report. Paragraph .39 of AU-C section 700 provides that other reporting responsibilities should be addressed in a separate section in the auditor's report with the heading "Report on Other Legal and Regulatory Requirements." or another heading that is appropriate to the content of the section. For example, if the audit is also performed in accordance with *Government Auditing Standards*, an alternative title would be "Other Reporting Required by *Government Auditing Standards*." When there are no such other reporting responsibilities, this section is excluded, and the "Report on the Audit of the Financial Statements" heading at the beginning of the report is not necessary.

15.235

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 State¹⁰² and *[identify the discretely presented component units]*¹⁰³ 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.^{104,105,106}

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.

¹⁰² As discussed in paragraph 16.69 of the of AICPA Audit and Accounting Guide *State and Local Governments*, if the entity being reported on is a component unit of a financial reporting entity, the auditor's report should disclose that fact.

¹⁰³ Presentation of a statement of cash flows for the discretely-presented component unit is not required.

¹⁰⁴ As noted in paragraph .A23 of AU-C section 700B, the identification of the title for each statement that the financial statements comprise may be achieved by referencing the table of contents.

¹⁰⁵ 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*.

¹⁰⁶ 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.

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

Opinions¹⁰⁷

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]

¹⁰⁷ 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*.

Example 15-2¹⁰⁸**Unmodified Opinions on Basic Financial Statements for the Current and Prior Year of a Special-Purpose Government That Has One Opinion Unit for the Primary Government and Another Opinion Unit for Its Discretely Presented Component Unit (a Foundation) and Presents RSI**Independent Auditor's Report

[Appropriate Addressee] of Governmental Hospital

Report on the Audit of the Financial Statements¹⁰⁹***Opinions***

We have audited the financial statements of the business-type activities¹¹⁰ and the discretely presented component unit of the Governmental Hospital (Hospital), as of and for the years ended June 30, 20X1 and 20X0, and the related notes to the financial statements, which collectively comprise the Hospital's basic financial statements as listed in the table of contents.

In our opinion, the accompanying financial statements referred to above present fairly, in all material respects, the respective financial positions of the business-type activities and the discretely presented component unit of the Governmental Hospital, as of June 30, 20X1 and 20X0, 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.

Basis for Opinions

We conducted our audits in accordance with auditing standards generally accepted in the United States of America (GAAS).¹¹¹ Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of the Hospital, and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

Responsibilities of Management for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally

¹⁰⁸ The grey-shaded example 15-2 is a different fact set than the extant text. SAS Nos. 134–140, and the amendments to other SASs made by SAS Nos. 134–140, are effective for periods ending after December 15, 2021. These SASs are interrelated; the effective dates are aligned so that they will be implemented as a suite. Accordingly, the ASB recommends that all of these SASs be implemented concurrently. Early implementation is permitted.

¹⁰⁹ The "Report on the Audit of the Financial Statements" heading is only necessary if the auditor's report contains a separate section that addresses other reporting responsibilities.

¹¹⁰ The example assumes that the governmental health care entity is engaged only in business-type activities. If the governmental health care entity is engaged in both business-type activities and fiduciary activities, see example 15-1.

¹¹¹ When the audit is also performed under *Government Auditing Standards*, issued by the Comptroller General of the United States, see the AICPA Audit Guide *Government Auditing Standards and Single Audits* for illustrations of the additional reporting required by *Government Auditing Standards* and other information on planning, performing and reporting on the audit in accordance with *Government Auditing Standards*.

accepted in the United States of America, and 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.

In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the Hospital's ability to continue as a going concern for twelve months beyond the financial statement date, including any currently known information that may raise substantial doubt shortly thereafter.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinions. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.

In performing an audit in accordance with GAAS, we

- exercise professional judgment and maintain professional skepticism throughout the audit.
- identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- obtain an understanding of internal control relevant to the audit 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, no such opinion is expressed.
- evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
- conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about the Hospital's ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control-related matters that we identified during the audit.

Required Supplementary Information

[Same paragraph on RSI as in grey-shaded example 15-1]

Supplementary Information

[If required, see illustrative wording in paragraph 15.232.]

Other Information

[If required, see illustrative wording in paragraph 15.233.]

Report on Other Legal and Regulatory Requirements¹¹²

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

[Signature of the auditor's firm]

[City and state where the auditor's report is issued]

[Date of the auditor's report]

¹¹² In some circumstances, the auditor may have other reporting responsibilities in addition to the auditor's responsibility under GAAS. When there are such other reporting responsibilities, they should be addressed in a separate section in the auditor's report. Paragraph .39 of AU-C section 700 provides that other reporting responsibilities should be addressed in a separate section in the auditor's report with the heading "Report on Other Legal and Regulatory Requirements." or another heading that is appropriate to the content of the section. For example, if the audit is also performed in accordance with *Government Auditing Standards*, an alternative title would be "Other Reporting Required by *Government Auditing Standards*." When there are no such other reporting responsibilities, this section is excluded, and the "Report on the Audit of the Financial Statements" heading at the beginning of the report is not necessary.

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 <https://us.aicpa.org/interestareas/frc/enhancingauditqualitypracticeaid.html>.

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 <https://pcaobus.org/oversight/standards/qc-standards>.

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
- 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

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."

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. 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

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.

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

(continued)

- 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.
- 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

(footnote continued)

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.

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:

- 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

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.

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.

Appendix B

References to 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 (GAAS).

Q&As are an "other auditing publication." In applying the auditing guidance included in an other auditing publication, the auditor should, exercising professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. Other auditing publications have no authoritative status; however, they may help the auditor understand and apply GAAS. The auditor is not expected to be aware of the full body of other auditing publications. The auditor may presume that other auditing publications published by the AICPA that have been reviewed by the AICPA Audit and Attest Standards staff are appropriate.

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&A sections,² not-for-profit health care entities may find the questions and answers listed in Q&A section 6140, *Not-for-Profit Entities*, useful. Other Q&A sections may also be useful and relevant to users of this guide, depending on the facts and circumstances.

<i>Q&A Section</i>	<i>Title</i>
2220.18	"Applicability of Practical Expedient"
2220.19	"Unit of Account"
2220.20	"Determining Whether NAV Is Calculated Consistent With FASB ASC 946, <i>Financial Services — Investment Companies</i> "
2220.21	"Determining Whether an Adjustment to NAV Is Necessary"
2220.22	"Adjusting NAV When It Is Not as of the Reporting Entity's Measurement Date"

(continued)

¹ See chapter 1, "Overview and Unique Considerations of Health Care Entities," for additional information regarding the hierarchy of generally accounting principles for nongovernmental health care entities.

² All Q&A sections can be found in *Technical Questions and Answers*. *Technical Questions and Answers* can be downloaded at <https://www.aicpa.org/resources/download/aicpa-technical-questions-and-answers-at-your-fingertips>.

<i>Q&A Section</i>	<i>Title</i>
2220.23	"Adjusting NAV When It Is Not Calculated Consistent With FASB ASC 946"
2220.26	"Classification of Investments for Disclosure Purposes"
2220.27	"Determining Fair Value of Investments When the Practical Expedient Is Not Used or Is Not Available"
2220.28	"Definition of <i>Readily Determinable Fair Value</i> and Its Interaction With the NAV Practical Expedient"
3200.18	"Borrower Accounting for a Forgivable Loan Received Under the Small Business Administration Paycheck Protection Program"
3700.01	"Effect of New Mortality Tables on Nongovernmental Employee Benefit Plans (EBPs) and Nongovernmental Entities That Sponsor EBPs"
6140.03	"Lapsing of Time Restrictions on Receivables That Are Uncollected at Their Due Date"
6140.19	"Application of FASB ASC 958 — Classification of Distributions From a Financially Interrelated Fundraising Foundation (Recipient Entity) to a Health Care Beneficiary"
6140.23	"Changing Net Asset Classifications Reported in a Prior Year"
6140.24	"Contributions of Certain Nonfinancial Assets, Such as Fundraising Material, Informational Material, or Advertising, Including Media Time or Space for Public Service Announcements or Other Purposes"
6140.25	"Multiyear Unconditional Promises to Give — Measurement Objective and the Effect of Changes in Interest Rates"
6140.27	"Definition of <i>Direct Care</i> of Collection Items"
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"

<i>Q&A Section</i>	<i>Title</i>
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 Fundraising Foundation (in the Beneficiary's Financial Statements) [Amended]"
6400.36	"Application of FASB ASC 958 — Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fundraising 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.) [Amended]"
6400.37	"Application of FASB ASC 958 — Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fundraising 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.) [Amended]"
6400.38	"Application of FASB ASC 958 — Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fundraising Foundation — Does Common Control Lead to the Conclusion That the Beneficiary Can Determine the Timing and Amount of Distributions from the Recipient? [Amended]"
6400.39	"Application of FASB ASC 958 — Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fundraising Foundation (More Than One Beneficiary — Some Contributions Are Designated) [Amended]"
6400.40	"Application of FASB ASC 958 — Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fundraising 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.) [Amended]"

(continued)

<i>Q&A Section</i>	<i>Title</i>
6400.41	"Application of FASB ASC 958 — Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fundraising 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.) [Amended]"
6400.42	"Application of FASB ASC 958 — Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fundraising Foundation (Recipient Entity) — Accounting for Unrealized Gains and Losses on Investments Held by the Foundation [Amended]"
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"
6400.48	"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"
6400.53	"Accounting for Costs Incurred in Connection With the Implementation of Electronic Health Record Systems"
6400.54	"Financial Presentation Considerations Related to Transactions Involving Provider Taxation Programs and Similar Arrangements"
6400.55	"Background to Sections 6400.56–.62 — Accounting for Lease Components in Type A Life Care Contracts by Continuing Care Retirement Communities"
6400.56	"Embedded Lease Component Within Type A Life Care Contracts"

Q&A Section	Title
6400.57	"Determination of the Lease Term When an Embedded Lease Component for an Independent Living Unit Is Present Within Type A Life Care Contracts"
6400.58	"Classification of an Embedded Lease Component Within Type A Life Care Contracts"
6400.59	"Non-Lease Components Within the Resident Agreement of Type A Life Care Contracts"
6400.60	"Measurement of Lease Payments if a Lease for an Independent Living Unit Exists in a Type A Life Care Contract"
6400.61	"Reassessment of Lease Term Within the Resident Agreement of Type A Life Care Contracts"
6400.62	"Impact on a Lease Component Within the Resident Agreement of Type A Life Care Contracts When a Resident Transitions to Assisted Living or Skilled Nursing"
6400.63	"Background to Sections 6400.64–.70 — CARES Act Provisions Specific to Health Care Entities"
6400.64	"Accounting for Provider Relief Fund General and Targeted Distribution Payments"
6400.66	"Period of Accounting for Provider Relief Fund Phase 1 General Distribution Payments"
6400.67	"Accounting for Uninsured Pool Portion of Provider Relief Funds"
6400.68	"Accounting for Payments Received Under the Medicare Accelerated and Advance Payment Program"
6400.69	"Accounting for Temporary Increases in Medicare and Medicaid Payments"
6400.70	"FEMA Public Assistance Payments to NFP Health Care Entities for Emergency Protective Measures During the COVID-19 Pandemic"
6950.24	"Auditor Assessment of a Special-Purpose Government's Only Immaterial Fiduciary Fund"
7100.01	"Use of the Term <i>Security</i> in the Definition of a Public Business Entity"
7100.02	"Types of Securities Included in the Definition of a Public Business Entity"
7100.03	"Use of the Term <i>Over-the-Counter Market</i> in the Definition of a Public Business Entity"
7100.04	"Use of the Term <i>Conduit Bond Obligor</i> in the Definition of a Public Business Entity"

(continued)

Q&A Section	Title
7100.05	"FINRA TRACE and MSRB EMMA Data and a Public Business Entity"
7100.06	"Use of the Phrase <i>Contractual Restriction on Transfer</i> and a Public Business Entity"
7100.07	"Use of the Terms <i>Prepare, Publicly Available, Financial Statement, and Periodic Basis</i> in the Definition of a Public Business Entity"
7100.08	"Application of the Definition of a Public Business Entity When Entities are Organized in Tiered Organizational Structures (Parent, Consolidated Subsidiaries, Nonconsolidated Entities, Guarantors, Equity Method Investees)"
7100.09	"Financial Statements or Financial Information Filed With the SEC and Considerations for Effective Dates and the Definition of a Public Business Entity"
7100.10	"Accounting Standard Update Effective Dates and the Definition of a Public Business Entity"
7100.14	"Private Resales (Rule 144 and Rule 144A) and the Definition of a Public Business Entity"
8100.04	"Reporting Guidance Upon Initial Implementation of Statement on Auditing Standards No. 134, as Amended,"
8700.03	"Auditor's Responsibilities for Subsequent Events Relative to a Conduit Debt Obligor"
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"
9110.22	"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"

<i>Q&A Section</i>	<i>Title</i>
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

Auditor Reporting Standards

This appendix is nonauthoritative and is included for informational purposes only.

Note: In May 2020, the AICPA Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 141, *Amendment to the Effective Date of SAS Nos. 134–140*. SAS No. 141 is effective upon issuance. In general, SAS Nos. 134–140 are effective for audits of financial statements for periods ending on or after December 15, 2021. Refer to each individual standard for specific effective date language. Early implementation is permitted, and the ASB recommends that SAS Nos. 134–140 be implemented at the same time.

The AICPA ASB has issued a suite of standards that affect the auditor's report. This appendix provides a summary of the following SASs issued and the resulting changes to the auditor's report:

- SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*
- SAS No. 137, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports* (AU-C sec. 720)¹
- SAS No. 138, *Amendments to the Description of the Concept of Materiality*
- SAS No. 139, *Amendments to AU-C Sections 800, 805, and 810 to Incorporate Auditor Reporting Changes From SAS No. 134*
- SAS No. 140, *Amendments to AU-C Sections 725, 730, 930, 935, and 940 to Incorporate Auditor Reporting Changes From SAS Nos. 134 and 137*

In addition to those reporting standards, the ASB also issued SAS No. 136, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA* (AU-C sec. 703).

In May 2019, the ASB issued SAS No. 134 aimed at enhancing the relevance and usefulness of the auditor's report. SAS No. 134 replaces AU-C sections 700B, *Forming an Opinion and Reporting on Financial Statements*; 705B, *Modifications to the Opinion in the Independent Auditor's Report*; and 706B, *Emphasis-of-Matter and Other-Matter Paragraphs in the Independent Auditor's Report*. It also establishes a new AU-C section 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, in the AICPA's *Professional Standards*. The requirements in SAS No. 134 have been subsequently amended as a result of the issuance of SAS Nos. 137, 138, and 140.

SAS No. 134, as amended, was developed in consideration of the following issues:

¹ All AU-C sections can be found in AICPA *Professional Standards*.

- Although users value the "pass/fail" nature of the auditor's opinion, they would like the auditor's report to provide greater transparency into the audit.
- Users would like the auditor's report to include more information about areas with higher assessed risks of material misstatement, areas that involve significant judgment by management and the auditor, and areas that relate to significant events or transactions.
- To address the long-standing "expectations gap," users and other stakeholders would like the auditor's report to expand the descriptions of the auditor's responsibilities in financial statement auditing and management's responsibilities in financial statement preparation.

In July 2019, the ASB issued SAS No. 137 to address the auditor's responsibilities relating to other information, whether financial or nonfinancial (other than financial statements and the auditor's report thereon), included in an entity's annual report. SAS No. 137 is codified in AU-C section 720, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*, and amends various other AU-C sections. Among other changes, SAS No. 137 amends AU-C section 700 to require the auditor to report in accordance with AU-C section 720, when applicable. AU-C section 720 contains new reporting requirements to be included in a separate section of the auditor's report with the heading "Other Information" when the auditor has obtained all the other information.²

In December 2019, the ASB issued SAS No. 138, *Amendments to the Description of the Concept of Materiality*. The amendments are neither expected nor intended to significantly change U.S. firm practices. However, the changes align the materiality concepts discussed in AICPA *Professional Standards* with the description of materiality used by the U.S. judicial system, the auditing standards of the PCAOB, the SEC, and FASB. SAS No. 138 amends various AU-C sections, including AU-C section 700, to align the description of materiality in the "Auditor's Responsibilities for the Audit of the Financial Statements" section of the auditor's report.

In March 2020, the ASB issued SAS No. 139. SAS No. 139 aligns the AU-C 800 series with the relevant auditor reporting standards in SAS No. 134, thereby updating the form and content of auditors' reports addressed in the AU-C 800 series. The AU-C 800 series of standards consists of the following AU-C sections: 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 810, *Engagements to Report on Summary Financial Statements*.

In April 2020, the ASB issued SAS No. 140. SAS No. 140 amends the following AU-C sections: AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole*; AU-C section 730, *Required Supplementary Information*; Section 930, *Interim Financial Information*; AU-C section 935, *Compliance Audits*; and AU-C section 940, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements*. The SAS also includes conforming changes to other AU-C sections.

² Paragraph .24 of AU-C section 720, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*.

In May 2019, the ASB issued SAS No. 135, *Omnibus Statement on Auditing Standards — 2019*. This standard is intended to more closely align ASB guidance with PCAOB standards primarily by amending AU-C section 260, *The Auditor's Communication With Those Charged With Governance*; AU-C section 550, *Related Parties*; and AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*, in AICPA Professional Standards. By eliminating unnecessary differences between the ASB guidance and PCAOB standards, auditors who perform audits under both sets of auditing standards will experience more consistency between the guidance and standards thereby enhancing audit quality.

The resource *Recently Issued Auditing and Attestation Standards: Information and Resources* provides links to the full text of the standards and gathers the AICPA's resources and information on these new auditing standards in one place. The site will continue to be updated as additional resources become available and can be accessed at www.aicpa.org/interestareas/frc/auditattest/auditing-standards-information-and-resources.html.

The following summarizes the sections of AICPA Professional Standards and key changes arising from the issuance of these SASs.

SAS No. 134, Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements, as amended

AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*

This is the foundational section that addresses the auditor's responsibility to form an opinion on the financial statements and prescribes the form and content of the auditor's report when issuing an unmodified "clean" opinion. Information about the foundational standard for employee benefit plans subject to ERISA is found in AU-C section 703, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA*. This section also includes an appendix of amendments to various AU-C sections relating to auditor reporting and disclosures. To enhance the communicative value and relevance of the auditor's report, the following key changes have been made:

- Requires the "Opinion" section to be presented first, followed by the "Basis for Opinion" section.
- Requires the "Basis for Opinion" section to follow the opinion section, and include a statement that the auditor is required to be independent of the entity and to meet the auditor's other ethical responsibilities, in accordance with the relevant ethical requirements relating to the audit.
- Enhances auditor reporting relating to going concern, including a description of the respective responsibilities of management when required by the applicable financial reporting framework, and the auditor for going concern.
- Amends AU-C section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, to include a separate

section in the auditor's report, when substantial doubt exists, under the heading "Substantial Doubt About the Entity's Ability to Continue as a Going Concern." (See the discussion of AU-C section 570 that follows.) **Note:** The underlying auditor performance requirements relating to going concern are not changing.

- Expands description of the auditor's responsibilities, including the auditor's responsibilities relating to professional judgment and professional skepticism, and the auditor's communications with those charged with governance.
- Revises definition of misstatements that are considered material in the auditor's report under the heading, *Auditor's Responsibilities for the Audit of the Financial Statements*, due to the issuance of SAS No. 138.
- Clarifies auditor's reporting on other information when included in the annual report in accordance with AU-C section 720 due to the issuance of SAS No. 137.

AU-C section 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

This section addresses the auditor's responsibility to communicate key audit matters (KAMs) in the auditor's report when the auditor is engaged to do so under the terms of the engagement. GAAS does *not* require the communication of KAMs. When engaged to include KAMs, AU-C section 701 addresses both the auditor's judgment about what to communicate in the auditor's report and the form and content of such communication of KAMs.

AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*

This section is new and aligns the form and content of the auditor's report with the changes in AU-C section 700 when the auditor concludes that a clean auditor's opinion in accordance with the requirements in AU-C section 700 is not appropriate (qualified, adverse, or disclaimer of opinion). **Note:** AU-C section 705 does not change the existing requirements regarding circumstances in which a modification of the auditor's opinion is required, and for determining the type of modification to the auditor's opinion.

AU-C section 706, *Emphasis-of-Matter and Other-Matter Paragraphs in the Independent Auditor's Report*

This section addresses additional communications in the auditor's report (emphasis-of-a-matter and other-matter paragraphs).

- Clarifies the relationship between emphasis-of-matter paragraphs and the communication of KAMs in the auditor's report.
- When AU-C section 701 applies, the use of an emphasis-of-matter paragraph is not a substitute for including the matter in the KAM section if the matter meets the definition of a KAM.
- Requires the auditor to use an appropriate heading for an emphasis-of-matter paragraph. This heading should include the term "Emphasis of Matter" when KAMs are communicated in the auditor's report. The auditor would be able to add additional context to the heading to further describe the nature of the matter (for example, "Emphasis of Matter — Subsequent Event").

Other Amendments to Certain AU-C Sections

- *The Auditor's Communication With Those Charged With Governance* (AU-C section 260). The amendments to AU-C section 260 add a requirement for the auditor to communicate with those charged with governance about circumstances that affect the form and content of the auditor's report, if any. They also include application material that provides examples of matters for which communication with those charged with governance may be important prior to issuance of the auditor's report.
- *Terms of Engagement* (AU-C section 210). The amendments to AU-C section 210 modify the application material relating to the form and content of the engagement letter and the example audit engagement letter to be consistent with the changes to the elements of the auditor's report in the AU-C section 700.
 - A new application material paragraph is added to provide guidance when management (and, as applicable, those charged with governance) has requested that the auditor communicate KAMs in the auditor's report and to provide guidance regarding the acknowledgment of this in the engagement letter.

Amendments Addressing Disclosures in the Audited Financial Statements

- Amends various AU-C sections to focus auditor attention on disclosures throughout the audit process, including new requirements in AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks*, and AU-C section 700.
- Includes enhanced application material in these and several other AU-C sections to assist auditors in addressing the practical challenges arising from the evolving nature of disclosures.

SAS No. 137, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports*

SAS No. 137 supersedes SAS No. 118, *Other Information in Documents Containing Audited Financial Statements*, as amended and codified in AU-C section 720. The changes made include the following:

- Clarification of documents that are within the scope of the standard
 - Clarifies the scope of documents the auditor is required to subject to the procedures in AU-C section 720.
 - Requires the auditor, through discussion with management, to determine and obtain management's acknowledgment regarding which document or documents comprise the annual report.

- Reading the other information
 - Clarifies the auditor's responsibility to consider whether a material inconsistency exists between the other information and the audited financial statements and remain alert for indications that a material misstatement of fact exists.
 - Requires the auditor to remain alert for indications that a material inconsistency exists between the other information and the auditor's knowledge obtained in the audit or the other information is otherwise misleading.
- Reporting
 - Requires the auditor to include a separate section in the auditor's report with the heading "Other Information," or other appropriate heading, when the auditor has obtained all of the other information at the date of the auditor's report.
 - Includes an exhibit with examples of an "other information" paragraph when the auditor
 - has not identified an uncorrected material misstatement of the other information.
 - has concluded that an uncorrected material misstatement of the other information exists.

SAS No. 138, Amendments to the Description of the Concept of Materiality

The changes in SAS No. 138 and Statement on Standards for Attestation Engagements (SSAE) No. 20, *Amendments to the Description of the Concept of Materiality*, result in various amendments to AU-C and AT-C sections in AICPA *Professional Standards*, as detailed at the end of this section.

Paragraph .07 of AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, revises the description of materiality as follows: Misstatements, including omissions, are considered to be material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.

Accordingly, SAS No. 138 amends SAS No. 134 to revise the description of the concept of materiality in the auditor's responsibility section of the auditor's report in accordance with SAS No. 138. This amendment has been codified in paragraph .35 of AU-C section 700 and requires the "Auditor's Responsibilities for the Audit of the Financial Statements" section of the auditor's report to state that, "misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgement made by a reasonable user based on the financial statements."

SAS No. 138 amends the following AU-C sections:

- Section 200
- Section 320, *Materiality in Planning and Performing an Audit*

- Section 450, *Evaluation of Misstatements Identified During the Audit*
- Section 600, *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)*
- Section 700

SSAE No. 20 amends the following AT-C sections:³

- Section 205, *Examination Engagements* [See amended paragraph .A17]
- Section 210, *Review Engagements* [See amended paragraph .A16]

SAS No. 139, Amendments to AU-C Sections 800, 805, and 810 to Incorporate Auditor Reporting Changes From SAS No. 134

AU-C section 800, Special Considerations — Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks

This section requires that a statement be added to the auditor's report indicating that the financial statements may not be suitable for another purpose when a description of the purpose for which the financial statements are prepared or a reference to a note in the special purpose financial statements that contains that information is required. (This description is required when financial statements are prepared on a regulatory or contractual basis of accounting or an other basis of accounting, and the auditor is required to restrict use of the auditor's report by paragraph .06a–b of AU-C section 905, *Alert That Restricts the Use of the Auditor's Written Communication*.)

AU-C section 805, Special Considerations — Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement

This section addresses factors to consider in determining whether a matter included in the auditor's report on the complete set of financial statements is relevant in the context of an engagement to report on a single financial statement or a specific element of a financial statement.

AU-C section 810, Engagements to Report on Summary Financial Statements

This section adds application paragraphs to AU-C section 810 indicating that although the auditor is required to include a statement in the auditor's report on the summary financial statements when the auditor's report on the audited financial statements includes communication of one or more key audit matters, the auditor is not required to describe the individual key audit matters or repeat the corresponding text in its entirety in the auditor's report on the summary financial statements.

³ All AT-C sections can be found in AICPA *Professional Standards*.

SAS No. 140, Amendments to AU-C Sections 725, 730, 930, 935, and 940 to Incorporate Auditor Reporting Changes From SAS Nos. 134 and 137

AU-C section 725, Supplementary Information in Relation to the Financial Statements as a Whole, and AU-C section 730, Required Supplementary Information

These sections include requirements for the auditor to report on supplementary information and required supplementary information, as applicable. As supplementary information and required supplementary information are comparable to other information, these sections are amended to require reporting in a separate section of the auditor's report as opposed to in an other-matter paragraph.

AU-C section 930, Interim Financial Information

The reporting requirements with respect to reviews of interim financial information are revised to harmonize with the requirements in PCAOB AS 4105, *Reviews of Interim Financial Information*.⁴ The changes include the placement of the auditor's review conclusion at the beginning of the review report on interim financial information. The changes to AU-C section 930 are now effective for reviews of interim financial information for interim periods of fiscal years beginning on or after December 15, 2021, with early implementation permitted.

AU-C section 935, Compliance Audits

This section is revised for consistency with the recent issuance of Uniform Guidance, changes in the Office of Management and Budget *Compliance Supplement*, and *Government Auditing Standards, 2018 Revision*. Significant changes include the following:

- Presents requirements for a combined report on compliance and internal control as the default form of report, followed by requirements addressing when the auditor chooses to issue separate reports on compliance and on internal control over compliance. This reverses how the requirements are presented in extant AU-C section 935 because combined reports are more common in practice.
- Amends the definition of material noncompliance to align with the description of materiality in SAS No. 138.

AU-C section 940, An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements

Significant changes to the reporting requirements with respect to audits of internal control over financial reporting that is integrated with an audit of financial statements include the following:

- When issuing a separate report on internal control over financial reporting (ICFR), requires paragraphs to be placed within (a) the "Opinion" section following the opinion paragraph in the auditor's report on the financial statements that references to the report on ICFR and (b) the "Opinion on Internal Control Over Financial Reporting" section following the opinion paragraph in the report on ICFR that references to the report on the financial statements.

⁴ All AS sections can be found in *PCAOB Standards and Related Rules*.

- Revises requirements on how to report when issuing an adverse opinion or disclaiming an opinion because of a scope limitation.
- Addresses situations when management includes additional information in management's report or includes additional information in a document containing management's report and the related auditor's report.

Technical Questions and Answers section 8100.04, "Reporting Guidance Upon Initial Implementation of Statement on Auditing Standards No. 134, as Amended,"⁵ issued in October 2019, provides guidance for the auditor's report in an audit of comparative financial statements in the first year of implementation of SAS No. 134. AICPA Technical Questions and Answers (Q&As) are an "other auditing publication." In applying the auditing guidance included in an other auditing publication, the auditor should, exercising professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. Other auditing publications have no authoritative status; however, they may help the auditor understand and apply generally accepted auditing standards (GAAS). The auditor is not expected to be aware of the full body of other auditing publications. The auditor may presume that other auditing publications published by the AICPA that have been reviewed by the AICPA Audit and Attest Standards staff are appropriate.

⁵ All Q&A sections can be found in *Technical Questions and Answers*. *Technical Questions and Answers* can be downloaded at <https://www.aicpa.org/resources/download/aicpa-technical-questions-and-answers-at-your-fingertips>.

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 existing financial instruments standards, an expected outcome is the simplification of accounting requirements for financial instruments. The project was split into three phases: classification and measurement, impairment, and hedge accounting. This appendix focuses 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. 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 non-public business entities.
- Eliminate the requirement for public business entities to disclose the methods and significant assumptions used to estimate fair value currently 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 (OCI) 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 in 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 ASC 960 through FASB ASC 965 on plan accounting	December 15, 2018	December 15, 2019

All nonpublic 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 adoption 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 OCI 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.
- Nonpublic business entities are not required to apply the fair value of financial instruments disclosure guidance in the "General" subsection of FASB *Accounting Standards Codification* (ASC) 825-10-50.

Except for as stated in this guidance, early adoption of the amendments in this ASU is not permitted.

Latest Developments

FASB ASU No. 2018-03, Technical Corrections and Improvements to Financial Instruments — Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities

In February 2018, FASB issued ASU No. 2018-03 to clarify certain aspects of the guidance issued in ASU No. 2016-01 as follows:

- *Equity securities without a readily determinable fair value — discontinuation.* The amendments in this ASU clarify that an entity measuring an equity security using the measurement alternative may change its measurement approach to a fair value method in accordance with FASB ASC 820, *Fair Value Measurement*, through an irrevocable election that would apply to that security and all identical or similar investments of the same issuer. Once an entity makes this election, the entity should measure all future purchases of identical or similar investments of the same issuer using a fair value method in accordance with FASB ASC 820.
- *Equity securities without a readily determinable fair value — adjustments.* The amendment in this ASU clarifies that adjustments made under the measurement alternative are intended to reflect the fair value of the security as of the date that the observable transaction for a similar security took place.
- *Forward contracts and purchased options.* The amendment clarifies that remeasuring the *entire* value of forward contracts and purchased options is required when observable transactions occur on the underlying equity securities.
- *Presentation requirements for certain fair value option liabilities.* The amendment clarifies that when the fair value option is elected for a financial liability, the guidance in paragraph 5 of ASC 825-10-45 should be applied, regardless of whether the fair value option was elected under either FASB ASC 815-15 or 825-10.
- *Fair value option liabilities denominated in a foreign currency.* The amendments clarify that for financial liabilities for which the fair value option is elected, the amount of change in fair value that relates to the instrument-specific credit risk should first be measured in the currency of denomination when presented separately from the total change in fair value of the financial liability. Then, both components of the change in the fair value of the liability should be remeasured into the functional currency of the reporting entity using end-of-period spot rates.
- *Transition guidance for equity securities without a readily determinable fair value.* The amendment clarifies that the prospective transition approach for equity securities without a readily determinable fair value in the amendments in ASU No. 2016-01 is meant only for instances in which the measurement alternative is applied. An insurance entity subject to the guidance in FASB ASC 944, *Financial Services — Insurance*, should apply a prospective

transition method when applying the amendments related to equity securities without readily determinable fair values. An insurance entity should apply the selected prospective transition method consistently to the entity's entire population of equity securities for which the measurement alternative is elected.

ASU No. 2018-03 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	June 15, 2018
All other entities	December 15, 2018	December 15, 2019

Public business entities with fiscal years beginning between December 15, 2017 and June 15, 2018 are not required to adopt these amendments until the interim period beginning after June 15, 2018, and public business entities with fiscal years beginning between June 15, 2018 and December 15, 2018 are not required to adopt these amendments before adopting the amendments in ASU No. 2016-01. All entities may early adopt these amendments for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years, as long as they have adopted ASU No. 2016-01.

FASB ASU No. 2019-04, Codification Improvements to Topic 326, Financial Instruments — Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments

In April 2019, FASB issued ASU No. 2019-04 to clarify, correct, and improve various aspects of the guidance in ASU Nos. 2016-01, 2016-13, and 2017-12 related to financial instruments. The discussion herein will only address those amendments related to ASU No. 2016-01. Amendments related to ASU Nos. 2016-13 and ASU No. 2017-12 will be addressed in subsequent sections of this appendix.

ASU No. 2019-04 clarifies certain aspects of the amendments in ASU No. 2016-01 as follows:

- *Scope clarifications for FASB ASC 320-10 and FASB ASC 321-10.* The amendments clarify the scope of FASB ASC 320-10 and FASB ASC 321-10 by specifically naming health and welfare plans accounted for in accordance with FASB ASC 965, *Plan Accounting — Health and Welfare Benefit Plans*, in the paragraphs limiting the scope of those subtopics.
- *Held-to-maturity debt securities fair value disclosures.* The amendments to the disclosure requirements addressed in FASB ASC 320-10-50-5 and FASB ASC 942-320-50-3 and the additions of paragraphs 5A–5B of FASB ASC 320-10-50 and paragraph 3A of FASB ASC 942-320-50 clarify FASB's intent to exempt entities other than public business entities from fair value disclosure requirements for financial instruments not measured at fair value on the balance sheet.

- *Applicability of FASB ASC 820 to the measurement alternative.* The amendments specifically require that an entity remeasure an equity security without readily determinable fair value at fair value when an orderly transaction is identified for an identical or similar investment of the same issuer in accordance with FASB ASC 820. That is, the amendments clarify that the measurement alternative is a nonrecurring fair value measurement. Additionally, the amendments clarify that an entity should adhere to the applicable disclosure requirements in FASB ASC 820 for a nonrecurring fair value measurement.
- *Remeasurement of equity securities at historical exchange rates.* The amendments clarify that equity securities without readily determinable fair values accounted for under the measurement alternative in accordance with FASB ASC 321-10-35-2 are required to follow FASB ASC 830-10-45-18, which requires remeasurement at historical exchange rates. In addition, the amendments clarify that the rate used should be the historical exchange rate as of the later of the acquisition date or the most recent date on which the equity security was adjusted to fair value in accordance with paragraphs 2–3 of FASB ASC 321-10-35, if applicable. In addition, the amendments to FASB ASC 830-10-45-18 are not intended to change items that should be remeasured at historical exchange rates.

Effective Date

The amendments in ASU No. 2019-04 related to No. 2016-01 are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted in any interim period following the issuance of ASU No. 2019-04 as long as the entity has adopted all of the amendments in ASU No. 2016-01.

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 generally 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 the entity's 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 (as amended by *FASB ASU No. 2019-10, Financial Instruments — Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*) is effective as follows:

	<i>Fiscal Years Beginning After</i>	<i>Interim Periods Within Fiscal Years Beginning After</i>
Public business entities that meet the definition of SEC filers, excluding entities eligible to be smaller-reporting companies as defined by the SEC ¹	December 15, 2019	December 15, 2019
All other entities	December 15, 2022	December 15, 2022
¹ The one-time determination of whether an entity is eligible to be a smaller reporting company should be based on an entity's most recent determination as of November 15, 2019, in accordance with SEC regulations.		

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 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 its 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 its efforts, including meeting materials and meeting summaries.

Latest Developments

FASB ASU No. 2018-19, Codification Improvements to Topic 326, Financial Instruments — Credit Losses

In November 2018, FASB issued ASU No. 2018-19 to amend the transition and effective date for nonpublic business entities as well as clarify guidance surrounding operating receivables.

The amendments in ASU No. 2018-19 mitigate transition complexity by requiring that for nonpublic business entities, the amendments in ASU No. 2016-13 are effective for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. In addition, the amendments clarify that receivables arising from operating leases are not within the scope of FASB ASC 326-20. Instead, impairment of receivables arising from operating leases should be accounted for in accordance with FASB ASC 842, *Leases*.

The effective date and transition requirements for ASU No. 2018-19 are the same as the effective dates and transition requirements in ASU No. 2016-13, as amended.

FASB ASU No. 2019-04

In April 2019, FASB issued ASU No. 2019-04 to clarify, correct, and improve various aspects of the guidance in ASU Nos. 2016-01; 2016-13, *Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*; and 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, related to financial instruments. The discussion herein will only address those amendments related to ASU No. 2016-13. Amendments related to ASU No. 2016-01 and ASU No. 2017-12 will be addressed in separate sections of this appendix.

ASU No. 2019-04 clarifies certain aspects of the amendments in ASU No. 2016-13 as follows:

- *Accrued interest.* The amendments to FASB ASC 326-20 allow an entity to do the following:

- Measure the allowance for credit losses on accrued interest receivable balances separately from other components of the amortized cost basis of associated financial assets.
 - Make an accounting policy election not to measure an allowance for credit losses on accrued interest receivable amounts if an entity writes off the uncollectible accrued interest receivable balance in a timely manner and makes certain disclosures.
 - Make an accounting policy election to write off accrued interest amounts by reversing interest income or recognizing credit loss expense, or a combination of both. The entity also is required to make certain disclosures.
 - Make an accounting policy election to present accrued interest receivable balances and the related allowance for credit losses for those accrued interest receivable balances separately from the associated financial assets on the balance sheet. If the accrued interest receivable balances and the related allowance for credit losses are not presented as a separate line item on the balance sheet, an entity should disclose the amount of accrued interest receivable balances and the related allowance for credit losses and where the balance is presented.
 - Elect a practical expedient to disclose separately the total amount of accrued interest included in the amortized cost basis as a single balance to meet certain disclosure requirements.
- *Transfers between classification or categories for loans and debt securities.* The amendments require that an entity reverse in earnings any allowance for credit losses or valuation allowance previously measured on a loan or debt security, reclassify and transfer the loan or debt security to the new classification or category, and apply the applicable measurement guidance in accordance with the new classification or category.
 - *Recoveries.* The amendments clarify that an entity should include recoveries when estimating the allowance for credit losses. In addition, expected recoveries of amounts previously written off and expected to be written off should be included in the valuation account and should not exceed the aggregate of amounts previously written off and expected to be written off by the entity. For collateral-dependent financial assets, an allowance for credit losses that is added to the amortized cost basis of the financial assets should not exceed amounts previously written off.
 - *Conforming amendments.* Correction of incorrect cross-referencing and further clarification surrounding the equity method losses allocation guidance.
 - *Clarification that reinsurance recoverables are within the scope of FASB ASC 326-20.* The amendment clarifies FASB's intent to include all reinsurance recoverables within the scope of FASB ASC 944 within the scope of FASB ASC 326-20, regardless of the measurement basis of those recoverables.

- *Projections of interest rate environments for variable-rate financial instruments.* The amendments clarify FASB's intent to provide flexibility in determining the allowance for credit losses by removing the prohibition of using projections of future interest rate environments when using a discounted cash flow method to measure expected credit losses on variable-rate financial instruments. Furthermore, an entity that uses projections or expectations of future interest rate environments in estimating expected cash flows should use the same assumptions in determining the effective interest rate used to discount those expected cash flows. The amendments also clarify that if an entity uses projections of future interest rate environments when using a discounted cash flow method to measure expected credit losses on variable-rate financial instruments, it also should adjust the effective interest rate to consider the timing (and changes in the timing) of expected cash flows resulting from expected prepayments.
- *Consideration of prepayments in determining the effective interest rate.* The amendments permit an entity to make an accounting policy election to adjust the effective interest rate used to discount expected future cash flows for expected prepayments on financial assets within the scope of FASB ASC 326-20 and on available-for-sale debt securities within the scope of FASB ASC 326-20 to appropriately isolate credit risk in determining the allowance for credit losses. Furthermore, an entity should not adjust the effective interest rate used to discount expected cash flows for subsequent changes in expected prepayment if the financial asset is restructured in a TDR.
- *Consideration of estimated costs to sell when foreclosure is probable.* The amendments clarify the guidance in FASB ASC 326-20-35-4 by specifically requiring that an entity consider the estimated costs to sell if it intends to sell rather than operate the collateral when the entity determines that foreclosure on a financial asset is probable. Additionally, when an entity adjusts the fair value of collateral for the estimated costs to sell, the estimated costs to sell should be undiscounted if the entity intends to sell rather than operate the collateral.
- *Vintage disclosures — line-of-credit arrangements converted to term loans.* The amendments require that an entity present the amortized cost basis of line-of-credit arrangements that are converted to term loans in a separate column.
- *Contractual extensions and renewals.* The amendments clarify that an entity should consider extension or renewal options (excluding those that are accounted for as derivatives in accordance with FASB ASC 815, *Derivatives and Hedging*) that are included in the original or modified contract at the reporting date and are not unconditionally cancellable by the entity.

Effective Date

For entities that have not yet adopted the amendments in ASU No. 2016-13, the effective dates and transition requirements for the amendments related to ASU No. 2019-04 are the same as the effective dates and transition requirements in ASU No. 2016-13, as amended. The transition adjustment includes adjustments

made as a result of an entity developing or amending its accounting policy upon adoption of the amendments in ASU No. 2019-04 for determining when accrued interest receivables are deemed uncollectible and written off.

For entities that have adopted the amendments in ASU No. 2016-13, the amendments in ASU No. 2019-04 are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted in any interim period after issuance of ASU No. 2019-04 as long as the entity has adopted the amendments in ASU No. 2016-13.

FASB ASU No. 2019-05, Financial Instruments — Credit Losses (Topic 326): Targeted Transition Relief

In May 2019, FASB issued ASU No. 2019-05, to provide entities that have certain instruments within the scope of FASB ASC 326-20 with an option to irrevocably elect the fair value option applied on an instrument-by-instrument basis for certain financial assets upon the adoption of FASB ASC 326. The fair value option election does not apply to held-to-maturity debt securities. An entity that elects the fair value option should subsequently apply the guidance in FASB ASC 820-10 and 825-10.

For entities that have not yet adopted the amendments in ASU No. 2016-13, the effective date and transition methodology for the amendments in ASU No. 2019-05 are the same as in ASU No. 2016-13, as amended.

For entities that have adopted the amendments in ASU No. 2016-13, the amendments in ASU No. 2019-05 are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted in any interim period after the issuance of ASU No. 2019-05, as long as an entity has adopted the amendments in ASU No. 2016-13.

FASB ASU No. 2019-11, Codification Improvements to Topic 326, Financial Instruments — Credit Losses

In November 2019, FASB issued ASU No. 2019-11 to clarify, correct errors in, or improve the codification.

ASU No. 2019-04 clarifies certain aspects of the amendments in ASU No. 2016-13 as follows:

- *Expected recoveries for PCD assets.* The amendments clarify that the allowance for credit losses for PCD assets should include in the allowance for credit losses expected recoveries of amounts previously written off and expected to be written off by the entity and should not exceed the aggregate of amounts of the amortized cost basis previously written off and expected to be written off by an entity.
In addition, the amendments clarify that when a method other than a discounted cash flow method is used to estimate expected credit losses, expected recoveries should not include any amounts that result in an acceleration of the noncredit discount. An entity may include increases in expected cash flows after acquisition.
- *Transition relief for TDRs.* The amendments provide transition relief by permitting entities an accounting policy election to adjust the effective interest rate on existing TDRs using prepayment assumptions on the date of adoption of FASB ASC 326 rather than the prepayment assumptions in effect immediately before the restructuring.

- *Disclosures related to accrued interest receivables.* The amendments extend the disclosure relief for accrued interest receivable balances to additional relevant disclosures involving amortized cost basis.
- *Financial assets secured by collateral maintenance provisions.* The amendments clarify that an entity should assess whether it reasonably expects the borrower will be able to continually replenish collateral securing the financial asset to apply the practical expedient.

The amendments clarify that an entity applying the practical expedient should estimate expected credit losses for any difference between the amount of the amortized cost basis that is greater than the fair value of the collateral securing the financial asset (that is, the unsecured portion of the amortized cost basis). An entity may determine that the expectation of nonpayment for the amount of the amortized cost basis equal to the fair value of the collateral securing the financial asset is zero.

- *Conforming amendment to FASB ASC 805-20.* The amendment to FASB ASC 805-20 clarifies the guidance by removing the cross-reference to FASB ASC 310-30 in FASB ASC 805-20-50-1 and replacing it with a cross-reference to the guidance on PCD assets in FASB ASC 326-20.

Effective Date

For entities that have not yet adopted the amendments in ASU No. 2016-13 as of the issuance date of this ASU, the effective dates and transition requirements for the amendments are the same as the effective dates and transition requirements in ASU No. 2016-13, as amended. For entities that have adopted the amendments in ASU No. 2016-13, the amendments in this ASU are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted in any interim period after issuance of this ASU as long as the entity has adopted the amendments in ASU No. 2016-13.

FASB ASU No. 2020-03, Codification Improvements to Financial Instruments

In March 2020, FASB issued ASU No. 2020-03 to clarify or improve the codification.

ASU No. 2020-03 clarifies or addresses specific issues as follows:

- *Fair value option disclosures (issue 1).* The amendments clarify that all entities are required to provide the fair value option disclosures in paragraphs 24–32 of FASB ASC 825-10-50.
- *Applicability of portfolio exception in FASB ASC 820 to nonfinancial items (issue 2).* FASB ASC 820-10-35-2A(g) and FASB ASC 820-10-35-18L are amended to include the phrase nonfinancial items accounted for as derivatives under FASB ASC 815 to be consistent with the previous amendments to FASB ASC 820-10-35 that were made by ASU No. 2018-09, *Codification Improvements*.
- *Disclosures for depository and lending institutions (issue 3).* The amendments clarify that the disclosure requirements in FASB

ASC 320 apply to the disclosure requirements in FASB ASC 942 for depository and lending institutions.

- *Cross-reference to line-of-credit or revolving-debt arrangements guidance in FASB ASC 470-50 (issue 4).* The amendments improve the understandability of the guidance.
- *Cross-reference to new asset value practical expedient in FASB ASC 820-10 (issue 5).* The amendments improve the understandability of the guidance.
- *Interaction of FASB ASC 842 and FASB ASC 326 (issue 6).* The amendments clarify that the contractual term of a new investment in a lease determined in accordance with FASB ASC 842 should be the contractual term used to measure expected credit losses under FASB ASC 326.
- *Interaction of FASB ASC 326 and FASB ASC 860-20 (issue 7).* The amendments to FASB ASC 860-20 clarify that when an entity regains control of financial assets sold, an allowance for credit losses should be recorded in accordance with FASB ASC 326.

Effective Date

Issues 1, 2, 3, 4, and 5: Conforming amendments. The amendments related to issues 1, 2, 4, and 5 are conforming amendments. For public business entities, the amendments are effective upon issuance of this ASU. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years beginning after December 15, 2020. Early application is permitted.

The amendment related to issue 3 is a conforming amendment that affects the guidance in the amendments in ASU No. 2019-04. That guidance relates to the amendments in ASU No. 2016-01. The effective date of ASU No. 2019-04 for the amendments to ASU No. 2016-01 is for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.

Issues 6 and 7: Amendments to ASU No. 2016-13. The amendments related to issues 6 and 7 affect the guidance in the amendments in ASU No. 2016-13. The effective date of ASU No. 2016-13 varies depending on the type of entity. For entities that have not yet adopted the guidance in ASU No. 2016-13, the effective dates and the transition requirements for these amendments are the same as the effective date and transition requirements in ASU No. 2016-13, as amended.

For entities that have adopted the guidance in ASU No. 2016-13, the amendments are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.

Hedge Accounting

Overview

In August 2017, FASB issued ASU No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, to better align an entity's risk management activities and financial reporting for hedging relationships through changes to both the designation and measurement guidance for qualifying hedging relationships and the presentation of hedge results.

To meet that objective, the amendments expand and refine hedge accounting for both nonfinancial and financial risk components and align the recognition and presentation of the effects of the hedging instrument and the hedged item in the financial statements.

The amendments in this ASU also make certain targeted improvements to simplify the application of hedge accounting guidance and ease the administrative burden of hedge documentation requirements and assessing hedge effectiveness.

Risk Component Hedging

Current GAAP contains limitations on how an entity can designate the hedged risk in certain cash flow and fair value hedging relationships. To address those current limitations, the amendments in this ASU permit hedge accounting for risk components in hedging relationships involving nonfinancial risk and interest rate risk as follows:

- For a cash flow hedge of a forecasted purchase or sale of a nonfinancial asset, an entity could designate as the hedged risk the variability in cash flows attributable to changes in a contractually specified component stated in the contract. The amendments remove the requirement in current GAAP that only the overall variability in cash flows or variability related to foreign currency risk could be designated as the hedged risk in a cash flow hedge of a nonfinancial asset.
- For a cash flow hedge of interest rate risk of a variable-rate financial instrument, an entity could designate as the hedged risk the variability in cash flows attributable to the contractually specified interest rate. By eliminating the concept of benchmark interest rates for hedges of variable-rate instruments in current GAAP, the amendments remove the requirement to designate only the overall variability in cash flows as the hedged risk in a cash flow hedge of a variable-rate instrument indexed to a non-benchmark interest rate.
- For a fair value hedge of interest rate risk, the amendments add the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate as an eligible benchmark interest rate in the United States in addition to those already permitted under current GAAP (the U.S. Treasury Rate, the London Interbank Offered Rate Swap Rate, and the Fed Funds Effective Swap Rate [or Overnight Index Swap Rate]). This allows an entity that issues or invests in fixed-rate tax-exempt financial instruments to designate as the hedged risk changes in fair value attributable to interest rate risk related to the SIFMA Municipal Swap Rate rather than overall changes in fair value.

Accounting for the Hedged Item in Fair Value Hedges of Interest Rate Risk

In some cases, current GAAP contains limitations on how an entity can designate the hedged item in a fair value hedge of interest rate risk. In other cases, current GAAP contains limitations on how an entity can measure changes in fair value of the hedged item attributable to interest rate risk in certain fair value hedging relationships. Those limitations may not align with an

entity's risk management strategies or the way in which interest rate risk can be hedged in the cash flow hedging model. To resolve those issues, the amendments in this ASU change the guidance for designating fair value hedges of interest rate risk and for measuring the change in fair value of the hedged item in fair value hedges of interest rate risk. Specifically, the amendments:

- Permit an entity to measure the change in fair value of the hedged item on the basis of the benchmark rate component of the contractual coupon cash flows determined at hedge inception, rather than on the full contractual coupon cash flows as required by current GAAP.
- Permit an entity to measure the hedged item in a partial-term fair value hedge of interest rate risk by assuming the hedged item has a term that reflects only the designated cash flows being hedged. Current GAAP does not allow this methodology when calculating the change in the fair value of the hedged item attributable to interest rate risk.
- For prepayable financial instruments, permit an entity to consider only how changes in the benchmark interest rate affect a decision to settle a debt instrument before its scheduled maturity in calculating the change in the fair value of the hedged item attributable to interest rate risk.
- For a closed portfolio of prepayable financial assets or one or more beneficial interests secured by a portfolio of prepayable financial instruments, permit an entity to designate an amount that is not expected to be affected by prepayments, defaults, and other events affecting the timing and amount of cash flows (the "last-of-layer" method). Under this designation, prepayment risk is not incorporated into the measurement of the hedged item.

Recognition and Presentation of the Effects of Hedging Instruments

The amendments in this ASU also align the recognition and presentation of the effects of the hedging instrument and the hedged item in the financial statements to increase the understandability of the results of an entity's intended hedging strategies.

The amendments in this ASU require an entity to present the earnings effect of the hedging instrument in the same income statement line item in which the earnings effect of the hedged item is reported. This presentation enables users of financial statements to better understand the results and costs of an entity's hedging program. Also, relative to current GAAP, this approach simplifies the financial statement reporting for qualifying hedging relationships. The amendments in this ASU require the following recognition and presentation guidance for qualifying hedges:

- For fair value hedges, the entire change in the fair value of the hedging instrument included in the assessment of hedge effectiveness is presented in the same income statement line that is used to present the earnings effect of the hedged item. The timing of recognition of the change in fair value of a hedging instrument included in the assessment of hedge effectiveness is the same as under current GAAP, but the presentation of hedge results could change because current GAAP does not specify a required presentation of the change in fair value of the hedging instrument.

- For cash flow and net investment hedges, the entire change in the fair value of the hedging instrument included in the assessment of hedge effectiveness is recorded in other comprehensive income (for cash flow hedges) or in the currency translation adjustment section of other comprehensive income (for net investment hedges). Those amounts are reclassified to earnings in the same income statement line item that is used to present the earnings effect of the hedged item when the hedged item affects earnings. The timing of recognition of the change in fair value of a hedging instrument could change relative to current GAAP because hedge ineffectiveness no longer is recognized currently in earnings. The presentation of hedge results also could change because current GAAP does not specify a required presentation of the change in fair value of the hedging instrument in the income statement.

Amounts Excluded from the Assessment of Hedge Effectiveness

Current GAAP permits an entity to exclude option premiums and forward points from the assessment of hedge effectiveness. The amendments in this ASU continue to allow an entity to exclude those components of a hedging instrument's change in fair value from the assessment of hedge effectiveness. Additionally, the amendments permit an entity to exclude the portion of the change in fair value of a currency swap that is attributable to a cross-currency basis spread from the assessment of hedge effectiveness.

For all types of hedges, if an entity excludes certain portions of a hedging instrument's change in fair value from the assessment of hedge effectiveness (excluded component), the amendments permit an entity to recognize in earnings the initial value of the excluded component using a systematic and rational method over the life of the hedging instrument. If an entity elects this method, any difference between the change in fair value of the excluded component and amounts recognized under the systematic and rational method is recognized in other comprehensive income, whereas for net investment hedges, the difference is recognized in the cumulative translation adjustment section of other comprehensive income. An entity also may elect to recognize all fair value changes in an excluded component currently in earnings, consistent with current GAAP.

For fair value and cash flow hedges, an entity should present amounts related to excluded components that are recognized in earnings in the same income statement line item that is used to present the earnings effect of the hedged item. For net investment hedges, the amendments do not specify a required presentation for excluded components.

Other Simplifications of Hedge Accounting Guidance

The amendments alter effectiveness testing as follows:

- In instances in which initial quantitative testing is required, an entity may perform subsequent assessments of hedge effectiveness qualitatively. An entity that makes this election is required to verify and document on a quarterly basis that the facts and circumstances related to the hedging relationship have not changed such that the entity can assert qualitatively that the hedging relationship was and continues to be highly effective. An entity may elect to perform qualitative assessments on a hedge-by-hedge basis.

- For purposes of assessing whether the qualifying criteria for the critical terms match method are met for a group of forecasted transactions, an entity may assume that the hedging derivative matures at the same time as the forecasted transactions if both the derivative maturity and the forecasted transactions occur within the same 31-day period or fiscal month.
- Entities will be able to perform the initial prospective quantitative assessment of hedge effectiveness at any time after hedge designation, but no later than the first quarterly effectiveness testing date, using data applicable as of the date of hedge inception.
- To provide additional relief on the timing of hedge documentation, private companies that are not financial institutions and not-for-profit entities (except for 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) may select the method of assessing hedge effectiveness, and perform the initial quantitative effectiveness assessment and all quarterly hedge effectiveness assessments before the date on which the next interim (if applicable) or annual financial statements are available to be issued. This incremental relief does not affect the simplified hedge accounting approach for private companies.
- If an entity that applies the shortcut method determines that use of that method was not or no longer is appropriate, the entity may apply a long-haul method for assessing hedge effectiveness as long as the hedge is highly effective and the entity documents at inception which long-haul methodology it will use.

Disclosures

The amendments in this ASU require a tabular disclosure related to the effect on the income statement of fair value and cash flow hedges and eliminate the requirement to disclose the ineffective portion of the change in fair value of hedging instruments. The amendments also require new tabular disclosures related to cumulative basis adjustments for fair value hedges.

Applicability and Effective Date

ASU No. 2017-12 applies to any entity that elects to apply hedge accounting in accordance with current GAAP and is effective (as amended by FASB ASU No. 2019-10) as follows:

	<i>Fiscal Years Beginning After</i>	<i>Interim Periods Within Fiscal Years Beginning After</i>
Public business entities	December 15, 2018	December 15, 2018
All other entities	December 15, 2020	December 15, 2021

Early application is permitted in any interim period after issuance of this ASU. All transition requirements and elections should be applied to hedging relationships existing (that is, hedging relationships in which the hedging instrument has not expired, been sold, terminated, or exercised or the entity has not

removed the designation of the hedging relationship) on the date of adoption. The effect of adoptions should be reflected as of the beginning of the fiscal year of adoption (that is, the initial application date).

Latest Developments

FASB ASU No. 2019-04

In April 2019, FASB issued ASU No. 2019-04 to clarify, correct, and improve various aspects of the guidance in ASU Nos. 2016-01, 2016-13, and 2017-12 related to financial instruments. The discussion herein will only address those amendments related to ASU No. 2017-12. Amendments related to ASU Nos. 2016-01 and ASU No. 2016-13 were addressed in previous sections of this appendix.

ASU No. 2019-04 clarifies certain aspects of the amendments in ASU No. 2017-12 as follows:

- *Partial-term fair value hedges of interest rate risk.* The amendments clarify that an entity may measure the change in fair value of a hedged item using an assumed term only for changes attributable to interest rate risk. They also clarify that an entity may measure the change in the fair value of the hedged item attributable to interest rate risk using an assumed term when the hedged item is designated in a hedge of both interest rate risk and foreign exchange risk. In that instance, the change in carrying value of the hedged item attributable to foreign exchange risk must continue to be measured based on changes in the spot exchange rate in accordance with FASB ASC 815-25-35-18. In addition, the amendments clarify that one or more separately designated partial-term fair value hedging relationships of a single financial instrument can be outstanding at the same time, and for forward-starting partial-term fair value hedges, the issuance of the hedged item is assumed to occur on the date in which the first hedged cash flow begins to accrue.
- *Amortization of fair value hedge basis adjustments.* The amendments clarify that an entity may, but is not required to, begin to amortize a fair value hedge basis adjustment before the fair value hedging relationship is discontinued. If an entity elects to amortize the basis adjustment during an outstanding partial-term hedge, that basis adjustment should be fully amortized by the hedged item's assumed maturity date in accordance with FASB ASC 815-25-35-13B.
- *Disclosure of fair value hedge basis adjustments.* The amendments clarify that available-for-sale debt securities should be disclosed at their amortized cost and that fair value hedge basis adjustments related to foreign exchange risk should be excluded from the disclosures required by FASB ASC 815-10-50-4EE.
- *Consideration of the hedged contractually specified interest rate under the hypothetical derivative method.* The amendment clarifies that an entity should consider the contractually specified interest rate being hedged when applying the hypothetical derivative method.

- *Scope for not-for-profit entities.* The amendments clarify that a not-for-profit entity that does not separately report earnings may not elect the amortization approach for amounts excluded from the assessment of effectiveness for fair value hedging relationships.
- *Hedge accounting provisions applicable to certain private companies and not-for-profit entities.* The amendments clarify that a private company that is not a financial institution as described in FASB ASC 942-320-50-1 should document the analysis supporting a last-of-layer hedge designation concurrently with hedge inception. Not-for-profit entities (except for 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) qualify for the same subsequent quarterly hedge effectiveness assessment timing relief for which certain private companies qualify in accordance with FASB ASC 815-20-25-142.
- *Application of a first-payments-received cash flow hedging technique to overall cash flows on a group of variable interest payments.* The amendments clarify that the application of the first-payments-received cash flow hedging technique to changes in overall cash flows on a group of variable interest payments continues to be permitted.
- *Transition guidance update.* The amendment to FASB ASC 815-20-65-3(e)(1) clarifies that transition adjustments to amend the measurement methodology of the hedged item in a fair value hedge of interest rate risk should be made as of the date of initial application of ASU No. 2017-12. The date of initial application differs from the date of adoption if an entity adopts the amendments in ASU No. 2017-12 in an interim period. The amendments also clarify the following:
 - An entity may rebalance its fair value hedging relationships of interest rate risk when it modifies the measurement methodology used for the hedged item from total contractual coupon cash flows to the benchmark rate component of the contractual coupon cash flows by any combination of increasing or decreasing the designated notional of the hedging instrument or increasing or decreasing the designated proportion of the hedged item. However, the entity may not add new hedged items or hedging instruments to the hedging relationship.
 - An entity may transition from a quantitative method of hedge effectiveness assessment to a method comparing the hedging relationship's critical terms in accordance with paragraphs 84 and 85 of FASB ASC 815-20-25 or paragraphs 129–129A of FASB ASC 815-20-25 without dedesignating the existing hedging relationship if the guidance in those paragraphs is met.
 - A debt security reclassified from held-to-maturity to available-for-sale in accordance with FASB ASC 815-20-65-3(e)(7) does not call into question an entity's assertion to hold to maturity those debt securities that continue to be classified as held-to-maturity, is not required to be

designated in a last-of-layer hedging relationship, and may be sold by an entity after reclassification.

Effective Date

For entities that have not yet adopted the amendments in ASU No. 2017-12 as of the issuance date of ASU No. 2019-04, the effective dates and transition requirements for the amendments to FASB ASC 815 are the same as the effective dates and transition requirements in ASU No. 2017-12.

For entities that have adopted the amendments in ASU No. 2017-12 as of the issuance date of ASU No. 2019-04, the effective date is as of the beginning of the first annual period beginning after the issuance date of ASU No. 2019-04. For those entities, early adoption is permitted, including adoption on any date on or after the issuance of ASU No. 2019-04.

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.

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</i> <i>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	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</i> 202.551.8090 <i>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 Reference¹
Paragraph 1.08c and footnote 2	Definition of <i>government</i>	1000.801; 1000 fn4
Paragraph 15.90	Reporting of proceeds from bonds issued by a financing authority	P80.801 Ho5.801
Paragraph 15.156	Exclusion of charity care from revenue	P80.802 Ho5.802
Paragraph 15.159	Disclosure information about charity care in the notes to the financial statements	P80.803 Ho5.803
Paragraph 15.168	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> (ACC sec. 10)	Ho5.804–.817

¹ References are to the Codification version dated December 31, 2020, copyright 2020 Governmental Accounting Standards Board, available in the Governmental Accounting Research System™ (GARS) at <https://gars.gasb.org/>.

Appendix G

The New Leases Standard: FASB ASC 842¹

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 this 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 FASB *Accounting Standards Codification (ASC)* 842, *Leases*, and makes conforming amendments to other FASB ASC topics. FASB ASU No. 2016-02 was subsequently amended by the following updates:

- ASU No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*
- ASU No. 2018-10, *Codification Improvements to Topic 842, Leases*
- ASU No. 2018-11, *Leases (Topic 842): Targeted Improvements*
- ASU No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*
- ASU No. 2019-01, *Leases (Topic 842): Codification Improvements*
- ASU No. 2019-10, *Financial Instruments — Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*
- ASU No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*
- ASU No. 2021-05, *Leases (Topic 842), Lessors — Certain Leases with Variable Lease Payments*

FASB ASC 842 consists of the following subtopics:

- a. Overall
- b. Lessee
- c. Lessor
- d. Sale and Leaseback Transactions
- e. Leveraged Lease Arrangements

¹ Appendix D, "GASB Statement No. 87, Leases," of the 2021 edition of the AICPA Audit and Accounting Guide *State and Local Governments* (Chapter 15 for the 2022 edition) describes the new lease standards application to governmental entities.

Applicability and Effective Dates

Applicability

FASB ASC 842 is applicable to any entity that enters into a lease and 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

Effective Dates

FASB ASC 842, as amended by ASU No. 2020-05, is effective as follows:

	<i>Fiscal Years Beginning After</i>	<i>Interim Periods Within Fiscal Years Beginning After</i>
Public business entities, not-for-profit entities with conduit financing arrangements that had issued before June 3, 2020, financial statements (or made financial statements available for issuance) reflecting the adoption of the new leases standards, and employee benefit plans	December 15, 2018	December 15, 2018
Not-for-profit entities with conduit financing arrangements that before June 3, 2020, had not issued financial statements (or made financial statements available for issuance) reflecting the adoption of the new leases standards	December 15, 2019	December 15, 2019
All other entities ²	December 15, 2021	December 15, 2022

See the "Subsequent Developments" section of this appendix for the effective dates of subsequently issued ASUs.

² In June 2020, FASB issued Accounting Standards Update (ASU) No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, which deferred the effective date of the new lease standards. The effective dates presented in this table reflect amendments in ASU No. 2020-05.

Transition

FASB ASC 842-10-65-1 describes the requirements for financial statement presentation when an entity first applies the guidance. Leases that exist at the application date and are within the scope of FASB ASC 842 should be recognized and measured using the appropriate approach described in FASB ASC 842-10-65-1 items (a)–(jj), which address the following:

- *Transition methods.* Entities should apply one of the following two methods:
 - Retrospective application to each prior reporting period presented in the financial statements with the cumulative effect of initial application recognized at the beginning of the earliest comparative period presented (subject to other transition requirements). Under this transition method, the application date should be the later of the beginning of the earliest period presented in the financial statements and the commencement date of the lease.
 - Retrospective application at the beginning of the period of adoption through a cumulative-effect adjustment (subject to other transition requirements). Under this transition method, the application date should be the beginning of the reporting period in which the entity first applies the guidance.
- *Practical expedients*
 - *Leases that commenced before the effective date.* For leases that commenced before the effective date, an entity may elect not to reassess the following:
 - Whether any expired or existing contracts are or contain leases
 - The lease classification for any expired or existing leases (for example, all existing leases that were classified as operating leases in accordance with FASB ASC 840, *Leases*, will be classified as operating leases, and all existing leases that were classified as capital leases in accordance with FASB ASC 840 will be classified as finance leases)
 - Initial direct costs for any existing leases

These practical expedients must be elected as a package and applied consistently by an entity to all of its leases (including those for which the entity is a lessee or a lessor).

- *Lease term.* An entity also may elect a practical expedient, which must be applied consistently by an entity to all of its leases (including those for which the entity is a lessee or a lessor) to use hindsight in determining the lease term (that is, when considering lessee options to extend or terminate the lease and to purchase the underlying asset) and in assessing impairment of the entity's right-of-use assets. This practical expedient may be

elected separately or in conjunction with either one or both of the other practical expedients.

- *Land easements.* An entity also may elect a practical expedient to not assess whether existing or expired land easements that were not previously accounted for as leases under FASB ASC 840 are or contain a lease under FASB ASC 842. This practical expedient may be elected separately or in conjunction with either one or both of the other practical expedients.
- *Disclosure.* Requirements for disclosure include the following:
 - Transition disclosures required by FASB ASC 250, *Accounting Changes and Error Corrections*, except for the requirements in FASB ASC 250-10-50-1(b)(2) and FASB ASC 250-10-50-3
 - Use of practical expedients, if applicable
 - For an entity that elects the modified retrospective transition method at the beginning of the period of adoption, the required FASB ASC 840 disclosures for all periods that continue to be in accordance with FASB ASC 840

Lessee transition disclosures are illustrated in paragraphs 243–254 of FASB ASC 842-10-55.

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) with that of 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; that is, (1) the contract must depend on the use of an identified asset, (2) the customer has to have the right to substantially all of the economic benefits from use of the asset, and (3) the customer has to have the right to direct the use of the asset.

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 nor 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 by class of underlying asset to treat associated lease and nonlease elements as a single lease component.

Lessors can similarly make an accounting policy by class of underlying asset to not separate lease and associated nonlease components when certain conditions are met. No such accounting policy election was available for lessors until FASB issued ASU No. 2018-11. For details, see the "Subsequent Developments" section of this appendix.

Lease Classification

When a lease meets any of the following specified criteria from FASB ASC 842-10-25-2 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. Ownership of the asset transfers to the lessee at the end of the lease term.
- b. The lease includes a purchase option that the lessee is reasonably certain to exercise.
- c. The lease term is for the major portion of the asset's remaining economic life.
- d. The present value of lease payments and residual value guaranteed by the lessee equals or exceeds substantially all of the fair value of the underlying asset.
- e. The specialized nature of the underlying asset results in no expectation of alternative use after the lease term.

If none of the preceding criteria are met, the lease should be classified as follows:

Lessee — Classify as an operating lease.

Lessor — Classify as an operating lease unless both of the following criteria are met: (1) The present value of the sum of the lease payments and any residual value guarantee 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. In addition, as amended by ASU No. 2021-05, notwithstanding the requirements in paragraphs 2–3 of FASB ASC 842-10-25, a lessor shall classify a lease with variable lease payments that do not depend on an index or a rate as an operating lease at lease commencement if classifying the lease as a sales-type lease or a direct financing lease would result in the recognition of a selling loss.

Lease Term and Measurement

The lease term is the noncancelable period of the lease together with all of the following:

- a. Periods covered by an option for the lessee to extend the lease if the lessee is reasonably certain to exercise that option
- b. Periods covered by an option for the lessee to terminate the lease if the lessee is reasonably certain not to exercise that option
- c. Periods covered by an option to extend (or not to terminate) the lease in which exercise of the option is controlled by the 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 (including in-substance fixed payments) less incentives paid or 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 in which the obligation is 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

FASB ASC 842-20-35 provides detailed guidance for lessee 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 judgments, 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:

Sales-Type Leases	
At the Commencement Date	After the Commencement Date
Lessor should derecognize the underlying asset and recognize the following: 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 if the fair value of the underlying asset is different from its carrying amount	Lessor should recognize all of the following: a. Interest income on the net investment in the lease b. Certain variable lease payments c. Any impairment
Direct Financing Leases	
At the Commencement Date	After the Commencement Date
Lessor should derecognize the underlying asset and recognize the following: 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	Lessor should recognize all of the following: a. Interest income on the net investment in the lease b. Certain variable lease payments c. Impairment
Operating Leases	
At the Commencement Date	After the Commencement Date
Lessor should defer initial direct costs	Lessor should recognize all of the following: a. The lease payments as income in profit or loss over the lease term on a straight-line basis (unless another method in 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 detailed guidance for lessor 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 lease 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 judgments, 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.

Subsequent Developments

ASU No. 2018-01

In January 2018, FASB issued ASU No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*. This ASU permits an entity to elect a practical expedient for transition. That practical expedient permits the entity to not evaluate under FASB ASC 842 existing or expired land easements not previously accounted for as leases under FASB ASC 840.

Effective Date

The effective date of FASB ASU No. 2018-01 is in line with the guidance in ASU No. 2016-02, as amended by ASU No. 2020-05.

ASU No. 2018-10

In July 2018, FASB issued ASU No. 2018-10, *Codification Improvements to Topic 842, Leases*. The amendments in this ASU affect narrow aspects of FASB ASC 842 and address the following 16 specific areas for improvement:

1. Residual Value Guarantees
2. Rate Implicit in the Lease
3. Lessee Reassessment of Lease Classification
4. Lessor Reassessment of Lease Term and Purchase Option
5. Variable Lease Payments That Depend on an Index or a Rate
6. Investment Tax Credits
7. Lease Term and Purchase Option
8. Transition Guidance for Amounts Previously Recognized in Business Combinations
9. Certain Transition Adjustments
10. Transition Guidance for Leases Previously Classified as Capital Leases under Topic 840
11. Transition Guidance for Modifications to Leases Previously Classified as Direct Financing or Sales-Type Leases under Topic 840
12. Transition Guidance for Sale and Leaseback Transactions
13. Impairment of Net Investment in the Lease
14. Unguaranteed Residual Asset
15. Effect of Initial Direct Costs on Rate Implicit in the Lease
16. Failed Sale and Leaseback Transaction

Effective Date

For entities that have not early adopted FASB ASC 842, the effective date and transition requirements are the same as ASU No. 2016-02, as amended by ASU

No. 2020-05. For entities that early adopted FASB ASC 842, the amendments were effective upon issuance of the ASU.

ASU No. 2018-11

In July 2018, FASB issued ASU No. 2018-11, *Leases (Topic 842): Targeted Improvements*. The amendments in this ASU can be organized into the following two areas:

1. Transition: Comparative Reporting at Adoption
2. Separating Components of a Contract for Lessors

Transition: Comparative Reporting at Adoption

The amendments to transition guidance related to comparative reporting at adoption apply to all entities with lease contracts that choose the additional transition method provided by this ASU.

This ASU amends FASB ASC 842-10-65-1 to permit an entity to elect an optional transition method to initially apply the new leases standard at the adoption date and recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption.

Separating Components of a Contract for Lessors

The amendments related to separating components of a contract apply only to lessors whose lease contracts qualify for the practical expedient provided by this ASU.

This ASU amends FASB ASC 842-10-15-42 to permit lessors to use a practical expedient, by class of underlying asset, to not separate nonlease components from the associated lease component and, instead, to account for those components as a single component if the nonlease components otherwise would be accounted for under FASB ASC 606 and both of the following conditions are met: (1) The timing and pattern of transfer of the nonlease component(s) and associated lease component are the same, and (2) the lease component, if accounted for separately, would be classified as an operating lease.

This ASU makes related amendments to FASB ASC 842 that affect the implementation guidance and illustrations in the subtopic "Overall" and the disclosure requirements in the subtopic "Lessors."

Effective Date

The effective dates are as follows:

- For entities that have not adopted FASB ASC 842 before the issuance of this ASU, the effective date and transition requirements are the same as those in ASU No. 2016-02, as amended by ASU No. 2020-05.
- For entities that have adopted FASB ASC 842 before the issuance of this ASU, the election and application of the practical expedient is specified in the ASU.

All entities electing the practical expedient should apply the guidance by class of underlying asset to all existing lease transactions that qualify for the expedient at the date elected.

ASU No. 2018-20

In December 2018, FASB ASU No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, was issued to address implementation issues related

to lessor accounting. The amendments in this ASU affect narrow aspects of FASB ASC 842 and address the following three specific areas for improvement:

1. Sales taxes and other similar taxes collected from lessees
2. Certain lessor costs
3. Recognition by lessors of variable payments for contracts with lease and nonlease components

Effective Date

The effective dates are as follows:

- For entities that have not adopted FASB ASC 842 before the issuance of this ASU, the effective date and transition requirements are the same as those in ASU No. 2016-02, as amended by ASU No. 2020-05.
- For entities that have adopted FASB ASC 842 before the issuance of this ASU, the entity should apply the amendments at the original effective date of FASB ASC 842 for the entity. Alternatively, the entity may elect to apply the amendments in either the first reporting period ending after the issuance of the ASU or in the first reporting period beginning after the issuance of the ASU. An entity may apply the amendments either retrospectively or prospectively.

ASU No. 2019-01

In March 2019, FASB ASU No. 2019-01, *Leases (Topic 842): Codification Improvements*, was issued to address implementation issues related to the new lease accounting standard. The amendments in this ASU affect narrow aspects of FASB ASC 842 and address the following three specific areas for improvement:

1. Determining the fair value of the underlying asset by lessors that are not manufacturers or dealers
2. Presentation on the statement of cash flows — sales-type and direct financing leases
3. Transition disclosures related to FASB ASC 250, *Accounting Changes and Error Corrections*

Effective Date

For the first two issues, the ASU is effective as follows:

- *For PBEs and certain employee benefit plans* — For fiscal years beginning after December 15, 2019, and interim periods within those fiscal years.
- *For 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 that as of June 3, 2020 have not yet issued financial statements or made financial statements available for issuance reflecting adoption of the new lease standards* — For fiscal years beginning after December 15, 2019, and interim periods within those fiscal years.
- *For all other entities* — For fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022

- Early adoption is permitted for all entities. If an entity early adopts, the ASU will be applied as of the date the entity first applies ASU No. 2016-02 (that is, when it adopts the new leasing standard in accordance with FASB ASC 842-10-65-1(c)).

The third issue is effective immediately as it only affects transition guidance.

ASU No. 2019-10

In November 2019, FASB issued ASU No. 2019-10, *Financial Instruments — Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842) Effective Dates*, which deferred the effective dates for certain major updates, including FASB ASC 842, for specified entities. Upon issuance of the ASU, FASB ASC 842 was already effective for certain entities; therefore, for those entities (including smaller reporting companies), the effective date was retained. That is, for public business entities; not-for-profit entities 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 employee benefit plans that file or furnish financial statements with or to the SEC, the initial effective date was retained. The effective date for all other entities was deferred by an additional year; however, that effective date was again deferred by ASU No. 2020-05. Early application continues to be allowed.

ASU No. 2020-05

In June 2020, FASB issued ASU No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842) Effective Dates for Certain Entities*, which, among other provisions, deferred the effective dates for applying FASB ASC 842 for certain not-for-profit entities that have not yet issued financial statements or made financial statements available for issuance as of June 3, 2020. The ASU also deferred the effective date for applying FASB ASC 842 by one year for entities within the "all other entities" category. Early application continues to be allowed. ASU No. 2020-05 also deferred the effective dates for applying FASB ASC 606 for certain entities.

ASU No. 2021-05

In July 2021, FASB issued ASU No. 2021-05, *Leases (Topic 842), Lessors — Certain Leases with Variable Lease Payments*, which amends the lease classification requirements for lessors to align them with practice under FASB ASC 840. Lessors should classify and account for a lease with variable lease payments that do not depend on a reference index or a rate as an operating lease if both of the following criteria are met:

1. The lease would have been classified as a sales-type lease or a direct financing lease in accordance with the classification criteria in paragraphs 2–3 of FASB ASC 842-10-25.
2. The lessor would have otherwise recognized a day-one loss.

When a lease is classified as operating, the lessor does not recognize a net investment in the lease, does not derecognize the underlying asset, and, therefore, does not recognize a selling profit or loss. The leased asset continues to be subject to the measurement and impairment requirements under other applicable GAAP before and after the lease transaction (for example, FASB ASC 360, *Property, Plant, and Equipment*).

The amendments in ASU No. 2021-05 are effective for fiscal years beginning after December 15, 2021, for all entities, and interim periods within those fiscal years for public business entities and interim periods within fiscal years beginning after December 15, 2022, for all other entities.

Appendix H

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, 2021

This schedule of changes identifies areas in the text and footnotes of this guide that have changed since the previous edition. Entries in the following table 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 gray-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. Prior years' guidance update boxes are removed if the standards are now effective.
General	Editorial changes, including rephrasing, may have been made in this guide to improve readability where necessary.
Preface	Updated.
Paragraph 2.01	Revised to reflect the issuance of Statement on Auditing Standards (SAS) No. 130, <i>An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements</i> .
Paragraphs 2.33 and 2.41	Revised for clarity.
Paragraph 2.45	Revised for the passage of time.
Paragraphs 2.90–.91	Revised for clarity.
Paragraph 2.94	Heading added.
Paragraph 2.100	Revised for clarity.

(continued)

Reference	Change
Paragraph 3.19	Revised to reflect the issuance of FASB Accounting Standards Update (ASU) No. 2017-07, <i>Compensation — Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost</i> .
Paragraph 3.26	Revised to reflect the issuance of FASB ASU No. 2020-10, <i>Codification Improvements</i> .
Paragraph 4.06	Revised for clarity.
Paragraph 4.40	Revised to reflect the issuance of FASB ASU No. 2020-03, <i>Codification Improvements to Financial Instruments</i> .
Paragraph 4.48	Revised for the changes of Technical Questions and Answers (Q&A) section 6400.42, "Application of FASB ASC 958 — Classification of a Beneficiary's Interest in the Net Assets of a Financially Interrelated Fundraising Foundation (Recipient Entity) — Accounting for Unrealized Gains and Losses on Investments Held by the Foundation."
Paragraph 4.76	Exhibit 4-1 updated.
Paragraphs 5.16 and 5.20	Revised for clarity.
Paragraph 6.35	Revised to reflect the issuance of Q&A section 6400.53, "Accounting for Costs Incurred in Connection With the Implementation of Electronic Health Record Systems."
Paragraph 6.39	Revised to reflect the issuance of FASB ASU No. 2021-03, <i>Intangibles — Goodwill and Other (Topic 350): Accounting Alternative for Evaluating Triggering Events</i> .
Paragraph 6.54	Exhibit 6-1 updated.
Paragraph 7.12	Revised to reflect the issuance of Q&A section 7100.14, "Private Resales (Rule 144 and Rule 144A) and the Definition of a Public Business Entity," and for clarity.

Reference	Change
Paragraphs 7.94 and 7.117	Revised to correspond more completely with chapter 18, "Auditor Involvement With Municipal Securities Filings," of AICPA Audit and Accounting Guide <i>State and Local Governments</i> and chapter 10, "Debt and Other Liabilities," of AICPA Audit and Accounting Guide <i>Not-for-Profit Entities</i> .
Paragraph 8.31	Revised for clarity.
Paragraph 8.85	Revised for issuance of the Further Consolidated Appropriations Act, 2020, Division N, Subtitle E, section 502.
Paragraph 8.101	Revised to reflect the issuance of Q&A section 6400.54, "Financial Presentation Considerations Related to Transactions Involving Provider Taxation Programs and Similar Arrangements."
Paragraphs 10.02 and 10.05	Revised for clarity.
Paragraph 10.54	Exhibit 10-1 updated.
Paragraph 10.55	Revised to correspond with changes since the last edition to chapter 7, "Health Care Entities" of AICPA Audit and Accounting Guide <i>Revenue Recognition</i> .
Paragraph 11.23	Revised to reflect the issuance of FASB ASU No. 2020-03.
Paragraph 11.32	Revised to reflect the issuance of FASB ASU No. 2020-10.
Paragraph 11.51	Revised for clarity.
Former paragraph 11.66	Deleted.
Paragraphs 12.100 and 12.112	Revised for clarity.
Paragraph 14.06	Revised for clarity.
Paragraph 14.07	Revised to reflect the issuance of Q&A sections 6400.55–.62, which are about lease components in Type A contracts of continuing care retirement communities.
Paragraphs 14.19–.20	Revised for clarity.
Former paragraph 14.23	Deleted.
Paragraph 14.44	Exhibit 14-2 updated.
Paragraph 15.28	Revised for the issuance of FASB ASU No. 2016-18, <i>Statement of Cash Flows (Topic 230): Restricted Cash (a consensus of the FASB Emerging Issues Task Force)</i> .

(continued)

Reference	Change
Paragraph 15.157	Revised to reflect the issuance of FASB ASU No. 2014-09, <i>Revenue from Contracts with Customers (Topic 606)</i> .
Paragraph 15.178	Revised to reflect the issuance of GASB Statement No. 97, <i>Certain Component Unit Criteria, and Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans — an amendment of GASB Statements No. 14 and No. 84, and a supersession of GASB Statement No. 32</i> .
Paragraph 15.219	Added to reflect the issuance of Q&A section 6950.24, "Auditor Assessment of a Special-Purpose Government's Only Immaterial Fiduciary Fund."
Former Supplement A	Deleted.
Appendix B	Updated.
Former Appendix C	Deleted.
Appendix D	Updated.
Appendix F	Updated.
Appendix G	Updated.
Former Appendix H	Deleted.
Former Appendix J	Relettered as appendix C.
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) Master 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.

board-designated endowment fund. An endowment fund created by an NFP's governing board by designating a portion of its net assets without donor restrictions to be invested to provide income for a long but not necessarily specified period (sometimes called funds functioning as endowment or quasi-endowment funds). In rare circumstances, a board-designated endowment fund also can include a portion of net assets with donor restrictions. For example, if an NFP is unable to spend donor-restricted contributions in the near term, then the board sometimes considers the long-term investment of these funds. See **endowment fund**.

board-designated net assets. Net assets without donor restrictions subject to self-imposed limits by action of the governing board. Board-designated net assets may be earmarked for future programs, investment, contingencies, purchase or construction of fixed assets, or other uses. Some governing boards may delegate designation decisions to internal management. Such designations are considered to be included in board-designated net assets.

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. To be considered a business, an integrated set must meet the requirements in paragraphs 4–6 and paragraphs 8–9 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 (donors include other types of contributors, including makers of certain grants) that represents a barrier that must be overcome before the recipient is entitled to the assets transferred or promised. Failure to overcome the barrier gives the contributor a right of return of the assets it has transferred or gives the promisor a right of release from its obligation to transfer its assets.

donor-imposed restriction. A donor stipulation (donors include other types of contributors, including makers of certain grants) that specifies a use for a contributed asset that is more specific than broad limits resulting from the following:

- a. The nature of the 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.

Some donors impose restrictions that are temporary in nature, for example, stipulating that resources be used after a specified date, for

particular programs or services, or to acquire buildings or equipment. Other donors impose restrictions that are perpetual in nature, for example, stipulating that resources be maintained in perpetuity. Laws may extend those limits to investment returns from those resources and to other enhancements (diminishments) of those resources. Thus, those laws extend donor-imposed restrictions.

donor-restricted endowment fund. An endowment fund that is created by a donor stipulation (donors include other types of contributors, including makers of certain grants) requiring investment of the gift in perpetuity or for a specified term. Some donors or laws may require that a portion of income, gains, or both be added to the gift and invested subject to similar restrictions. The term does not include a **board-designated endowment fund**. See **endowment fund**.

donor-restricted support. Donor-restricted revenues or gains from contributions that increase net assets with donor restrictions (donors include other types of contributors, including makers of certain grants).

economic interest. 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 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.

endowment fund. An established fund of cash, securities, or other assets to provide income for the maintenance of an NFP. The use of the assets of the fund may be with or without donor-imposed restrictions. Endowment funds generally are established by donor-restricted gifts and bequests to provide a source of income in perpetuity or for a specified period. See **donor-restricted endowment fund**. Alternatively, an NFP's governing board may earmark a portion of its net assets as a **board-designated endowment fund**. See **funds functioning as endowment**.

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 expense classification. A method of grouping expenses according to the purpose for which the costs are incurred. The primary functional classifications of an NFP 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.

funds functioning as endowment. Net assets without donor restrictions (donors include other types of contributors, including makers of certain grants) designated by an entity's governing board to be invested to provide income for generally a long but not necessarily specified period. A board-designated endowment, which results from an internal designation, is generally not donor-restricted and is classified as net assets without donor restrictions. The governing board has the right to decide at any time to expend such funds. In rare circumstances, funds functioning as endowment also can include a portion of net assets with donor restrictions. For example, if an NFP is unable to spend donor-restricted contributions in the near term, the board sometimes considers the long-term investment of these funds. (Sometimes referred to as **quasi-endowment funds** or **board-designated endowment funds**.)

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. Supporting activities that are not directly identifiable with one or more program, fundraising, or membership-development activities.

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 (NFPEs) 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, professional services, supplies, interest expense, rent, utilities, and depreciation.

net assets. The excess or deficiency of assets over liabilities of a not-for-profit entity, which is divided into two mutually exclusive classes according to the existence or absence of donor-imposed restrictions. See **net assets with donor restrictions** and **net assets without donor restrictions**.

net assets with donor restrictions. The part of net assets of a not-for-profit entity that is subject to donor-imposed restrictions (donors include other types of contributors, including makers of certain grants).

net assets without donor restrictions. The part of net assets of a not-for-profit entity that is not subject to donor-imposed restrictions (donors include other types of contributors, including makers of certain grants).

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

orderly transaction. A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).

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.

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.

readily determinable fair value. An equity security has a readily determinable fair value if it meets any of the following conditions:

- a.* The fair value of an equity security is readily determinable if sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the U.S. Securities and Exchange Commission (SEC) or in the over-the-counter market, provided that those prices or quotations for the over-the-counter market are publicly reported by the National Association of Securities Dealers Automated Quotations systems or by OTC Markets Group Inc.

Restricted stock meets that definition if the restriction terminates within one year.

- b. The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to above.
- c. The fair value of an equity security that is an investment in a mutual fund or in a structure similar to a mutual fund (that is, a limited partnership or a venture capital entity) is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.

reclassification of net assets. Simultaneous increase of one class of net assets and decrease of another. A reclassification of net assets usually results from a donor-imposed restriction (donors include other types of contributors, including makers of certain grants) being satisfied or otherwise lapsing.

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.

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 by-laws
- d. Limits resulting from contractual agreements with suppliers, creditors, and others entered into by the NFP in the course of its business

underwater endowment fund. 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.

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.

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 settling 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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