1985

Financial reporting by not-for-profit health care entities for tax-exempt debt and certain funds whose use is limited: amendment to AICPA industry audit guide, Hospital audit guide; Statement of position 85-1;

American Institute of Certified Public Accountants. Accounting Standards Division

Follow this and additional works at: https://egrove.olemiss.edu/aicpa_sop

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation
American Institute of Certified Public Accountants. Accounting Standards Division, "Financial reporting by not-for-profit health care entities for tax-exempt debt and certain funds whose use is limited: amendment to AICPA industry audit guide, Hospital audit guide; Statement of position 85-1;" (1985). Statements of Position. 184.
https://egrove.olemiss.edu/aicpa_sop/184

This Article is brought to you for free and open access by the American Institute of Certified Public Accountants (AICPA) Historical Collection at eGrove. It has been accepted for inclusion in Statements of Position by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.
Financial Reporting by Not-for-Profit Health Care Entities for Tax-Exempt Debt and Certain Funds Whose Use Is Limited

January 1, 1985

Amendment to
AICPA Industry Audit Guide
Hospital Audit Guide

Issued by
Accounting Standards Division
American Institute of
Certified Public Accountants
NOTE

This statement of position amends the AICPA Industry Audit Guide, Hospital Audit Guide.

Statements of position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statements of position do not establish standards enforceable under rule 203 of the Institute’s Code of Professional Ethics. However, Statement on Auditing Standards (SAS) No. 5, The Meaning of “Present Fairly in Conformity With Generally Accepted Accounting Principles” in the Independent Auditor’s Report, as amended by SAS No. 43, Omnibus Statement on Auditing Standards, identifies AICPA statements of position as another source of established accounting principles the auditor should consider. Accordingly, members should be prepared to justify departures from the recommendations in this statement of position.
# Table of Contents

Summary .................................................................................. 4

Financial Reporting by Not-for-Profit Health Care Entities for Tax-Exempt Debt and Certain Funds Whose Use Is Limited ...................................................... 5

Introduction and Scope ............................................................... 5

Definitions .................................................................................. 6

The Basic Issues ........................................................................... 8

Diversity in Practice ..................................................................... 8

Views on the Issues ..................................................................... 10
  Classifying the Debt ................................................................ 10
  Classifying Assets Whose Use Is Limited ............................... 10
  Presenting Investment Income and Expense ......................... 11

Conclusions ............................................................................... 11

Effective Date and Transition .................................................... 12

Appendix—Illustrative Financial Statements .............................. 13
SUMMARY

This statement of position provides guidance for not-for-profit health care entities (a) reporting long-term debt issued through a financing authority, (b) classifying funds whose use is limited as either general (unrestricted) or restricted, and (c) reporting related investment income and interest expense in the financial statements.

The statement recommends the following:

- Unrestricted funds should be called general funds (as defined) and health care entities should report, as liabilities in the general funds section of the balance sheet, debt issued for their benefit and for repayment of which they are responsible when the debt is issued.

- Only assets restricted by a donor or by a grantor should be reported in the donor-restricted funds section of the balance sheet. Other assets should be reported in the general funds section.

- Assets whose use is limited in substance under terms of debt indentures, trust agreements, third-party reimbursement arrangements, or other similar arrangements should be reported in the general funds section as assets whose use is limited.

- Interest expense and investment income on borrowed funds held by a trustee (to the extent they are not capitalized) should be reported separately as operating expense or operating revenue, respectively, or alternatively, may be netted and reported as operating expense or operating revenue with the offsetting amount disclosed parenthetically. Investment income related to funds whose use is limited under third-party reimbursement arrangements (funded depreciation) and funds held by a trustee that are not borrowed funds should be reported as nonoperating revenue.

The provisions of this statement are effective for periods beginning on or after January 1, 1985.
Introduction and Scope

1. Increased construction costs of health care facilities, resulting from rising prices and a decline in philanthropy and government grants as sources of capital, have caused health care entities to finance facilities acquisitions, additions, and renovations with long-term debt.

2. Issuance of tax-exempt or taxable bonds are among the long-term financing alternatives available to health care entities. Approximately three-fourths of all health care entity debt instruments issued in recent years have been tax-exempt bonds, generally revenue bonds. Tax-exempt bonds can usually be issued to obtain a higher ratio of project financing (up to 100 percent), a longer maturity period (up to thirty years), and a lower interest cost than taxable bonds.

3. Because many hospitals cannot legally issue tax-exempt revenue bonds directly, a significant number of states have enacted legislation permitting health care entities to borrow funds for capital projects by issuing bonds through financing authorities. Financing authorities are authorized to issue tax-exempt bonds or other obligations and use the proceeds for the benefit of the health care entities. To obtain project financing, a health care entity is sometimes required by a financing authority to enter into a lease arrangement or sublease arrangement or both. At other times a lease or sublease arrangement is not required. In either case a liability is recorded in the health care entity's balance sheet.

4. In the absence of definitive guidance, diverse reporting practices related to funds whose use is limited under those financing arrangements, or under third-party reimbursement arrangements, have developed in the health care industry. The Accounting Stand-
ards Division believes that specific guidance is needed to achieve uniform reporting practices for—

- Long-term debt issued through financing authorities for the benefit of health care entities, repayment of which is the entities’ responsibility.
- Funds whose use is limited under the terms of debt-financing agreements.
- Investment income earned on funds whose use is limited under debt-financing agreements and the interest expense on the debt.
- Funds whose use is limited under third-party reimbursement arrangements and related investment income.

5. This statement addresses the reporting of tax-exempt bonds or other tax-exempt obligations issued through financing authorities to finance the facilities of not-for-profit health care entities, which are responsible for repayment of the bonds. It also addresses issues related to the reporting of funds established under the terms of debt-financing instruments and of the investment (interest) income and expense on such funds, neither of which is addressed by the AICPA Industry Audit Guide, Hospital Audit Guide.

6. In addition, this statement modifies the reporting of funds whose use, under third-party reimbursement arrangements, is limited to such purposes as replacements or additions to property, plant, and equipment. Those funds are addressed in the Hospital Audit Guide.

Definitions

7. The following definitions apply for purposes of this statement.

Assets (Funds) Whose Use Is Limited. Assets whose use is limited appear in the general (unrestricted) funds section of the balance sheet and include—

- Assets set aside by the governing board for identified purposes and over which the board retains control and may, at its discretion, subsequently use for other purposes.
• Proceeds of debt issues and funds of the health care entity deposited with a trustee and limited to use in accordance with the requirements of an indenture or similar document.

• Other assets limited to use for identified purposes through an agreement between the health care entity and an outside party other than a donor or grantor.

**Donor-Restricted Funds.** Funds restricted for specific purposes by donors or grantors, for example, endowment funds or funds restricted to plant replacement and expansion.

**General Funds.** See paragraphs 8, 9, and 10.

**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.

**Revenue Bonds.** Bonds generally issued by a financing authority for the benefit of a health care entity and secured by a pledge of the entity’s revenues.

8. A health care entity’s resources and obligations are generally segregated into logical account groups based on external restrictions (restricted funds) or administrative requirements (unrestricted or general funds). Unrestricted funds are used for general operating purposes and reflect those resources or obligations that are not restricted by donors or grantors.

9. Classifying funds whose use is limited under terms of debt-financing agreements or third-party reimbursement agreements as unrestricted funds is often confusing to readers of a health care entity’s financial statements because the readers may infer that the limitations require the funds to be classified as restricted rather than unrestricted. However, as discussed further in this statement, only funds restricted by a donor or a grantor should be reported as donor-restricted funds; other funds should be reported as general funds.

10. Although the term “unrestricted funds” has been used historically to identify those funds that are not restricted by donors or grantors, the caption “unrestricted funds” should be changed to
"general funds" because this term is more meaningful to readers of financial statements. The term "unrestricted funds" in the Hospital Audit Guide should be replaced with the term "general funds" and be defined as follows:

**General Funds.** Funds not restricted for identified purposes by donors or grantors, including resources that the governing board may use for any designated purpose and resources whose use is limited by agreement between the health care entity and an outside party other than a donor or grantor.

### The Basic Issues

11. Not-for-profit health care entities face the following reporting issues related to tax-exempt debt and funds whose use is limited under a debt-financing agreement or a third-party reimbursement arrangement.

   a. How and when should a health care entity report long-term debt issued for its benefit and for which it is responsible for repayment in full?

   b. Should funds whose use is limited under the terms of an indenture agreement or a third-party reimbursement arrangement be classified on the balance sheet as general (unrestricted) or as restricted funds?

   c. How should related investment income and interest expense be reported in the financial statements?

Issues associated with the accounting for board-designated assets are discussed adequately in the Hospital Audit Guide.

### Diversity in Practice

12. When a financing authority issues tax-exempt bonds or similar debt instruments and uses the proceeds for the benefit of a health care entity, some entities report the obligation in the general (unrestricted) funds section of the balance sheet. Others report the obligation in the restricted funds section of the balance sheet.

13. Reporting practices also differ for funds whose use is limited or for funds that are required by terms of an indenture agreement to
be held by trustees for construction costs, debt service reserve payments, and other costs related to the project. Some entities report those funds as assets of the restricted funds. Others report them as noncurrent assets in the general (unrestricted) funds section of the balance sheet. Others net the assets with the corresponding debt, reporting the net amount either in the general (unrestricted) fund or in the restricted fund and disclosing in a note to the financial statements the amounts the indenture requires to be held by bond trustees for debt service payments and other purposes.

14. In addition to the variety of asset reporting practices described above, several methods are used to report the related investment income and interest expense in the statement of revenues and expenses. Some entities report investment income and interest expense either in the operating or in the nonoperating revenues and expenses sections. Others report net investment income or expense as either operating or nonoperating revenue or operating or nonoperating expense. If the assets have been reported as restricted funds, others report the related investment income as an addition to the restricted fund balance.

15. With respect to funds whose use is limited under third-party reimbursement arrangements, Medicare regulations encourage, but do not require, that hospitals fund depreciation by setting aside cash or other liquid assets in a separate fund account to be used for the acquisition or replacement of depreciable assets. Some Blue Cross plans and some state Medicaid programs reimburse hospitals for depreciation only if it is funded. However, most Blue Cross plans and Medicaid programs do not require funding as a prerequisite for depreciation reimbursement. In addition, some state regulations may require assets to be set aside for capital improvements or other purposes. Some health care entities report assets representing funded depreciation or assets set aside for capital improvements or other purposes in the board-designated (noncurrent) section of the general (unrestricted) fund balance sheet. Others report them in the restricted fund section of the balance sheet. The related income from investing those assets is reported either in the statement of revenues and expenses or in the restricted fund balance, respectively.
Views on the Issues

Classifying the Debt

16. Some believe that 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 debt should be reported as an obligation in the general (unrestricted) funds section of the entity's balance sheet. They hold this view because any limitations on the use of the proceeds are imposed by the voluntary action of the governing board. Others believe that the debt should be reported in the restricted funds section of the balance sheet because, generally, the proceeds of the bond issue are administered under the terms of the indenture by an independent trustee. Since the proceeds are limited to use for project costs, they consider them to be restricted and, therefore, the related debt should also be restricted.

Classifying Assets Whose Use Is Limited

17. Some believe that funds whose use is limited by terms of an indenture agreement or by a third-party reimbursement agreement should be reported in the restricted funds section of the balance sheet, since under the terms of the contract or agreement, such funds cannot be used for other purposes.

18. Others hold, however, that restricted funds should be used only to account for funds restricted by donors or by grantors (a treatment consistent with the Hospital Audit Guide) and that general (unrestricted) funds should be used to account for all other resources. They believe that, although donor restrictions are common in health care entities, debt-financing instruments that contain contract limitations on the use of funds are not unique to health care entities but are prevalent throughout American industry. Such financing agreements or third-party reimbursement agreements are normal and recurring business activities that are necessary for carrying out the organization's objectives and are entered into at the discretion of the governing board and are related to the general (unrestricted) business operations of the entity. Thus, they believe that funds whose use is limited under terms of an indenture agreement or a third-party reimbursement agreement should be reported, with appropriate disclosure, as noncurrent assets in the
general (unrestricted) funds section of the balance sheet; they do not support reporting those assets in the restricted funds section of the balance sheet.

19. Those who net the assets with the corresponding debt during the construction period, either in the restricted or in the general (unrestricted) funds section, maintain that such treatment is preferable since the proceeds of the debt issue are limited to payment for the work in process.

Presenting Investment Income and Expense

20. Some believe that investment income and interest expense on borrowed funds held by a trustee should be reported separately in the operating section of the statement of revenues and expenses because such amounts are earned or incurred for operating purposes and are necessary to continue normal business operations. Others believe that such amounts should be netted because that treatment recognizes the economics of the transaction, namely, that income generated by the investment of the proceeds reduces the cost of borrowing. Either approach properly matches interest expense and the related investment income on borrowed funds, and each includes the net effect of borrowing in the results of operations.

21. Others report investment income on borrowed funds held by a trustee and on funded depreciation in the nonoperating section of the statement of revenues and expenses because they believe that this method is consistent with the AICPA Hospital Audit Guide, which recommends reporting income from investments of board-designated and other general (unrestricted) funds as nonoperating revenue.

22. Some report assets as restricted funds and the related investment income as an addition to the restricted fund balance because they consider investment income as an increase in the equity of the restricted funds.

Conclusions

23. Unrestricted funds should be called general funds (as defined in paragraphs 8, 9, and 10), and the following are the conclusions on the issues addressed in this statement:
a. Not-for-profit health care entities should report, as liabilities in the general funds section of the balance sheet, obligations issued for their benefit and for repayment of which they are responsible when the obligations are issued.

b. (1) Only assets restricted by a donor or by a grantor should be reported in the donor-restricted funds section of the balance sheet. Other assets should be reported in the general funds section of the balance sheet.

(2) Assets whose use is limited in substance under terms of debt indentures, trust agreements, third-party reimbursement arrangements, or other similar arrangements should be reported in the general funds section of the balance sheet as assets whose use is limited.

c. Interest expense and investment income on borrowed funds held by a trustee (to the extent they are not capitalized pursuant to FASB Statement of Financial Accounting Standards No. 62, Capitalization of Interest Cost in Situations Involving Tax-Exempt Borrowings and Certain Gifts and Grants) should be reported separately as operating expense or operating revenue, respectively, or alternatively, may be netted and reported as operating expense or operating revenue with the offsetting amount disclosed parenthetically. Investment income related to funds whose use is limited under third-party reimbursement arrangements (for example, funded depreciation) and general funds held by a trustee that are not borrowed funds should be reported as nonoperating revenue. If material, each amount should be reported separately.

Effective Date and Transition

24. This statement of position is effective for fiscal years beginning on or after January 1, 1985, with earlier application encouraged. Accounting changes and reclassifications adopted to conform to the provisions of this statement of position should be applied retroactively by restating the financial statements of prior periods.
APPENDIX

Illustrative Financial Statements

The following illustrate the financial statement presentation of the foregoing discussion. In addition, the accounting policies footnote would describe differences between general funds, including those limited as to use, and restricted funds.

Balance Sheet

Assets whose use is limited under the terms of an indenture agreement, through board designation or through an agreement between the health care entity and an outside party other than a donor or grantor should be reported below current assets in the general fund section of the balance sheet, as follows.

Exhibit 1

(Details of assets reported in the notes to the financial statement)

<table>
<thead>
<tr>
<th>General Fund</th>
<th>19X1</th>
<th>19X0</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASSETS WHOSE USE IS LIMITED (NOTES X AND Y)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>By board for capital improvements</td>
<td>$300,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>By agreements with third-party payors</td>
<td>700,000</td>
<td>400,000</td>
</tr>
<tr>
<td>Under bond indenture agreement — held by trustee</td>
<td>3,000,000</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Total assets whose use is limited</td>
<td>4,000,000</td>
<td>2,500,000</td>
</tr>
<tr>
<td>Less assets whose use is limited and that are required for current liabilities*</td>
<td>(500,000)</td>
<td>(500,000)</td>
</tr>
<tr>
<td>Noncurrent assets whose use is limited</td>
<td>$3,500,000</td>
<td>$2,000,000</td>
</tr>
</tbody>
</table>

*Contra amount reflected as a current asset of the general fund.
### ASSETS WHOSE USE IS LIMITED (NOTES X AND Y)

<table>
<thead>
<tr>
<th>Description</th>
<th>19X1</th>
<th>19X0</th>
</tr>
</thead>
<tbody>
<tr>
<td>By board for capital improvements Investments</td>
<td>$300,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>By agreements with third-party payors</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>100,000</td>
<td>—</td>
</tr>
<tr>
<td>Investments</td>
<td>600,000</td>
<td>400,000</td>
</tr>
<tr>
<td>Under bond indenture agreement — held by trustee</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$500,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>Investments</td>
<td>2,500,000</td>
<td>1,600,000</td>
</tr>
<tr>
<td>Total assets whose use is limited</td>
<td>$4,000,000</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Less assets whose use is limited and that are required for current liabilities*</td>
<td>(500,000)</td>
<td>(500,000)</td>
</tr>
<tr>
<td>Noncurrent assets whose use is limited</td>
<td>$3,500,000</td>
<td>$2,000,000</td>
</tr>
</tbody>
</table>

*Contra amount reflected as a current asset of the general fund.
Statement of Revenues and Expenses

Income on investments of assets whose use is limited, on board-designated assets, or on those assets whose use is limited in accordance with an agreement between the health care entity and an outside party other than a donor or grantor should be reported in the statement of revenues and expenses as shown in exhibits 3 and 4, based on the following assumptions.

Investment income from board-designated funds $50,000
Investment income from assets whose use is limited
  Unexpended debt proceeds held by trustee
    under indenture agreement 75,000
  Other assets held by trustee
    under indenture agreement(1) 100,000
  Depreciation funds 150,000

(1) Includes investment income on funds held by trustee that were not generated through borrowed funds.

Exhibit 3

Investment income on unexpended debt proceeds held by trustee and reported as other operating revenue.

Other operating revenue (Note X)* $400,000
Nonoperating revenue
  Unrestricted gifts and bequests $400,000
  Income on investments
    Board-designated funds 50,000
    Assets whose use is limited under indenture agreement 100,000
    Depreciation funds 150,000
  Total nonoperating revenue $700,000

*Note X to the financial statements would disclose that other operating revenue includes $75,000 of interest income on unexpended debt proceeds whose use is limited under an indenture agreement and which are held by a trustee.
**Exhibit 4**

Investment income on unexpended debt proceeds and interest expense reported as a net amount in operating expense.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other operating revenue</td>
<td>$325,000</td>
</tr>
<tr>
<td>Operating expenses</td>
<td></td>
</tr>
<tr>
<td>Salaries and professional fees</td>
<td>$9,800,000</td>
</tr>
<tr>
<td>Supplies and other expenses</td>
<td>7,300,000</td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>600,000</td>
</tr>
<tr>
<td>Interest (Note X)*</td>
<td>400,000</td>
</tr>
<tr>
<td><strong>Total operating expenses</strong></td>
<td><strong>$18,100,000</strong></td>
</tr>
<tr>
<td>Nonoperating revenue (same as exhibit 3)</td>
<td>$700,000</td>
</tr>
</tbody>
</table>

*Note X to the financial statements would disclose that interest expense was net of $75,000 of interest income on unexpended debt proceeds whose use is limited under an indenture agreement and which are held by a trustee.*
Accounting Standards Executive Committee
(1983-1984)

ROGER CASON, Chairman
HAROLD E. ARNETT
JOSEPH S. BURNS
DONALD C. ELLWOOD
MARVIN A. GOLDMAN
VAUGHN L. HERSEY, JR.
JOHN W. HOYT
HOWARD B. LEVY
PAUL B. LukENS

RONALD J. MURRAY
SANDRA S. SCHMIDT
WALTER P. SCHUETZE
JAMES O. STEPP
RONALD L. WOLF
LESTER I. WOLOSOFF

PAUL ROSENFIELD, Director
Accounting Standards

Health Care Subcommittee
(1983-1984)

CLARK A. CABLE, Chairman
M. JACK BROSE
RAYMOND J. CISNEROS
CLIFTON M. FLETCHER
JOHN K. FREEMAN
THOMAS J. GAZDIC
GERARD C. HAAS
MANFRED HEINZELLER
WILLIAM A. SCHEIDERICH
DARWIN W. SCHLAG, JR.
J. WILLIAM TILLETT

LARRY S. WESTFALL
GARY M. WETSTEIN
JOEL M. ZIFF
LEON W. ZUCKER

JOSEPH F. MORAGLIO, Director
Federal Government Division

FRANK S. SYNOWIEC, JR.
Technical Manager
Federal Government Division

The subcommittee gratefully acknowledges the contributions made to the development of this statement of position by former members of the subcommittee (1982-1983):

ROBERT A. CERRONE
DONALD E. HARDER
CHARLES L. KAMPMANN

CHARLES L. LESTER
ROBERT E. SCHIMMEL
MILES L. WATSON