ACCOUNTING PRINCIPLES AND CONCEPTS

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INTRODUCTION 1001

This Manual is the foundation for uniform accounting and reporting for long-term care facilities within the State. This particular chapter of the Manual presents a set of guidelines and procedures which will enable long-term care facilities to collect and present financial data in a consistent and informative manner. The guidelines and procedures presented here are taken from a set of rules developed over the years by the accounting profession which are known as Generally Accepted Accounting Principles. This chapter discusses those major Generally Accepted Accounting Principles that are expected to be used most often in accounting and reporting for long-term care facilities, and which will be followed throughout this Manual.

The accounting principles and concepts incorporated in this Manual are based on the Audit and Accounting Guide "Audits of Providers of Health Care Services," issued in July 1990, prepared by the Health Care Committee and the Health Care Audit Guide Task Force for the American Institute of Certified Public Accountants which should be referenced for guidance on principles and concepts not covered in this Manual.

Although they are not included in this Manual, Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards and FASB Interpretations; American Institute of Certified Public Accountants (AICPA) and Accounting Principles Board (APB) Opinions, Statements of Positions, and Accounting and Auditing guides; Accounting Research Bulletins; and Statements and Interpretations of the Governmental Accounting Standards Board (GASB), all should serve as reference sources for specific questions on accounting policies and concepts. However, this Manual published by the Office shall be the official and binding interpretation of accounting and reporting treatment within a facility's accounting and reporting system and shall take precedence over the aforementioned publications including the AICPA Providers of Health Care Services Audit and Accounting Guide.

BASIC CONCEPTS 1010

Financial accounting is the process of recording, classifying, and summarizing the economic events of a business. The result of this process is a compilation of information which reports the financial position of a business at a certain point in time and the results of its operations during a period of time. A basic objective of financial statements is to provide reliable and relevant financial information for evaluation of a business. Bookkeeping is the process of recording economic events in accordance with an accounting system.

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The accounting process records the economic events of an organization by making additions to and removals from specific classification groupings known as accounts. There are five general types of accounts: assets, liabilities, owners' equity or fund balances, revenues, and expenses. The first three of these categories are used to describe the financial position of an organization at a point in time. Periodically, these categories are shown on a statement called a balance sheet, which is divided into two major sections. One section lists the assets of the organization, and the other lists both its liabilities and owners' equity or fund balance. The total shown in the assets section always equals the sum of the totals shown in the liabilities and owners' equity or fund balance sections.

Assets are economic resources over which an organization has control and ownership or stewardship. Examples of these include cash, claims to receive cash, buildings, land, equipment, and ownership or stewardship interests in other organizations. Generally, assets are divided into current and noncurrent portions on the balance sheet. The current portion shows those assets which are equivalent to cash or are expected to be realized in the form of cash within one year. The noncurrent portion contains assets such as plant, property, equipment, and investments which will be held by the organization for an extended period of time.

Liabilities are economic obligations of the organization such as taxes, outstanding bills, mortgages, and other kinds of debt. Liabilities are also presented in current and noncurrent portions. Current liabilities consist of obligations which will require the use of current assets in their settlement, while the noncurrent liabilities will require settlement more than one year in the future.

Owners' Equity represents the excess of the assets of an organization over its liabilities. Owners' equity consists of the direct financial investment of the owners plus the increase or decrease in the assets of the organization which result from its net income or loss. Fund balance usually replaces the term owner's equity for nonprofit organizations and reflects the stewardship those organizations have over assets and liabilities. In this Manual the term owner's equity would also have similar reference to fund balance unless otherwise specified.

The two remaining categories of accounts, revenues and expenses, are used to record the results of an organization's operations during a specified period of time. Revenues are assets earned in exchange for providing goods, services, or the resources of the organization to others. Expenses are costs that have been incurred during the period in the course of carrying out these types of activities.

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Total revenues and expenses are compared at the end of the period and an excess of revenues over expenses is added to owners' equity. If expenses exceed revenues, then a deduction from owners' equity is made. Revenues, expenses, and the resulting difference of a period are presented in a financial report entitled Statement of Income.

Underlying Generally Accepted Accounting Principles are several fundamental concepts, which are discussed in the following sections:

THE ACCOUNTING ENTITY 1011

Each accounting entity must be a unit capable of conducting operations separate from the private or personal affairs of those who own or manage it. A corporation is an entity for both accounting and legal purposes. Sole proprietorships and partnerships, however, although not considered legal entities, are accounted for as units separate and distinct from owners and management. For reporting purposes under the Health Data and Advisory Council Consolidation Act, each long-term care facility is considered a separate accounting entity hand each must file the required annual report.

THE ACCOUNTING PERIOD 1012

Long-term care facilities are required to report their financial data to the Office on an annual basis. Individual institutions may choose the annual period most convenient to them, since a particular period, such as January 1 to December 31, has not been prescribed. The annual period selected may be twelve monthly periods, thirteen four-week periods or any other yearly accounting period used by a facility. However, once a particular period has been selected by a facility, that period must be used from year to year. A facility must notify the Office in writing within 30 days whenever the health facility fiscal year is changed. It is recommended that for internal purposes the annual period be broken down further into interim periods to enable the facility to adjust and balance its records on a more frequent basis. This will reduce the amount of work necessary at the end of the annual period and provide the management of the facility with current information on the financial results of its operations.

CONSISTENCY 1013

Methods of accounting and of recording identical transactions should be uniform from one period to another. This is necessary to permit comparisons to be made among different periods. However, to permit comparisons of long-term care facilities with each other, the methods of accounting and recording identical transactions should be consistent among all facilities. Generally Accepted Accounting Principles specify a single required method of accounting for most transactions. For certain other transactions, alternative accounting methods are permitted under Generally Accepted

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Accounting Principles. To facilitate comparability of the annual reports to be submitted, a required method of accounting has been prescribed in this Manual.

OBJECTIVE EVIDENCE 1014

Accounting information should be based, to the degree possible, upon objectively determined facts. The term objective refers to measurements that are unbiased and subject to verification. Examples of these include invoices, contracts, receiving reports, and canceled checks. In some cases objective evidence is not available and estimates must be used. These will be discussed later in this section.

HISTORICAL COST 1015

One basic element of Generally Accepted Accounting Principles is the requirement that all assets be presented in financial statements at their historical cost. Because of inflation that occurs from time to time, one subject discussed in accounting circles has been that of allowing organizations to report the current market value of their assets rather than the historical cost. Regardless of those discussions, organizations must continue to report assets at historical cost. For assets purchased, historical cost is the amount paid to acquire the asset and to prepare it for use in the facility. For donated assets, the estimated fair market value of the asset at the time of donation should be used. Long-term care facilities will be required to observe this rule and will not be permitted to revalue their assets to reflect current replacement or market value.

MATERIALITY 1016

Materiality is defined as the relative importance of any item that if not correctly accounted or reported is misleading. For this Manual, an item is material if it causes any line item of the Integrated Disclosure and Medi-Cal cost report to be incorrect by 5% or more of its correct value on the income statement or detail scheduled information feeding into the income statement of the uniform report. An example of materiality is as follows:

> A facility pays $1000 in property taxes and its report shows none because the taxes are included in administration. The report is materially incorrect because the line item on the income statement shows zero whereas the correct amount should be $1000 which is greater than 5% x $1000 or $50 of its correct value. The report should be corrected.

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ACCRUAL BASIS ACCOUNTING 1020

During the process of providing services to the community, the long-term care facility incurs a wide variety of expenses. For the most part, these expenses are paid from revenues provided in exchange for care furnished to its patients. It is important to note that both revenues and expenses result from the provision of services by the facility, and because of this, an attempt should be made to match these revenues and expenses. This matching should be evident in the presentation of the financial information for the period in which the service was performed.

In order to present financial information in such a manner, Generally Accepted Accounting Principles require that the long-term care facility maintain its records on the accrual basis. Under the accrual basis, revenues and expenses are recognized when the service to which they relate is performed; the actual time when money is received or paid usually has nothing to do with the recognition of revenue or expense in the accounting records. A facility which records revenues and expenses only when money actually changes hands is using the cash basis of accounting. The cash basis of accounting is not in accordance with Generally Accepted Accounting Principles and facilities are not permitted to use it in accounting for revenues and expenses or for reporting to the Office.

The preferability of the accrual basis over the cash basis of accounting, in matching revenues and expenses with their related services, is demonstrated in the following illustration.

On April 25, a patient makes arrangements to enter a skilled nursing facility for the month of May to recuperate from an operation. At this time he pays the May fee of $100. During the month of May, the patient requires meals costing $40, linen costing $5, and nursing care costing $50. The facility pays its staff on the first of each month for the previous month's service and also pays bills on June 1 from the suppliers of food and linen during May. Under the cash basis, the following entries would be made in April, May or June.

April 25	Dr.	1001	Cash	$100	
	Cr.	3100.00	Skilled Nursing Care - Self-Pay		$100

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June 1	Dr.	6110.12	Skilled Nursing Care Expense	$ 50	
	Dr.	6500.55	Dietary	40	
	Dr.	6400.56	Laundry and Linen	5	
	Cr.	1001	Cash		$ 95

Under the accrual basis, the following entries would be made in April, May and June.

April 25	Dr.	1001	Cash	$100	
	Cr.	2099	Other Current Liabilities		$100
May 30	Dr.	2099	Other Current Liabilities	$100	
	Cr.	3100.00	Skilled Nursing Care - Self-Pay Revenue		$100
	Dr.	6110.12	Skilled Nursing Care Expense	$ 50	
	Dr.	6500.55	Dietary	40	
	Dr.	6400.56	Laundry and Linen	5	
	Cr.	2011	Trade Payable		$ 45
	Cr.	2021	Accrued Payroll		50
June 1	Dr.	2011	Trade Accounts Payable	$ 45	
	Dr.	2021	Accrued Payroll	50	
	Cr.	1001	Cash		$ 95

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The following table illustrates the effects of the two systems.

	CASH				ACCRUAL		
	April	May	June		April	May	June
Service performed	None	Nursing Care	None		None	Nursing Care	None
Revenue recorded	$100	None	None		None	$100	None
Expenses recorded	**None**	**None**	**$ 95**		**None**	**$ 95**	**None**
Income (loss) recognized	$100	None	$ (95)		None	$ 5	None

From the above illustration, it can be seen that although the cash basis involves fewer bookkeeping entries, it fails to produce a matching between the service and the revenues and expenses that result from it. The accrual basis, however, accomplishes the matching of revenues and expenses in the period of service and more accurately reflects the activities of the facility. It is this matching ability that is the major feature of the accrual basis of accounting.

MATCHING OF REVENUES AND EXPENSES 1021

Determination of the net income of an accounting period requires measurement of revenues, deductions from revenue, and expenses associated with the period. Revenues must be recorded in the period in which they are earned; that is, in the time period during which the services are rendered to patients and a legal claim arises for the value of those services. Once a revenue determination is made, a measurement must be made of the amount of expense incurred in rendering the services on which the revenue determination was based. Unless there is such a matching of accomplishment (revenues) and effort (expenses), the reported net income of a period may be meaningless.

For example, where an organization continues to record deductions (such as contractual allowances) from revenue, the requirement that deductions from revenue must also be matched properly against the gross revenues of the accounting period must not be overlooked. It is important also that these deductions from revenue be given

accounting recognition in the same period that the related revenues were recorded, even though certain of these deductions from revenue cannot be precisely determined.

Deductions from revenue may result from the following two instances:

1. A facility may agree to accept less than 100% of charges as payment in full through a contractual arrangement. The difference between gross charges and the agreed upon payment, which may include patient liability, is referred to as a contractual adjustment.

2. A facility may treat a patient who does not have the ability to pay for the services rendered. This type of care is written-off as charity care.

Revenues, expenses and deductions from revenue are to be matched not only for the facility as a whole, but also for each revenue/cost center. That is, the costs of the functions and activities must be included in each applicable or appropriately described cost center accounts. Revenues related to such functions and activities must be included in the matching revenue account.

For example:

4100.00 Patient Supplies (net revenues)	$50
8100.50 Patient Supplies (direct expenses)	$45
Margin from Patient Supplies	$ 5

AMORTIZATION

1030
(Rev. October 2023)

Often it is necessary for a facility to purchase goods or services in bulk quantities or amounts that will be used over more than one accounting period. In such cases it is necessary to spread the cost of the goods or services over the several accounting periods in which used. This process of spreading is known as amortization. For example, suppose a long-term care facility purchased a fire insurance policy on its building covering three years. The policy is purchased for $300 on January 1, 19Xl and covers all of 19Xl, 19X2 and 19X3. Proper treatment of this purchase would require the assignment of $100 ($300) 3 years) to each of the three years as insurance expense.

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The initial entry to record this policy would be:

Jan. 1	Dr.	1101	Prepaid Insurance	$300	
	Cr.	1001	Cash		$300

The policy is recorded as an asset and not as an expense at this time because it represents a service that has been paid for in advance which has not been provided. At the end of 19Xl, one year's worth of this service has been used and must be matched with revenues produced during the period by reducing the asset by $100 and recording insurance expense of $100.

Dec. 31	Dr.	7400.90	Property Insurance	$100	
	Cr.	1101	Prepaid Insurance		$100

Similar entries would be made at the end of 19X2 and 19X3. The facility may choose to make these entries on a monthly basis in order to provide itself with a more timely and continuous record of expenses. In this case the monthly charge to insurance expense and credit to prepaid insurance would be one-twelfth of the annual amount or $8.33.

The most common type of amortization that a long-term care facility will use involves the spreading of the cost of a physical asset such as an automobile, piece of equipment, or leasehold improvements over its estimated useful life. Amortization, when applied to such an asset, is most commonly referred to by the term depreciation. For example, a leasehold improvement erected at a cost of $20,000 and having a life of forty years would be recorded as an asset in the period of its completion. Each year, $500 ($20,000 / 40 years) of its original cost would be charged to depreciation expense. Note: In this example, the estimated life remaining on the original lease is greater than 40 years.

There is a problem, however, in applying depreciation to a physical asset, since its exact life span is rarely known in advance. This inability to determine exactly a fact that is necessary to properly match revenues and expenses generally will not allow the rules of accrual accounting to be ignored. In such cases, it is required that an estimate of the necessary facts be made and that this estimate be used in allocating the

cost of the asset to future periods' revenues. As better information becomes available in the future, the estimate should be revised to more accurately assign the remaining cost of the asset to the remaining part of its useful life. A more complete discussion of the subject of depreciation is presented later in this chapter.

ESTIMATION 1040

Compliance with Generally Accepted Accounting Principles frequently requires the use of estimation. In addition to its use in connection with anticipating the lives of depreciable assets, estimation is also used for such things as determining the portion of accounts receivable that is uncollectible and determining the liability for goods and services which have been consumed by the facility, but for which a bill has not been received. In general, once an estimate has been made, it should be reviewed periodically to determine if it is still likely to be valid, or whether new information allows a better estimate to be made. If a new estimate causes substantially different results to be obtained, then an adjustment in the accounting records should be made. As an illustration, assume that at the beginning of 19Xl, a facility has $10,000 of accounts receivable on its books. Based upon its experience in recent years, it appears that approximately 5% of the accounts receivable at any one time will eventually prove to be uncollectible. Accordingly, the facility provides an allowance for doubtful accounts at 5% of $10,000 or $500. However, during 19Xl, economic conditions deteriorate and the facility has a greater amount of trouble collecting its receivables. Based upon its experience during 19Xl and expectations that the economy will not improve significantly during 19X2, it appears that approximately 7% of the accounts receivable at the end of 19Xl will not be collected. If the total amount of receivables at the end of 19Xl is still $10,000, then it will be necessary to increase the allowance for doubtful accounts to 7% of $10,000 or $700. The $200 increase from $500 to $700 must be charged to expense during 19Xl, even though the bad debts are not actually written off until 19X2 or later. The proper matching of revenues and expenses requires that the expense be charged in 19Xl, since the services that resulted in the revenues and their accompanying accounts receivable were performed during 19Xl. A more detailed discussion of the allowance for doubtful accounts is presented later in this chapter.

Another common case where estimation is necessary to properly report financial information for a specific period on the accrual basis involves providing for expenses and revenues which have been incurred and earned during a period but which have not been recorded during the normal accounting process as of the end of the period because an invoice has not been created. For example, electric power is consumed by the facility throughout a period, but often the bill is not received from the utility until several weeks after the end of the period. Although the exact amount of electric expense for the period cannot be determined until the bill is finally received, an estimate of the

amount must be recorded in the records of the period. Assume that the facility's annual reporting period ends on December 31; that it normally receives a bill from the utility every two months and the average amount of this bill is $250. The bill for December and January is expected to arrive sometime in February. In order to close the accounting records for the period ending December 31, the facility must provide for, or accrue, the portion of this bill that applies to December. It could do this by estimating its electric expense at one-half of the expected amount of the bill due in February and making the following entry:

Dec. 31	Dr.	6205.82	Plant Operations and Maintenance - Utilities	$125	
	Cr.	2019	Other Accounts Payable		$125

In a similar manner, any services which have been provided by the facility, but which have not been billed to its patients prior to closing of the period's books must be accrued in order to prepare the financial reports. In actual practice, the necessity of accruing unbilled expenses and revenues assumes a critical importance only at the end of the annual reporting period, and the facility may use its own judgement in deciding how extensively it wants to make these accruals at the end of each month during the year. Generally, much of the uncertainty in estimating the amounts to be recorded in these adjusting entries can be resolved by leaving the books open for a reasonable period of time after the end of the annual period and awaiting the determination of the actual amounts. However, it is usually not practical to wait for all the amounts to be resolved prior to closing the financial records and therefore some accruals will be necessary.

The preceding paragraphs have focused on several of the most important concepts underlying Generally Accepted Accounting Principles, with simple illustrations where necessary for explanatory purposes. In the remainder of this chapter of the Manual, the application of these principles to specific situations commonly encountered by long-term care facilities is shown in sufficient detail to allow a facility's compliance with the Office's uniform accounting and reporting systems.

REVENUE 1050

Revenue is derived from the sale of a health facility's merchandise or services, and from the earnings of interest, dividends, and rents. For purposes of this Manual, these revenues are divided into the following four categories: routine, ancillary, other operating, and nonhealth care. Routine revenues are earned from performance of

inpatient nursing services which are part of the ongoing, major or central operations of the facility. Ancillary revenues (e.g., patient supplies, physical therapy, etc.) are earned from sales of medical supplies for patient care and performing ancillary services for patients. Other operating revenues include revenue from sources other than health care services provided to patients, and sales and activities to persons other than patients. Other operating revenue is income derived in the course of operating the facility such as providing personal laundry services for patients, social service fees, the fair market value of donated supplies and services, and vending machine commissions. Nonhealth care revenues include income earned from activities not relating directly to the day-to-day operations of an organization. Nonhealth care revenues include such things as rents that are earned from property owned primarily for income purposes, gains on disposal of a facility's assets, dividends and interest from securities investments, and all other gifts, grants, and legacies which have no donor-imposed restrictions. Revenues earned from providing residential care are also nonhealth care revenues.

The classification long-term care facility applies to institutions which provide one and sometimes several levels of care. As a result, such facilities are required to maintain records sufficiently detailed to allow them to report routine and ancillary revenues as stated below.

Routine Services Revenues

Skilled Nursing Care

Intermediate Care

Mentally Disordered Care

Developmentally Disabled Care

Sub-Acute Care

Sub-Acute Care - Pediatric

Transitional Inpatient Care

Hospice Inpatient Care

Other Routine Services

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Ancillary Services Revenues

Patient Supplies

Specialized Support Surfaces

Physical Therapy

Respiratory Therapy

Occupational Therapy

Speech Pathology

Pharmacy

Laboratory

Home Health Services

Other Ancillary Services

Each long-term care facility will report operating revenues under one or more of the routine service classifications and under any of the ancillary service classifications which are applicable to its operations.

Gross service revenue must be recorded in the accounting records on an accrual basis at the facility's established rates (called gross charges).

A complete list of the required revenue-reporting categories is presented in the Chart of Accounts chapter of this Manual.

DONATED SUPPLIES AND SERVICES 1051

Occasionally, a long-term care facility will receive donations of goods such as medicines, linen, office supplies, and other materials which would normally be purchased. In such cases, the facility should record the fair market value of these goods at the time of donation as a credit to Other Operating Revenue with an accompanying charge to the normal expense or asset account that would be used if the materials had been purchased.

Similarly, a facility may also receive donated services from individuals or organizations. If there is the equivalent of an employer-employee relationship between an individual and the facility, the services performed are significant and form an integral part

of the efforts of the entity, and there is a clearly measurable basis for the amount to be recorded, the fair value of the donated services should be recorded as a credit to Nonhealth Care Revenue with a corresponding entry debiting the appropriate expense - account. The fair value of such service should be determined on the basis of objective evidence, such as the salary and fringe benefits that would have to be paid to obtain the services from a regular employee. In situations where a donor accepts a small fee for his services, the fair value of the donation would consist of the difference between the amount actually paid and the facility's normal salary for these services. For donated materials or services to be recorded as revenue and expense, it is required that they be necessary to the operation of the facility. Services which are traditionally rendered on a voluntary basis, such as counseling and companionship performed by members of community service organizations, should not be recorded in the accounting records.

Not-for-profit facilities sometimes receive donations of property and equipment. When placed in service, these assets are recorded at their fair market value by debiting the appropriate asset account and crediting general fund balance.

EXAMPLES OF RECORDING REVENUE **1052**

Of primary importance in the accounting for revenue is the reporting of them properly in the period in which they were actually earned. Following are three sample situations to illustrate the proper recognition of revenue.

1. A skilled nursing patient is billed a fee of $100 at the end of December for that month's care in a long-term care facility. The patient pays the bill in January.

Dec. 31	Dr.	1023	Accounts Receivable - Private	$100	
	Cr.	3100.00	Skilled Nursing Care - Self-Pay		$100
Jan. 15	Dr.	1001	Cash	$100	
	Cr.	1023	Accounts Receivable - Private		$100

2. The patient is billed in advance on December 26 for January care, and pays in January. Since this billing is in advance of the performance of the related service, it must be recorded as deferred revenue until it is earned.

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Dec. 26	Dr.	1023	Accounts Receivable - Private	$100	
	Cr.	2091	Other Current Liabilities (Deferred Revenue - Patient Deposits)		$100
Jan. 15	Dr.	1001	Cash	$100	
	Cr.	1023	Accounts Receivables - Private		$100
Jan. 31	Dr.	2091	Other Current Liabilities (Deferred Revenue - Patient Deposits)	$100	
	Cr.	3100.00	Skilled Nursing Care - Self-Pay		$100

3. A facility receives a donation of one month's worth of cleaning supplies. If the facility had to purchase this, it would cost approximately $200.

	Dr.	6300.57	Housekeeping	$200	
	Cr.	5740	Donated Supplies		$200

ACCOUNTS RECEIVABLE **1053**

Receivables for health care services are to be reported at their net estimated realizable value which is accounts receivable net of contractual adjustments and discounts. Accounts receivable may initially be recorded at full or gross established rates. For reporting purposes, however, receivables must be reduced by the appropriate contractual adjustments. An allowance for doubtful accounts, if material, must also be reported.

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DEDUCTIONS FROM REVENUE 1060

CONTRACTUAL ADJUSTMENTS 1061

(Rev. October 2023)

In general, each facility will have established standard rates that are charged for various types of services. However, in many cases, the full amount of the charge is not actually collected due to contracts with third-party payors which specify lower rates, or for other reasons. A facility must record revenues from providing patient care to persons under third-party contractual agreements at its full established rates and also record a contractual adjustment. In such instances, contractual adjustments is the term representing deductions from revenue recorded for the difference between the amount of patient charges (based on full established rates) for services which are rendered during a reporting period and are covered by a third-party contract, and the amount received or to be received from third-party payors in payment of such charges.

There are basically four types of transactions which can result in a contractual adjustment. Two are discussed below, and two are discussed under the caption "Accounting for Managed Care and Other Contracts," which follows.

1. Medicare Interim Reimbursement Rate (MIRR) - For interim cost reimbursement purposes, the Medicare intermediary will pay to the facility a per diem interim reimbursement which is based on an estimate of allowable costs plus, in some instances, a small return on equity. There is normally a difference between recorded gross charges and the interim reimbursement for the corresponding items of patient service. This difference is recorded as an adjustment to revenue. Since MIRR is only an estimate of allowable cost plus return on equity, there is an adjustment to the contractual adjustment account required at year-end based upon an estimate of final reimbursement, and when cost reports are prepared and filed.

2. Periodic Interim Payments (PIP) - These payments from the Medicare program are made on a regular basis to a facility on the PIP program. They are based on an estimate of the allowable costs (plus, in some instances, a small return on equity) applicable to covered patient charges for the current cost report period. When such payments are received, the Cash (Account 1001) is debited and Accounts Receivable - Medicare (1021), is credited. When applicable Medicare charges are earned, Account 1021 is debited and the appropriate revenue account is credited.

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At year end, several adjustments are necessary to properly reflect the amount receivable from (Account 1051), or due to (Account 2051), the Medicare intermediary. First, all Medicare charges in Account 1021 (net of deductibles, coinsurance, and PIP payments) at year end must be transferred to Account 5310, Contractual Adjustments - Medicare.

If there is an amount due to Medicare -

Dr. 5310 Contractual Adjustments - Medicare

Cr. 2050 Payable to Third-Party Payors

If there is an amount receivable from Medicare -

Dr. 1050 Receivables from Third-Party Payors

Cr. 5310 Contractual Adjustments - Medicare

Separate contractual adjustment accounts are provided for the Medicare program, the Medi-Cal program, and for other programs. It is suggested that separate subaccounts be kept for each year for which cost or other similar reports are not yet finalized by the intermediary. It is further suggested that separate subaccounts be kept to differentiate fee-for-service contractual adjustments from managed care contractual adjustments. For more information on this topic, see Section 4020.5.

To provide accurate interim financial data, it is recommended that each facility adjust its contractual adjustment accounts based on the above procedures and estimated cost report determinations at each month end.

The Medicare program limits reimbursement in each year to the lower of reimbursable costs or charges. Amounts of reimbursable costs in excess of this limitation may be carried forward, in accordance with Medicare regulations, for potential reimbursement in subsequent years. The benefit of such carry-forward amounts should not be recognized in the year in which it arises since reimbursement for the carry-forward is not assured. Rather, such benefit should be recognized in the contractual adjustment account in the subsequent year in which the carry-forward becomes reimbursable.

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There may be a difference each year between the cost report filed by the facility and the final settlement received from the third party payor. These differences should not be treated as prior period adjustments unless they meet the criteria set forth in Financial Accounting Standards Board Statement No. 16, "Prior Period Adjustments", or are deemed to result from an error as indicated in Accounting Principles Board Opinion No. 20, "Accounting Changes". It is assumed that prior period adjustments for accounting purposes will be rare.

ACCOUNTING FOR MANAGED CARE AND OTHER CONTRACTS 1062

(Rev. October 2023)

Long-term care facilities are contracting with HMO's, and other health care organizations. Instead of receiving payment on a fee for service basis, the facilities are generally being paid under one of two methodologies to be discussed later in this chapter.

To provide a common understanding, the terms used in this chapter are defined below:

Capitation Fee - A fixed amount (usually per individual) that is paid periodically (usually monthly) to the contracting facility as compensation for providing comprehensive health care services for the period. The fee is set by contract between a prepaid health care plan (e.g., HMO) and provider.

Contracting Facility - The facility (e.g., a nursing home) which has contracted with a prepaid health care plan (e.g., HMO) to provide services for members on a risk-based capitation fee basis.

Copayment - A payment required to be made by a member to the contracting facility when specific health care services are rendered. Typical copayments included fixed charges for each prescription or certain elective procedures.

Health Maintenance Organization (HMO) - Health care organizations organized to deliver and finance health care services. An HMO provides comprehensive health care services to enrolled members for a fixed fee.

Member - An individual who is enrolled as a subscriber, or an eligible dependent of a subscriber, in a prepaid health care plan or insurer (e.g., HMO or PPO).

The most common contracts fit into the following two categories:

1. Per Diem - This is a contract with an agency to accept a fixed amount per patient day. Generally, fixed rate per diem contracts are based on

rates discounted from established rates, including managed care providers such as a health maintenance organization (HMO) and hospitals. Medi-Cal also pays long-term care facilities based on fixed rates. An example of the accounting entries for a fixed rate contract transaction follows. Assume that the facility has a contract to provide care at $100 per day to members of an HMO, and that the facility's normal charge is $125 per day:

June 1 To record a fixed rate contract and revenues from an individual patient:

Dr.	1039	Other Accounts Receivable	$125	
Cr.	3100.15	Skilled Nursing Care - Medi-Cal Managed Care		$125

June 30 To record payment from HMO:

Dr.	1001	Cash	$100	
Cr.	1039	Other Accounts Receivable		$100

June 30 To record the discount from an individual patient:

Dr.	5320.15	Contractual Adjustments - Medi-Cal	$25	
Cr.	1039	Other Accounts Receivable		$25

2. Capitation Contract - Under this arrangement, the facility agrees to treat the members of the health plan for a fixed rate per member per month. The facility is at risk and is liable for any expenses incurred beyond the monthly capitation payments. Under certain circumstances, an HMO may remit payments in advance to facilities for services not yet identified. Situations such as this should be accounted for similarly to the accounting for capitated contracts. Facilities may purchase what is termed reinsurance which will indemnify the facility for any patient whose charges exceed a stop loss amount.

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To record a capitation contract and revenues:

June 1 To record the capitation ($100 per member for 10 members):

Dr.	1001	Cash	$1,000	
Cr.	2049	Advances - Other Third-Party Payors		$1,000

June 10 To record revenues (one member receives services for two days at $125 a day):

Dr.	2049	Advances - Other Third-Party Payors	$250	
Cr.		Various Revenue Accounts		$250

June 30 To record remaining advances as revenue:

Dr.	2049	Advances - Other - Third-Party Payors		$750
Cr.	5330.11	Contractual Adjustments - Commercial Coverage		$750

OTHER DEDUCTIONS FROM REVENUE **1063**
(Rev. October 2023)

In addition to not charging full standard rates for contractual reasons, a facility may choose to charge less than the standard rates for charitable or administrative reasons. In such cases, the facility again must record revenue at full established rates accompanied by a charity adjustment (Account 5100) or administrative adjustment (Account 5200). These adjustment accounts will be reported as deductions from revenue in a manner similar to that used for contractual adjustments. Individual cases should be examined at the time the revenue is recorded and the reason for any adjustment should be identified. The entry recording the adjustment can then be made at the same time as the revenue is recorded, or later at the end of the period. For example, suppose that, for charitable reasons, a decision is made to charge an individual only $80 of the normal $100 per month fee in an intermediate care facility. The proper treatment of this situation would be:

ACCOUNTING PRINCIPLES AND CONCEPTS

June 1	Dr.	1023	Accounts Receivable - Private	$80	
	Dr.	5100	Contractual Adjustments - Charity	20	
	Cr.	3200.00	Intermediate Care - Self-Pay		$100

The amount of total charity care incurred in a reporting period, must be disclosed as a footnote to the facility's report.

CHARITY CARE vs. BAD DEBT **1064**

The determination of what is classified as bad debt versus what is considered charity care can be made by establishing whether or not the patient has the ability to pay. The patient's accounts receivable must be written off as bad debt if the patient has the ability but is unwilling to pay off the account.

The critical factor involved is at what point should ability to pay be determined. According to the Healthcare Financial Management Association (HFMA) Principles and Practice Board Statement Number 2, "Defining Charity Services as Contrasted to Bad Debts," this determination should be made at the point of admission or as soon as possible thereafter.

Long-term care facilities must maintain written documentation regarding their charity care criteria, and for individual patients, long-term care facilities must maintain written documentation regarding all charity care determinations.

Included in the documentation of a long-term care facility's criteria for establishing ability to pay, should be procedures for recognizing the impact of events subsequent to a patient's admission that may change the ability to pay. The HFMA statement also notes that once a patient is determined to be eligible for charity care, that decision is final unless an error was made in the determination. However, a patient who is determined to have the ability to pay, may at some point in the future, be changed to charity care status due to additional subsequent information.

In order to be considered indigent and eligible for charity care, a patient should generally meet the facility's requirements. Suggested criteria for the facility to consider in determining if a patient is indigent may include, but are not limited to, the following:

- The patient's gross income should be within the established range for determining the poverty level.

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- Net worth should be considered along with asset liquidity (ability to convert assets into cash) and claims against those assets.

- Employment status and capacity to produce future earnings as compared to ability to meet future obligations.

- Other living expenses and financial obligations should be considered in conjunction with the size of the patient's family.

All available resources must first be applied, including Medi-Cal, welfare, and other third-party sources. Only the portion of the patient's bill that is uncollectible due to inability to pay should be written off as charity care.

The following examples are to assist in clarifying the differences between bad debt and charity care.

Example 1:

A long-term care facility treats a patient who claims to have insurance which covers the cost of the care. However, later it is determined that the patient's insurance does not provide coverage for the services and the facility determines that the patient is unable to pay for the care. Should the patient be classified as charity care or bad debt?

Response:

If the patient claims to have insurance covering the cost of care, but subsequently, it is determined that the patient does not have insurance nor the ability to pay, then the care would be classified as charity care.

Example 2:

Must the facility classify the entire care as charity care or can a portion of the care be classified as charity care?

Response:

If the patient can pay the charges as determined at time of admission, but because of medical complications the charges have increased dramatically, the portion of the charges that the patient is unable to pay would be classified as charity care.

ACCOUNTING PRINCIPLES AND CONCEPTS

Example 3:

A patient who has insurance is admitted to the long-term care facility. While the patient is inhouse, the facility determines that the insurance covers only a portion of the services. The facility determines that the patient is unable to pay for the non-covered services. Can the unreimbursed amount be considered charity care?

Response:

The charges related to services not covered by insurance (deductibles, coinsurance, copayments, or other non-covered charges for Medicare, Medi-Cal, HMO, PPO's, contracts and commercial insurances) would be charged to charity care based on the facility's determination that the patient is unable to pay for the charges not covered by insurance.

INCLUSIVE RATE FACILITIES 1070

As a system of billing patients, inclusive rates are in contrast to the presently widespread itemized method, the latter charging in large part on the basis of itemization of services actually used. While the possible bases for charging under inclusive rate systems are varied, the critical feature of any such system is that, with the exception of accommodations, the patient's charge is independent of his utilization of particular services.

An "inclusive rate" system, then, typically conforms to the following definition, provided by the American Hospital Association:

> "Total charges consist of a rate based on type of accommodation multiplied by length of stay, regardless of utilization of ancillary services."

It is important to recognize that the adoption or utilization of an inclusive rate system results only in a modification of the patient billing and revenue accounting system. It does not eliminate the need to maintain cost center data as provided for in the Chart of Accounts. Thus, facilities using inclusive rates will be required to report costs and related statistics by cost center and prepare the appropriate cost and disclosure reports.

ACCOUNTING PRINCIPLES AND CONCEPTS

For reporting purposes an inclusive rate facility is required to classify its inclusive rate revenue among the various nursing services and ancillary services revenue accounts included in this Chart of Accounts. The classification should be calculated based on the ratio of costs for each revenue producing cost center to total costs for all revenue producing cost centers taken from the cost studies used by the facility to establish its inclusive rates in the current reporting period. A factor can be developed and used consistently from period to period, but it must be evaluated periodically for accuracy.

PATIENT TRUST FUNDS 1080

Patient trust funds consist of amounts deposited on behalf of a patient which are to be used only for the personal care and expenditures of that patient. If these funds are administered by the facility itself, rather than by a bank or other independent party, the facility is not permitted to mix such funds with its own bank account, but must keep them in a separate demand trust account. Special asset and liability accounts have been provided which may be used at the facility's option to maintain separate control of these funds and to assist in collecting the information necessary to prepare reports on their use. Since the funds are not true assets of the facility, the balance of these asset and liability accounts, which should always equal one another, are not included in total assets and liabilities shown on the facility's balance sheet. Disclosure of the amount of these patient trust funds administered by the facility is required in the Integrated Disclosure and Medi-Cal Cost Report.

PLEDGES 1090

All pledges of gifts, less a provision for amounts estimated to be uncollectible, must be recorded in the accounting records when the pledges are made to the facility. If pledges are unrestricted, revenue from pledges (net of provision for uncollectibles) must be included in Account 9100 - "Nonhealth Care Revenues and Expenses." If pledges are restricted, they must be reflected in the appropriate restricted fund, less a provision for amounts estimated to be uncollectible.

ALLOWANCE FOR DOUBTFUL ACCOUNTS 1100

An Allowance for Doubtful Accounts and Contractual Adjustments, Account 1040, must be established to provide for the estimated amount of accounts and notes receivable at year end that are likely to be credit losses. The allowance should be estimated based on a variety of factors, including historical experience and detailed aging

and analysis of patients' individual accounts. Because facilities experience different bad debt patterns with various classes or types of patients, it is recommended that the computation of the allowance take into consideration these differences. The recording of an allowance for doubtful accounts receivable results in a charge to Provision for Bad Debts, Account 7700, which is reported as an expense.

When collection efforts are exhausted on a delinquent account and a balance is deemed uncollectible, it should be removed from accounts or notes receivable and written off to the allowance account. If payments are subsequently received on an account which has been written off, the payments should be credited to the allowance account.

CLASSIFICATION OF EXPENSES 1110

In order to comply with financial reporting requirements, all costs and expenses incurred by a long-term care facility (except income taxes and extraordinary items) must initially be assigned to one of the cost centers specified in the Chart of Accounts. These cost centers are divided into six groups as follows:

The expense cost centers are:

Routine Service Cost Centers

- Skilled Nursing Care
- Intermediate Care
- Mentally Disordered Care
- Developmentally Disabled Care
- Sub-Acute Care
- Sub-Acute Care - Pediatric
- Transitional Inpatient Care
- Hospice Inpatient Care
- Other Routine Services

Support Service Cost Centers

- Plant Operations and Maintenance
- Housekeeping
- Laundry and Linen
- Dietary
- Social Services
- Activities
- Inservice Education - Nursing
- Administration

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Ancillary Service Cost Centers

Patient Supplies
Specialized Support Surfaces
Physical Therapy
Respiratory Therapy
Occupational Therapy
Speech Pathology
Pharmacy
Laboratory
Home Health Services
Other Ancillary Services

Property Cost Centers

Depreciation and Amortization - Land Improvements
Depreciation and Amortization - Building and Improvements
Depreciation and Amortization - Leasehold Improvements
Depreciation and Amortization - Equipment
Depreciation and Amortization - Goodwill
Depreciation and Amortization - Other
Leases and Rentals
Property Taxes
Property Insurance
Interest - Property, Plant and Equipment

Other Cost Centers

Interest - Other
Provision for Bad Debts

Nonhealth Care Revenue and Expenses

Income taxes and extraordinary items are assigned to special accounts which are discussed separately.

ACCOUNTING PRINCIPLES AND CONCEPTS

TRANSFERS 1120

Under certain circumstances, it may be necessary to transfer an expense initially recorded in one cost center to another cost center which is directly responsible for the expense. In cases where such direct interdepartmental transfers are necessary, the cost used must be identical to the net cost of the item transferred. This net cost is defined as that cost which includes purchase price, freight, plus any other incidental costs if they are significant and can be practically determined. Note that the purchase price is net of any trade discounts or rebates that may be received. Careful use of the Chart of Accounts will minimize the need to make direct cost transfers between cost centers; however, when such transfers are necessary, it is recommended that they be made on a monthly basis rather than waiting until the end of the year. Proper recording of expenses in the appropriate cost center either initially or through transfers, is necessary to match the cost center's expense to the related revenues and avoid significant distortion of that cost center's income on a stand alone basis. For example, a cost center reporting revenue without any cost could result without proper matching.

TRANSACTIONS WITH HOME OFFICE AND OTHER RELATED PERSONS AND ORGANIZATIONS 1130

HOME OFFICE 1131

A facility which is part of a multi-facility group may be charged for expenditures paid on its behalf by the home office. The nature and type of home office charges will vary with each organization, depending on the type of operations and management's philosophy. Usually such charges will consist of expenditures directly identifiable with one or more of the facilities (for example, lease payments and administrator salaries) or expenditures identifiable with the entire organization rather than individual facilities (for example, the chief executive's salary). The latter type of expenditures is usually allocated among the various facilities using a method determined by the organization. Any reasonable method is permissible as long as it is in accordance with Generally Accepted Accounting Principles and consistently applied.

When home office charges are recorded in the facilities' accounting records, they should be analyzed to determine the type and amount of each charge to the facility. Those charges directly identifiable with the facility should be assigned to the facility's cost centers that receive direct benefit from the expenditures and to the appropriate account within the cost center. For example, if the home office charge includes the cost of the facility's rent expense, that cost should be assigned to Account 7200, Leases and Rentals, on the records of the facility. The allocated costs, which would represent, among others, such activities as central accounting, administrative and management services expenses, would be assigned to Account 8900, Administration.

ACCOUNTING PRINCIPLES AND CONCEPTS

OTHER RELATED PERSONS AND ORGANIZATIONS 1132

For purposes of this accounting and reporting system a related party is, to a large extent, an individual or organization with which the facility is associated or affiliated, has control of, or is controlled by. Common ownership arises when an individual, individuals, or an organization, holds significant ownership or equity in both the facility and the organization serving the facility. The term "control" means that an individual or an organization has power to influence or direct the actions or policies of both a facility and a related organization to a significant extent. Disclosure of material related party transactions is required.

EDUCATION AND RESEARCH COSTS 1140

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FORMAL EDUCATION AND RESEARCH PROGRAMS 1141

Direct expenses which are incurred under formal programs of education and research should be recorded as follows: Education in Administration and Research in Nonhealth Care Expense. A formal program of education is one which is organized to train students to enter an occupational specialty.

INSERVICE EDUCATION - NURSING 1142

Nursing inservice education activities are defined as educational activities conducted within the facility for facility nursing personnel. The cost of time spent by nursing personnel as students in such classes and activities must remain classified in the cost center in which their normal salary and wage costs are charged (i.e., the cost center in which they work). However, the cost (defined as salary, wages, and payroll-related employee benefits) of time spent in such classes and activities by those instructing and administering the programs must be included in cost center 6800, Inservice Education - Nursing.

If instructors do not work full-time in the inservice education program, the cost (as defined above) of the portion of time they spend working in the inservice education program must be included in the Inservice Education - Nursing cost center. This may be accomplished by direct distribution of these costs (by natural classification of expense category) each payroll period or by reclassification (based upon time spent) at year end.

The costs of nursing inservice education supplies (such as cassettes, books, medical supplies, etc.) and outside lecturers must be reflected in the Inservice Education - Nursing cost center.

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Nursing inservice education does not include orientation of new employees. Such orientation costs must be charged to the cost center in which new employees are, or will be, assigned.

INSERVICE EDUCATION - OTHER **1143**

All costs relative to non-nursing inservice education activities should be included in the cost center to which they apply (e.g., Physical Therapy, etc.), as such inservice education activities will rarely apply to more than one functional activity.

TIMING DIFFERENCES **1150**
(Rev. October 2023)

Timing differences result when accounting policies and practices used in an organization's accounting records differ from those used for reporting operations to governmental units collecting taxes or to outside agencies making payments based upon those reported operations.

These timing differences must be reflected on the long-term care facility's accounting records. The two types of timing differences are income tax allocation and third-party reimbursement.

Example of Timing Differences:

The following condensed income statement illustrates a timing difference attributable to different methods of calculating depreciation expense for books and for federal taxes and third-party reimbursement.

Assumptions:

1. Depreciation for accounting purposes is calculated on the straight-line method and amounts to $10 for the current year.

2. Depreciation for tax and third-party reimbursement purposes is calculated on a declining balance method and amounts to $20 for the current year.

3. The tax rate is forty percent.

4. The third-party utilization is fifty percent.

5. The only deduction from revenue is the contractual adjustment.

ACCOUNTING PRINCIPLES AND CONCEPTS

	Accounting Records	Tax/Cost Report
Revenue	$180	$180
Deductions from Revenue (B)	30	25
Net Revenue	150	155
Expenses (excluding Depreciation)	110	110
Depreciation	10	20
Total Expenses before taxes	120	130
Income before taxes	30	25
Taxes (A)	12	10
Net Income	$ 18	$ 15

(A) The income tax expense comprises three components: (1) $10 currently payable, (2) $4 payable in future periods related to the tax effect of the difference between depreciation expense for accounting and tax purposes (40% X $10 = $4), and (3) $2 to be applied against tax liabilities in future periods, related to the tax effect of the differences in reimbursement caused by the difference between depreciation for accounting purposes and cost report purposes, computed as follows:

40% (Tax effect) X 50% (Third-party utilization) X $10 (Difference between depreciation for accounting and cost report purposes) = $2

The journal entry to record these items is:

Dr.	1111	Prepaid Income Taxes	$ 2	
Dr.	9201.89	Provision for Income Taxes - Federal - Current	12	
Cr.	2071	Federal Income Taxes Payable		$10
Cr.	2112	Deferred Taxes Payable - Federal		4

ACCOUNTING PRINCIPLES AND CONCEPTS

(B) The deduction from revenue (contractual adjustment) is calculated as follows:

	Accounting Records	Tax/Cost Report
Medicare Revenue ($180 X 50%)	$ 90	$ 90
Reimbursable Costs:		
$120 X 50%	60	
$130 X 50%	—	65
Contractual Adjustment - Medicare	$ 30	$ 25

Of the $30 contractual adjustment for accounting purposes, $25 is the current portion and $5 is the deferred portion. The journal entry to record this expense is:

Dr.	5310	Contractual Adjustments - Medicare	$30	
Cr.	1042	Allowance for Contractual Adjustments - Medicare		$25
Cr.	2121	Deferred Revenue - Medicare Reimbursement		5

DEPRECIATION

1160
(Rev. October 2023)

As mentioned earlier in this section, depreciation is the process by which the original cost of a physical asset is assigned to the periods in which it provides service. There are several techniques that are used to determine the amount of depreciation charged to each period of service. The simplest and most common of these is the straight-line method, which assigns to each period an equal portion of the asset's cost. NOTE: THE STRAIGHT-LINE METHOD MUST BE USED TO ACCOUNT FOR AND REPORT DEPRECIATION FOR ASSETS ACQUIRED ON OR AFTER AUGUST 1, 1970. In applying the straight-line method, the estimated salvage value of the asset, if any, is subtracted from its cost, and the resulting figure is divided by the estimated useful life of the asset. Estimates of useful lives used in computing depreciation should be taken from the recommendations made in the 2018 edition of Estimated Useful Lives of Depreciable Hospital Assets by the American Hospital

ACCOUNTING PRINCIPLES AND CONCEPTS

Association. However, with the rapidly changing technology in health care facilities, these recommendations may not be comprehensive; in that case, the manufacturer should be consulted.

For example, the depreciation for a piece of equipment purchased for $1,500, and having an estimated salvage value of $200 at the end of 10 years of service would be $130 per year ($1,500 minus $200, divided by 10 years). The entry to record depreciation for this asset would be:

Dr.	7140.92	Depreciation and Amortization - Equipment	$130	
Cr.	1291	Accumulated Depreciation - Major Movable Equipment		$130

Notice that the credit is not to the Equipment asset account, but to an account called "Accumulated Depreciation - Major Movable Equipment". The use of this account allows the retention of the original cost of an asset in the accounting records. The remaining undepreciated cost, or book value, can be readily determined by subtracting the balance in the Accumulated Depreciation account from the asset account:

Equipment	$1,500
Accumulated Depreciation - Equipment	130
Book Value	$1,370

Other techniques of computing depreciation, such as the sum of the years digits method and the double declining balance method, are called accelerated methods, since they result in larger amounts of depreciation in the years when an asset is new and cause the book value to be reduced at a faster rate. Accelerated methods of depreciation may be used by long-term care facilities only for those assets which have been acquired before August 1, 1970. For assets acquired on this date or after, the straight-line method must be used to compute depreciation for reporting purposes. Facilities are permitted to continue to compute and report depreciation on an accelerated method for older assets which have been consistently depreciated on an accelerated method.

ACCOUNTING PRINCIPLES AND CONCEPTS

A special problem occurs in computing depreciation expense on an asset for the periods of acquisition and disposal. If a purchase or disposal is made during a period, depreciation should be reported only for the portion of the period for which the asset is held. For example, if the annual reporting period ended on December 31, and an asset was acquired three months earlier on September 30, then only 3/12 of a year's depreciation should be reported. However, to comply with this requirement literally could require extensive calculations involving only minor amounts. To avoid this additional work, a facility is permitted to adopt a policy similar to one of those presented below in lieu of exact calculation:

1. Record one-half of the yearly depreciation expense in the years of acquisition and disposal, regardless of the actual date of the action.

2. Record a full year's depreciation if the asset was acquired during the first half of the year or disposed of during the second half, and record no depreciation if it was acquired in the second half of the year or disposed of in the first half.

The policy established, however, must be followed consistently from year to year and for all assets.

CAPITALIZATION 1170

The term capitalization refers to the process of recording, as an asset, a cost which will provide benefits to a facility in more than one period. Any cost of this type should be capitalized so that a portion of it can be assigned as an expense to each of the periods in which it is to produce revenue. Most commonly, capitalization is used to refer to recording acquisition of items of property, plant and equipment. In this context, a facility may adopt a policy of capitalizing only costs that exceed a certain dollar limit. It is recommended that all depreciable assets be capitalized. An item is considered to be a depreciable asset if it has a unit cost of at least $500 and has a minimum useful life of two years.

The area in which the question of capitalization arises most frequently is in connection with expenditures for the modification and maintenance of plant and equipment. Normal maintenance costs which are required to keep an asset in useful condition are expensed in the period in which the maintenance was performed. However, costs which renew or extend the usefulness of an asset beyond its original life or function should be capitalized and depreciated over the remaining life of the asset.

ACCOUNTING PRINCIPLES AND CONCEPTS

LEASES 1180

Often a facility will obtain the use of land, buildings, or equipment by entering into an agreement to lease them from an outside party. If the amount paid is merely to obtain the use of the asset for the period of the lease, it is properly treated as expense and charged to Account 7200, Leases and Rentals. This is known as an "operating lease." However, when a lease agreement is used as a way for a facility to obtain eventual ownership of the property, a special treatment may be required. Under certain conditions, a lease is considered in substance to be a purchase of the property, and the property must be recorded by the facility as an asset accompanied by a liability for future lease payments. These conditions are specified in Financial Accounting Standards Board Statement No. 13 and other related pronouncements.

If a lease meets the capitalization criteria in Financial Accounting Standards Board Statement No. 13, the asset and the related liability must be initially recorded at an amount which represents the present value of the future series of lease payments. This is known as a "capital lease." The procedure for determining the present value of this payment stream involves estimating a rate of interest and using this rate to reduce each payment to its value as of the day the lease was entered. The details of making the present value calculation will not be presented here, but can be obtained by referring to an accounting textbook and relevant present value tables. When a lease is recorded in this way, lease payments do not constitute rent expense, but are treated partially as a reduction in the original liability and partially as interest expense on the remaining portion of this liability. Leases for which it is clear that the terms of the lease agreement have been significantly affected by the fact that the lessee and the lessor are related, must be adjusted to reflect the economic substance of the lease rather than the legal form. For further details on leases between related parties, see FASB No. 13.

The following example will illustrate the entries necessary to properly record a lease that is equivalent to the purchase of property.

On January 1, 19Xl, a facility agrees to lease a piece of equipment from a manufacturer. The facility will make a $4,000 payment at the beginning of each of the next four years with the first payment on the date of agreement, and will acquire legal ownership of the equipment at the end of the fourth year upon payment of one dollar. Accordingly, this lease must be treated as a purchase and as a capitalized lease. The expected useful life of this machine is ten years. Although the total of the lease payments plus option payments is $16,001, the present value of the five payments, using an interest rate of 8% per year, is $14,309. The proper entry to record this lease is therefore:

ACCOUNTING PRINCIPLES AND CONCEPTS

Jan. 1, 19X1	Dr.	1241	Major Movable Equipment	$14,309	
	Cr.	2240	Capitalized Lease Obligations		$14,309

The initial payment will result in the following entry:

Jan. 1, 19X1	Dr.	2240	Capitalized Lease Obligations	$4,000	
	Cr.	1001	Cash		$4,000

At the end of 19Xl, the second payment of $4,000 will be made, but this payment will be only partially applied to the remaining balance of $10,309 ($14,309 less the first payment of $4,000). The other portion will be recorded as interest expense on this balance. The amount of interest expense is $825 (8% of $10,309) and the remaining $3,175 portion of the payment will be applied to the capitalized lease obligation balance.

Dec. 31, 19X1	Dr.	7500.91	Interest - Property Plant and Equipment	$825	
	Dr.	2240	Capitalized Lease Obligations	3,175	
	Cr.	1001	Cash		$4,000

A similar procedure would be followed for the final three payments:

Dec. 31, 19X2	Dr.	7500.91	Interest - Property, Plant and Equipment ($10,309 - $3,175 = $7,134 x .08)	$ 571	
	Dr.	2240	Capitalized Lease Obligations	3,429	
	Cr.	1001	Cash		$4,000

ACCOUNTING PRINCIPLES AND CONCEPTS

Dec. 31, 19X3	Dr.	7500.91	Interest - Property, Plant and Equipment ($7,134 - $3,429 = $3,705 x .08)	$ 296	
	Dr.	2240	Capitalized Lease Obligations	3,704	
	Cr.	1001	Cash		$4,000
Dec. 31, 19X4	Dr.	7500.91	Interest - Property, Plant and Equipment ($3,705 - $3,704 = $1 x .08)	$ 0	
	Dr.	2240	Capitalized Lease Obligations	1	
	Cr.	1001	Cash		$ 1

When a lease is capitalized in the above manner, a facility should record depreciation as it would on any other depreciable asset.

Any improvements or additions that a facility makes to a leased asset which fall within the limits of the facility's mandated capitalization policy, regardless of whether the asset itself has been capitalized, should be capitalized and depreciated. For example, if a facility spent its own money to modify and prepare a leased building for occupancy, it should record these costs as an asset in Account 1230, Leasehold Improvements (if the building is leased through an operating lease), or Account 1220, Buildings and Improvements (if leased through a capital lease). In both cases, depreciation should be accounted for in a normal manner. For an operating lease, the period over which the asset should be depreciated must not exceed the lesser of the useful life of the improvement or the remaining life of the lease.

SUPPLIES INVENTORY 1190

Long-term care facilities are required to report as an asset the cost of expendable supplies owned by the facility and on hand at the end of a reporting period. Such items may include patient supply items, drugs and dietary items, office supplies, maintenance and cleaning supplies, and any other supply items that are consumed during the operation of the facility. The cost of these items should then be assigned to the appropriate inventory accounts listed in the Chart of Accounts. Types of supplies which are not maintained in material amounts need not be included in inventory.

ACCOUNTING PRINCIPLES AND CONCEPTS

In general, the easiest and most appropriate method for a smaller facility to handle inventory accounting is to charge all supplies that are purchased during the period to an expense account in the cost center that will consume the supply item. Then, at the end of the period a physical count of the items still on hand should be taken and entries should be made to remove the cost of these items from the expense accounts of the cost centers and to put them in inventory accounts for reporting purposes. After the report is prepared, then the inventory accounts may be closed back to the expense accounts for the new period.

An alternate method can be used by facilities which need a continual record of the amount of supplies in inventory. Under this method, all purchases are recorded directly to an inventory account. When supplies are withdrawn for use, the appropriate expense account is debited and the inventory account is credited for the withdrawal. An annual physical count is also required for this method in order to compare the recorded inventory to the actual inventory. For example, if at the end of a reporting period the records show fifty items in inventory and an actual count reveals that only forty are on hand an adjustment must be made to record the ten-item shortage.

Inventories are to be valued at cost determined under any generally accepted method; however, the method used must be consistently applied from year to year.

SEPARATE FUND ACCOUNTING 1200

At times long-term care facilities may receive gifts, bequests, or grants from donors or other third parties which must be used for stipulated purposes. As a means of separating these restricted donations from the other assets of a facility, a system of separate fund accounting must be used. Fund accounting is most extensively employed by a facility that is organized on a not-for-profit basis, but it must also be used by an investor owned facility to account for any donations received upon which restrictions are imposed. When such a donation is received, it should be recorded as a charge to a restricted asset account rather than an unrestricted (general fund) asset account. Donations in the form of pledges should be recorded as receivables, less an allowance for uncollectible amounts, and donations of other noncash assets should be recorded at fair market value at the date of donation. The accompanying credit will be made to an account representing the balance of a restricted fund. This fund balance is composed of all restricted donations which have been received and which are still available for specific purposes. There are three separate donor-restricted funds: Specific Purpose Fund, the Plant Replacement and Expansion Fund, and the Endowment Fund.

ACCOUNTING PRINCIPLES AND CONCEPTS

SPECIFIC PURPOSE FUND 1201

The Specific Purpose Fund is actually a classification that is used to summarize donations which have restrictions that do not fall into one of the other two categories. Donations may be accompanied by any of an unlimited variety of restrictions on their use. It will generally be necessary for the facility to maintain a separate fund balance subaccount for each type of restriction for its internal use; however, the details of each fund balance are not required for reporting purposes.

No separate fund accounting procedures should be performed for expenses relating to any of the donor-restricted funds. These expenses are to be recorded in the nominal expense accounts in the general fund for the cost centers to which they apply, regardless of whether the actual expenditures of cash are made from the general fund or a restricted fund. Donor-restricted funds are established to aid the facility's operations in specified ways. As such, an expenditure made by the facility which meets a requirement set by a specific purpose fund is subject to reimbursement from that fund. This reimbursement should be recorded by the facility in one of the three transfer accounts established for this purpose in the other operating revenue section of the Chart of Accounts. For example, suppose that a facility spends $100 to purchase supplies that will be used in an inservice education program for nurse assistants. The entry to record the expenditure would be:

Dr.	6800.93	Inservice Education - Nursing	$100	
Cr.	1001	Cash		$100

Suppose also that the facility has a specific purpose fund intended to help support these educational activities: since the facility may draw from this fund to pay for the supplies, the restricted fund should record a payable in the following manner:

Dr.	2870	Specific Purpose Fund Balance	$100	
Cr.	2810	Due to General Fund		$100

At the same time, a corresponding receivable and other operating revenue should be recorded in the general fund accounts:

Dr.	1072	Due From Specific Purpose Funds	$100	
Cr.	5990	Other Operating Revenue		$100

As will be noted in the Chart of Accounts, generally the only liability accounts included in the restricted funds are liabilities to other funds. An exception is made in the accounts for the Endowment Fund, which allows for the inclusion of certain obligations, such as mortgages, on Endowment Fund assets. Otherwise, all liabilities incurred by the facility are to be recorded in the general fund accounts.

PLANT REPLACEMENT AND EXPANSION FUND 1202

The Plant Replacement and Expansion Fund is maintained to account for donations which may be used only for the acquisition and construction of new plant assets. Assets are recorded in a restricted asset account until the time that they are appropriated for their intended purpose. For example, suppose that a cash donation of $100,000 was made for the purpose of purchasing new equipment. The initial entry to record the donation would be as follows:

Dr.	1710	Cash - Plant Replacement and Expansion Fund	$100,000	
Cr.	2770	Plant Replacement and Expansion Fund Balance		$100,000

Assuming an acquisition of equipment costing $20,000 is made under the terms of the donation, the following entry is made in the restricted accounts to transfer the necessary funds to the unrestricted accounts:

Dr.	2772	Plant Replacement and Expansion Fund Balance (Capital Outlay)	$20,000	
Cr.	1710	Cash - Plant Replacement and Expansion Fund		$20,000

ACCOUNTING PRINCIPLES AND CONCEPTS

At the same time, an entry would be made in the unrestricted (general fund) accounts to record the receipts of cash and the transfer of a portion of the restricted fund balance to the general fund balance, as follows:

Dr.	1001	Cash	$20,000	
Cr.	2410	Fund Balance - General Fund		$20,000

(For this example the recording of the equipment purchase is assumed to have been recorded in the normal accounting process.)

When accounting for transfers between restricted funds and the general fund, it should be observed that a separate entry must be made for each fund involved so that the fund is maintained in balance. All portions of each separate entry would be recorded within the same fund.

ENDOWMENT FUND 1203

The Endowment Fund is maintained to account for assets given to the facility under endowment contracts which provide that the assets are to remain intact for a limited (term endowment) or unlimited (pure endowment) period of time. The purpose for restricted donations of this type to make funds available which will earn income for the facility. This income, depending on the terms of the contract, may be restricted or may be available for general use by the facility. If the donor has imposed restrictions on the use of this income, then this income must be transferred to the appropriate restricted fund. If there are no restrictions on the income, it is recorded in Account 9100, Nonhealth Care Revenues and Expenses. Similar accounting treatment as indicated for the Plant Replacement and Expansion Fund is given to portions of the endowment fund balance when made available for other purposes under a term endowment contract.

EXTRAORDINARY ITEM, PRIOR PERIOD ADJUSTMENTS, AND ACCOUNTING CHANGES 1210

EXTRAORDINARY ITEM 1211

Occasionally, a facility will experience an event or transaction which results in completely unexpected and highly unusual revenues (gains) or expenses (losses). Such revenues or expenses, if material, may then qualify for classification as an extraordinary

item on the Statement of Income. An extraordinary item is defined by Accounting Principles Board Opinion No. 30 and FASB No. 4 as an event or transaction which is of unusual nature and not expected to recur in the foreseeable future. Not included in this category are things such as gains or losses on disposal of assets of a facility, write-downs of receivables, inventories or intangible assets, or the receipts of donations or property or money. The determination of an extraordinary item is a highly technical subject and should be made in strict accordance with APB Opinion No. 30 and FASB No. 4.

PRIOR PERIOD ADJUSTMENTS 1212

In some rare circumstances, a facility may determine that a material item of revenue or expense cannot be properly associated with either the current or future periods, but are directly related to a past period. In such cases the item may be recognized as a prior period adjustment. The amount of this prior period adjustment is a change in the General Fund Balance for a non-profit institution. Prior period adjustments are relatively rare. However, the most common reason for prior period adjustment is the correction of an accounting error in a prior year's financial statement. The criteria for making prior period adjustments exclude those items which are susceptible to reasonable estimation in the period to which they relate. These latter items must be estimated and included in that period's financial statements. Therefore, writeoffs of accounts receivable or final settlements on third-party contractual agreements are not usually to be shown as prior period adjustments. Detailed procedures for recognizing and presenting prior period adjustments may be obtained by reference to Accounting Principles Board Opinions No. 9, No. 20; FASB No. 16, No. 58, No. 73 and No. 96.

ACCOUNTING CHANGES 1213

Accounting principles, once adopted by a facility, should be applied consistently from period to period. However, in some cases it may be appropriate to adopt an alternative Generally Accepted Accounting Principle in lieu of the one currently in use. An example of such a change would be the decision to value inventory using the "last-in first-out" (LIFO) assumption instead of the "first-in first-out" (FIFO) assumption. Both of these assumptions are in accordance with Generally Accepted Accounting Principles, but may produce different valuations of the same inventory. A change in accounting principle that has a significant effect on the financial statements of a facility usually requires that the cumulative effect of the change be separately identified. Accounting Principles Board Opinion No. 20 discusses accounting changes and should be consulted for further information on the subject. It should be pointed out, however, that a change in accounting estimate, which can occur when additional information is available, is not a change in accounting principle.

ACCOUNTING PRINCIPLES AND CONCEPTS

SHARED SERVICES 1220

In some cases, a facility may provide services to other facilities or organizations using certain of its own nonrevenue producing cost centers under a shared service arrangement. In such cases, the facility will maintain capacity in certain areas in excess of that necessary for its own needs, and sell services from those areas to outside parties. For example, a facility may provide management or administrative assistance to other organizations from its staff, or it may operate a laundry plant which supplies clean linen to itself and other facilities. When activities such as these are performed, the proper treatment of all related expenses is to charge them directly to the appropriate expense cost center. Revenues which are received under these arrangements should be recorded as other operating revenue.

GOVERNMENTAL SUPPORT 1230

Facilities receiving governmental support in the form of tax revenues should account for these revenues in the same manner as donations and grants. If they are restricted as to use, they should be included in an appropriate restricted fund. If they are not restricted as to use, they should be reflected in Account 9100, Nonhealth Care Revenues and Expenses in the General Fund.

GOVERNMENT ACCOUNTING STANDARDS 1231

A health care entity may be a part of another organization such as a government, medical school or a university which follow the pronouncements of the Government Accounting Standards Board (GASB), in addition to FASB and APB pronouncements. The recommendations contained in this Manual which call for separate statements apply to these entities as if they stand alone. The purpose of this Manual is to establish uniform accounting and reporting for comparability. Therefore, these health care entities must comply with this Manual and its chart of accounts.

ASSETS WHOSE USE IS LIMITED 1240

The term "restricted" must not be used in connection with board or other internal facility appropriations or designations of funds. These assets are to be categorized as assets whose use is limited and are included in the general fund. Three categories of assets whose use is limited have been identified.

1. Board Designated Assets - These assets have been identified for a designated purpose by the governing board. The board may at any time change the purpose for which the assets have been designated.

2. Indenture Agreements - This includes funds held by a trustee. These funds are set aside for use in accordance with debt instruments or similar agreements.

3. Agreements with Outside Parties - Assets set aside based on agreements with third parties other than the donor or grantor. These would include assets set aside under agreements with third-party payors to meet depreciation funding requirements and assets set aside under self-insurance fund arrangements.

ACCOUNTING FOR CONTINUING CARE CONTRACTS 1250

A continuing care contract represents a form of prepaid health insurance. There are three basic types of contracts used by Continuing Care Retirement Communities (CCRCs). They include all-inclusive (type A), modified (type B), and fee-for-service (type C) contracts.

A. 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.

B. 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.

C. 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, when it is needed, at full per diem rates.

Continuing-care contracts contain a number of different approaches to providing delivery of services. Contract provisions, for example, may stipulate the amount of the advance fee, whether periodic fees will be required, and, if so, whether they can be adjusted. In addition, contracts generally do the following: detail the future services that will be provided to residents; explain how a resident will be charged for

services; describe the CCRC's refund policies and the formula for calculating the amount of the refund, which may be simple or complex; and describe the obligations of the CCRC and the resident if a contract is terminated or a residential unit is reoccupied.

A CCRC may require several different payment methods for services and the use of facilities. Three of the most prevalent methods are mentioned below.

1. **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 CCRC housing-related services (for example, meals, laundry, housekeeping, and social services) and health care and are usually 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.

2. **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.

3. **Periodic fees only**. Under this method, a resident pays a fee at periodic intervals for services and the use of the facilities provided by the CCRC. Such fees may be either fixed or adjustable.

The estimated amount of advance fees that is expected to be refunded to current residents under the terms of the contracts should be accounted for and reported as a liability (Account 2271, Refundable Fees). The estimated amount should be based on the individual facility's own experience or, if records are not available, on the experience of comparable facilities. The remaining amount of advance fees should be accounted for as deferred revenue within the liability section of the balance sheet. The deferred revenue should be amortized to income over future periods based on the estimated life of the resident or contract term, if shorter. The period of amortization should be adjusted annually based on the actuarially determined estimated remaining life expectancy of each individual or joint and last survivor life expectancy of each pair of residents occupying the same unit. The straight-line method should be used to amortize deferred revenue except in certain circumstances where costs are expected to increase at a significantly higher rate than future revenues in the later years of residence. In those situations, deferred revenue may be amortized to income using a method that reflects the

disproportionate ratio between the costs of the expected services and expected revenues. The amortized amount should not exceed the amount available to the CCRC under state regulations, contract provisions, or management policy. Unamortized deferred revenue from nonrefundable advance fees should be recorded as revenue upon a resident's death or termination of the contract. The method of amortization should be disclosed in the notes to the financial statements.

That portion of annual amortization of deferred revenue that may be allocated to health care is computed as follows:

Health care cost incurred related to contract X) / Health care and Residential cost (related to contract X)	x	Yearly amortization of deferred revenue (related to contract X)	=	Amount of yearly amortization allocable to health care

For example: A contract is entered into by a facility to provide ten years of continuing care for an advance fee of $50,000. Yearly amortization is $5,000 ($50,000 ÷ 10 years).

As health care is provided to the resident during year one of the contract, the appropriate routine and ancillary services revenue accounts are credited at their full established rates, and Account 5340, Contractual Adjustments - Other Payers, is debited, as in the following entry recording revenue for Skilled Nursing and Patient Supplies:

Dr.	5340	Contractual Adjustments - Other Payers	$500	
Cr.	3100.09	Skilled Nursing - Other Payers		$450
Cr.	4100.09	Patient Supplies - Other Payers		50

Similar entries are made as care is provided during the year. At the end of the year, the costs incurred relating to the contract are:

$3,000 - Cost of health care (90% for skilled nursing and 10% patient supplies)
$1,000 - Cost of residential care
$4,000

ACCOUNTING PRINCIPLES AND CONCEPTS

To calculate the portion of the $5,000 yearly amortization of deferred revenue allocable to health care, the formula above would be used as follows:

$$\frac{\$3,000}{\$4,000} \times \$5,000 = \$3,750$$

$3,750 of the $5,000 yearly amortization of deferred revenue is allocable to health care.

The entry to record annual earned advanced fees is as follows:

Dr. 2131	Deferred Revenues from Advanced Fees	$5,000	
Cr. 5340	Contractual Adjustments - Other Payers		$3,750
Cr. 9108	Other - Nonoperating Revenue		1,250

A liability must also be recorded in Account 2270, Noncurrent Liabilities, to recognize the obligation to provide future services to current residents, in excess of the related anticipated revenues. The increase or decrease in this liability must be recorded in Account 9100, Nonhealth Care Revenues and Expenses.

For further discussion of continuing-care contracts, please see AICPA Statement of Position No. 90-8.

POST RETIREMENT BENEFITS 1260

The cost of post retirement benefits is required to be accounted for on an accrual basis during the years that the employee renders the necessary service. The expected cost of providing benefits to an employee, an employee's beneficiaries and covered dependents should be accrued. For further details, see FASB No. 106.

ACCOUNTING PRINCIPLES AND CONCEPTS

ASSERTED AND UNASSERTED MALPRACTICE CLAIMS 1270

Due to the increasing number of malpractice claims being filed and the increase in the awards to the plaintiffs, malpractice costs have increased dramatically in recent years. This increase has resulted in a number of methods of insurance to protect the health care providers against future loss. The insurance alternatives include retrospectively rated policies, captive insurance, multi-provider captive insurance, and claims-made insurance. There are a number of methods for accounting for asserted and unasserted claims. The purpose of this section is to provide guidance to standardize the accounting for malpractice claims, asserted and unasserted. Listed below are pertinent definitions of terminology to be used in the following discussion.

Asserted claim - A claim made against a health care provider by or on behalf of a patient alleging improper professional service.

Claims-made policy - A policy that covers only malpractice claims covered by the policy reported to the insurance carrier during the policy term.

Multi-provider captive - An insurance company owned by two or more health care providers that underwrites malpractice insurance for its owners.

Occurrence-basis policy - A policy that covers claims resulting from incidents that occur during the policy terms, regardless of when the claims are reported to the insurance carrier.

Reported incident - An occurrence identified by a health care provider, usually under some form of claim-management-reporting system, as one in which improper professional service may be alleged, thereby resulting in a malpractice claim.

Retrospectively rated policy - An insurance policy with a premium that is adjustable based on the experience of the insured health care provider or group of health care providers during the policy term.

Self-insurance - Risk of loss assumed by a health care provider. No external insurance coverage.

Tail coverage - Insurance designed to cover malpractice claims incurred before, but reported after, cancellation or expiration of a claims-made policy.

ACCOUNTING PRINCIPLES AND CONCEPTS

Trust fund - A fund established by a health care provider to pay malpractice claims and related expenses as they arise. (In the case of government, the trust fund often is established as an "internal service fund.")

Unasserted claim - A medical malpractice claim that has not been, but may in the future be, asserted by or on behalf of a patient related to a reported or unreported incident.

Unreported incident - An occurrence in which improper professional service may have been administered by the health care provider that may result in a malpractice claim. The occurrence, however, has not yet been identified by the health care provider under a formal or informal claims-reporting system.

Wholly owned captive - An insurance company subsidiary of a health care provider that provides malpractice insurance primarily to its parent.

In regard to these incidents, the cost of malpractice claims, including the cost of litigation, should be accrued in the period that the incident creating the cause for claim occurred. If it is probable that a loss has been incurred and the loss can be estimated, then it should be accrued. If a range of the loss can be determined, then the most likely amount within that range should be accrued. If that cannot be determined, then the minimum amount in that range should be accrued.

All facilities will have to review their accounting systems to be assured they have a procedure or system in place for logging and tracking these claims as they occur, and to determine losses that have to be recorded.

Estimated losses from asserted claims should be accrued either on a group or individual basis as should unasserted claims. The accrual should be based on all information relevant to the situation, which may include industry experience and the historical experience of the health care provider. An accrual should also be made for the estimated cost of unreported incidents. The estimate of cost associated with unreported incidents may also be based on the above sources as well as existing reported incidents and asserted claims. The health care provider should note that as the amount of services provided increases, so does the likelihood of unasserted claims and reported incidents.

If a health care provider cannot reasonably estimate the liability relating to a particular category of malpractice claims, the loss contingency should be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5.

ACCOUNTING PRINCIPLES AND CONCEPTS

An increasing number of health care providers are purchasing claims-made policies. If the policy is not continually renewed, the health care provider is uninsured for malpractice claims when the policy expires. The health care provider can purchase tail coverage to protect itself against such an event. The cost of tail coverage should be expensed in the period it is purchased. The health care provider should accrue for liabilities that are expected to occur during the period that the claims-made policy and/or tail coverage do not cover.

The following entries indicate how to account for some of the various transactions involved with asserted claims, unasserted claims and tail coverage:

1. The long-term care facility estimates at December 31, 19XX that it has $1,000 in asserted and unasserted claims. The losses are probable and the health care provider has a reasonable basis for estimating the amount.

Dr.	6904.90	Administration - Insurance - Professional Liability	$1,000	
Cr.	2039	Other Accrued Expenses Payable		$1,000

To accrue estimated expenses related to asserted and unasserted claims at December 31, 19XX.

2. The facility purchases 2-year tail coverage for $1,500 for a claims-made insurance policy covering the period January 1, 19XX to December 31, 19XX, a one-year period. The cost of the tail coverage for the claims-made policy period of January 1, 19XX to December 31, 19XX is recorded as expense in the year it is purchased.

Dr.	6904.90	Administration - Insurance - Professional Liability	$1,500	
Cr.	1001	Cash		$1,500

To record tail coverage purchased for the year-end, December 31, 19XX.

ACCOUNTING PRINCIPLES AND CONCEPTS

ACCOUNTING FOR SELF-INSURANCE 1280

The absence of insurance, commonly referred to as self-insurance, covering possible property losses or the possibility that injury claims (non-professional) will be made against the facility does not justify the recording of an expense if the probability of such events is uncertain and the amount of the loss cannot be reasonably estimated. However, you may accrue expenses and related liabilities for malpractice (professional liability) and employee medical and dental benefits once the criteria for the accrual of a loss contingency are met. The facility is responsible for the actuarial methods used, along with the assumptions.

Examples of how to account for the accrual of expenses and related liabilities for self-insurance programs are as follows:

1. The long-term care facility becomes self-insured for malpractice coverage. The long-term care facility has an actuary determine the amount of liability it has related to malpractice claims. The actuary estimates that $10,000 will need to be accrued for the year ended December 31, 19XX. The actuary estimates the amount will be paid within one year. The entry is as follows:

Dr.	6904.90	Administration - Insurance - Professional Liability	$10,000	
Cr.	2099	Other Current Liabilities		$10,000

2. Next year the long-term care facility pays out the $10,000 accrued in the prior year.

Dr.	2099	Other Current Liabilities	$10,000	
Cr.	1001	Cash		$10,000

Similar accounting can be used for self-insurance programs for employee medical and dental benefits, except that the expense would be recorded as an employee benefit and recorded in the cost center where the employee works.

ACCOUNTING PRINCIPLES AND CONCEPTS

INCOME TAXES 1290

All facilities must meet the objective of proper accounting for income taxes by following the appropriate procedures stated in FASB Statement No. 96 as amended by FASB Statement No. 103. The objective of this statement is to recognize the amount of current and deferred taxes payable or refundable at the date of the financial statements (a) as a result of all events that have been recognized in the financial statements and (b) as measured by the provisions of enacted tax laws. For further details see FASB Statement No. 96 as amended by FASB Statement No. 103, effective for fiscal years beginning after December 15, 1991.

DIVISIONAL EQUITY AND INCOME TAX CONSIDERATIONS OF A SUBSIDIARY OR DIVISION OF A CORPORATION 1300

A facility which is a subsidiary or division of a corporation is to record the following balances in its general ledger.

1. Divisional Equity (Fund Balance) - This is the net accumulation of investments, earnings, and distributions since inception. The divisional equity of a facility that is a subdivision or division of a corporation must be recorded in Divisional Equity (Account 2460).

2. Income Taxes - The facility or division's share of the corporate tax benefit or liability must be recorded in Receivables from Related Parties - Current (Account 1090) or Receivable from Related Parties - Noncurrent (Account 1340) if it is a benefit. If it is a liability, it must be recorded in Payables to Related Parties - Current (Account 2080) or Payables to Related Parties - Noncurrent (Account 2260). The income statement recording must be to Provision for Income Taxes (Account 9200).

MARKETABLE EQUITY SECURITIES 1310

Marketable equity security portfolios are reported at the lower of aggregate cost or market value, determined at the balance sheet date. The amounts by which the aggregate cost of each portfolio exceeds market value can be recorded as valuation allowances using the undesignated account numbers within the appropriate marketable

securities control account, unless the decline in market value is judged to be other than temporary. See the "Providers of Health Care Services Audit and Accounting Guide" for further details.

CONSOLIDATIONS

1320
(Rev. October 2023)

Foundations, auxiliaries, guilds, and similar organizations frequently assist and, in many instances, are related to health care entities. While Accounting Standards Codification (ASC) 810-10 provides guidance on consolidations of related organizations, each separately licensed health facility must maintain separate balance sheet and income statement accounts and report separately to the Office.