

Principles and Practices Board Statement Number 15 Valuation and Financial Statement Presentation of Charity Service and Bad Debts by Institutional Healthcare Providers

The Principles and Practices (P&P Board) Statement No. 2, issued in 1978, provided a basis for differentiating between charity service and bad debts. The statement acknowledged that, while the differentiation was helpful, the financial accounting and reporting of charity service and bad debts were the same. In 1990, the American Institute of Certified Public Accountants (AICPA) published (after review and approval by the Financial Accounting Standards Board) an extensive revision of the guide titled "Audits of Providers of Health Care Services." The revised guide substantially changed the reporting of bad debts and eliminated charity service from revenue. Disclosure of the entity's policy for providing charity service and the level of charity provided is required by the revised guide. An extensive revision of the 1990 guide was made in 1996 and a new edition of the AICPA Audit and Accounting Guide, "Health Care Organizations" was published as of June 1, 1996. The 1996 guide did not change the provisions relating to bad debts and charity care as contained in the 1990 guide.

The P&P Board decided that a substantive revision of its Statement No. 2 was required to bring it into conformity with the revised 1990 guide and to provide direction on implementation of the revised 1990 guide's requirements.

This statement supercedes Statement No. 2 and deals with the same issues, including bad debts.

Statement No.15 was reviewed for conformity with the 1996 guide and technical references were updated in January 1997.

Provisions of this Statement need not be applied to immaterial items.

I. Background

1.1 Bad debts result from the unwillingness of a patient to pay, whereas charity service is provided to a patient with demonstrated inability to pay. For example, one authority states, "...the financial status of each patient should be determined so that an appropriate classification and distinction can be made between uncollectible amounts arising from [the] patient's unwillingness to pay (bad debts) and those arising from [the] patient's inability to pay (charity service)." [\(1\)](#) Determining each patient's ability to pay and the amount of service eligible for charity support is complex and requires judgment, as further discussed in this statement.

1.2 The American Institute of Certified Public Accountants Audit and Accounting Guide, Health Care Organizations, published in 1996 and hereafter referred to as the guide, requires the following with respect to bad debts and charity care:

- classifying bad debts as an expense,
- eliminating charity service from both revenue and receivables, and
- requiring disclosure of the charity service policy and the amount of charity service provided.

1.3 While charity service and bad debts can be distinguished, there are several issues that must be considered. These issues are discussed in the indicated sections of this statement:

- What criteria are used to identify patients who qualify for charity service? (Section 2)
- When must the patient's eligibility for charity service be determined? (Section 3)
- What charity service records are needed? (Section 4)
- How is charity service valued and disclosed? (Section 5)

How are bad debts valued and disclosed? (Section 6)

How are receipts that relate to charity service or bad debts classified? (Section 7)

How is a shortfall between cost and payments classified? (Section 8)

1.4 It is necessary to differentiate charity service from bad debts because:

charity service represents the consumption of valuable resources that must be managed wisely.

charity service is one of the important indicators of the fulfillment of an organization's charitable purposes and, therefore, should be clearly identified and disclosed [\(2\)](#).

provider eligibility for certain financial assistance is dependent on identification of charity service [\(3\)](#).

bad debt expense is a measure of the effectiveness of the organization's credit and collection process.

1.5 All types of healthcare providers, including tax-exempt, governmental, and investor-owned, need to differentiate bad debts from charity service. The extent of disclosure about charity service will be influenced by the organization's mission and the amount of these services.

1.6 Healthcare organizations generally do not extend credit to facilitate sales, as is typical of other businesses. Rather, the nature of the illness or injury frequently requires the provision of service without consideration of the ability to pay. Also, the complex payment arrangements for healthcare services, including the heavy involvement of government agencies and third-party payers, often result in processing and payment delays. Accommodating the financial status of patients with costly, unplanned needs and the special circumstances related to complex billing requirements must be considered when evaluating the amount of collections, the cost of bad debts, the time required to collect accounts, and management's control over receivables.

1.7 Charity service is only one of the types of community service provided by healthcare organizations. Provision of other community services can be important evidence of fulfillment of mission and can help identify the reasons an organization qualifies for tax exemption. The content and method of disseminating this type of disclosure is beyond the scope of this statement.

II. Criteria for Charity Service

2.1 Each institutional provider of healthcare [\(4\)](#) services must establish criteria for charity service consistent with the organization's mission and financial ability. Some providers have financial resources designated for the provision of charity service while other providers must recover the cost of charity service from the amounts paid by or for other patients. Some communities provide financial support to specific organizations to ensure that charity service is available, while other communities prefer that each provider arrange for charity service based on demand. For these reasons, no single set of criteria is universally applicable and each provider must develop and administer its own criteria.

2.2 Some government regulations identify criteria for charity service for specific purposes, such as eligibility for certain types of financial assistance. While these external criteria may influence the provider's criteria and the provider must be able to identify patients who fulfill these externally determined criteria, such external criteria do not supersede the organization's own criteria, which may be more or less stringent.

2.3 Criteria for determining the amount of charity service for which a patient is eligible at the time of an occasion of service could include some of the following factors as well as others. The following factors are discussed in the indicated paragraphs of this statement:

individual or family income (see 2.4)

- individual or family net worth (see 2.5)

- employment status and earning capacity (see 2.6)

- family size (see 2.7)

- other financial obligations (see 2.8)

- the amount and frequency of bills for healthcare services (see 2.9)

- other sources of payment for the services rendered (see 2.10)

2.4 Individual or family income may recognize standards for determination of poverty with consideration of family size, geographic area, and other pertinent factors. Individual or family income generally are not the exclusive criteria for determining the appropriate amount of charity service.

2.5 Individual or family net worth considers all liquid and nonliquid assets owned, less liabilities and claims against assets. Eligibility for Medicaid if some assets are depleted can be considered.

2.6 Employment status should consider the likelihood of future earnings sufficient to meet the healthcare-related obligation within a reasonable period of time.

2.7 Implications of family size in addition to adequacy of individual or family income are appropriate considerations.

2.8 Other financial obligations include living expenses and other items of a reasonable and necessary nature.

2.9 The amount and frequency of bills for healthcare services must be considered in relation to all the other factors outlined above. While eligibility relates to meeting criteria at the time service is rendered, the history of service and the need for future service may be considered. A separate determination of the amount of charity service for which a patient is eligible is made on each occasion of service, or regular confirmation of eligibility is made during extended programs of service.

2.10 The appropriate amount of charity service is determined in relation to amounts due after applying all other resources. Criteria may be more detailed and call for more specific evidence of eligibility for large amounts than for small amounts.

2.11 A number of factors must be considered, all of which require judgment. Thus, adoption of rigid criteria is undesirable.

2.12 Different providers may apply similar criteria differently. For example, a patient with catastrophic hospitalization costs but with substantial net worth may be eligible for charity service by one provider, but another provider may require that net worth in excess of a threshold be used to pay for healthcare services before the patient is eligible for charity service. Some providers may be able to establish automatic criteria for certain classes of patients (such as for noncovered services to Medicaid patients), and other providers may require case-by-case determination.

2.13 Application of these factors by individual providers involves several considerations, including:

- availability of information (see 2.14), and

- verification of information (see 2.15).

2.14 Determining the amount of charity service for which a patient is eligible is based in large part on information supplied by the patient or someone acting on the patient's behalf. The charity service policy needs to address eligibility for charity service when there is insufficient information to fully evaluate all the criteria and the ability to pay cannot be reliably determined.

2.15 Data used in making a determination concerning eligibility for charity service should be verified to the extent practical in relation to the amount involved and the significance of an element of information in the overall determination. For example, extensive investigation in relation to a small balance due would not be cost effective. Similarly, a single element of information may provide all the information necessary to make a reasonable determination, and additional investigation would not be cost effective. The procedures implementing the charity service policy should address the extent of verification and any modification of a determination already made if subsequent information indicates that information relied upon was in error.

III. Timing of Determination of Eligibility for Charity Service

3.1 While it is desirable to determine the amount of charity service for which a patient is eligible as close to the time of service as possible, there should be no rigid limit on the time when the determination is made. In some cases, eligibility is readily apparent and a determination can be made before, on, or soon after the date of service. In other cases, it can take investigation to determine eligibility, particularly when the patient has limited ability or willingness to provide needed information.

3.2 Collection efforts can yield essential information about the amount of charity service for which a patient is eligible. Commencement of collection efforts does not alter the patient's financial status. A provider's collection efforts, including use of outside collection agencies, are part of the information collection process and can appropriately result in identification of eligibility for charity service.

3.3 A patient's ability to pay may change over time. For example, a patient may have agreed to a payment plan that was reasonable in relation to the circumstances at the time, but subsequent events, such as a change in employment status or another need for healthcare services, could change the patient's ability to pay. Alternatively, a patient who was deemed eligible for charity service may subsequently have a financial windfall that would allow payment for the services provided. Since eligibility for charity service relates to fulfilling the provider's criteria when service is rendered, these subsequent events do not influence the charity service determination. Information obtained after service is rendered, including information obtained during collection efforts, that more accurately describes eligibility at the time of service should be considered. Once a provider makes a determination that an uncollected amount is charity service or bad debt and the amount is written-off to the appropriate allowance (see paragraphs 4.1(b) and (d) and 6.1(d)), that determination should not be changed.

IV. Recordkeeping Related to Charity Service

4.1 As discussed in section 1.2, charity service is not to be reported in revenue or receivables. However, it is generally not known whether services will meet charity service criteria at the time the services are rendered, so there is no alternative to keeping records for charity service in the same manner as for any other service. Use of a charity service provision and allowance, analogous to the recordkeeping for bad debts (see paragraph 6.1), is usually necessary. Appropriate recordkeeping for charity service consists of:

(a) recording services at the full established charges amount in revenue and receivables as services are rendered.

(b) adjusting revenue and receivables to the amount that a payer has an obligation to pay. If it is possible to determine that an amount qualifies as charity service, it is written-off immediately as described in step(d). Note: It is desirable to identify charity service as soon as possible to minimize collection effort and

deal with patients more equitably. However, paragraph 3.2 describes the importance of the collection effort in identifying services that qualify for charity, and it is generally necessary to make the estimate described in step (c).

(c) estimating the amount of the remaining receivables that will eventually be written off as charity service. This amount is recorded as a provision for charity service (a revenue contra account) and an allowance for charity service (a receivable contra account).

(d) writing off receivables as they are determined to meet charity service criteria against the allowance for charity service. Documentation concerning the eligibility for charity service should be retained.

(e) regularly evaluating the adequacy of the allowance for charity service with adjustments to increase or decrease the allowance offset by adjustments in the provision for charity service.

V. Valuation and Disclosure of Charity Service

5.1 As discussed in paragraph 4.1, charity service is initially valued for recordkeeping purposes at the provider's full established charges. For general purpose external financial statement presentation, patient receivables must be reduced by the allowance for charity service, and patient service revenue must be reduced by the provision for charity service.

5.2 These financial statement requirements result in an absence of information about the provision of charity service from the face of the operating statement (also called the statement of revenue and expense). A provider's mission or volume of charity service may make disclosure about charity service on the face of the operating statement, in the notes, or both, important. The guide also calls for disclosure of the "level of charity care provided...based on the provider's rates, costs, units of service, or other statistical measures." Calling attention to the provision of charity service on the face of the operating statement and each of the suggested note disclosures has advantages and disadvantages. This statement, in the indicated paragraphs, discusses and provides suggested wording for the following types of disclosure:

- Calling attention to the provision of charity service on the face of the operating statement (see 5.3)
- Note disclosure about the organization's charity service policy (see 5.4)
- Note disclosure based on charges (see 5.5)
- Note disclosure based on costs (see 5.6)
- Note disclosure based on units of service or statistical information (see 5.7)

The P&P Board concludes that a single note with all information about the provision of charity service will best meet the needs of financial statement users. This note should include: a) a description of the organization's charity service policy as discussed in paragraph 5.4; b) the volume (also sometimes referred to as the amount, value, quantity, or level) of charity service, quantified as discussed in paragraphs 5.5, 5.6, and 5.7; and c) receipts relating to charity service, as discussed in paragraph 7.1. (In addition, disclosure may be made of shortfalls in payments received, as discussed in paragraph 8.1.)

5.3 A provider's mission or volume of charity service may make it important that information about the provision of charity service be included on the face of the operating statement. The P&P Board concludes that such disclosure should generally be limited to a reference to the note that discusses the provision of charity service. If the quantity of charity service is expressed in relation to charges foregone, the reference may be included with the patient service revenue caption in

the operating statement. If the quantity of charity service is expressed in relation to cost, the reference may be included with the operating expense heading or the total of all operating expense. More than one reference is appropriate if more than one method of quantification is used. Appendix B illustrates the possible operating statement locations of references to the charity service note.

5.4 Disclosure about the organization's charity service policy is required. The note about this policy may include information such as the following:

The Xxx Hospital provides services to patients who meet the criteria of its charity service policy without charge or at amounts less than its established rates. The criteria for charity service consider (describe criteria, such as family income, net worth, extent of financial obligations for healthcare services, etc.).

5.5 The guide's illustrative note disclosure concerning a hospital's charity service uses the phrase "the amount of charges foregone for services and supplies furnished under the hospital's charity care policy. "Under the terms of the guide, there is no net revenue related to charity service. While "charges foregone" has been the traditional basis of valuing and disclosing charity service, the absence of gross revenue from the operating statement, under the terms of the guide, leaves no benchmark for evaluating the amount if expressed in this way. Therefore, disclosure of charity service, valued at charges, when there is no other information about services valued at charges, is inappropriate. The P&P Board similarly concludes that disclosure in the notes of the charges value of charity service does not represent the relative significance of charity service and should be accompanied by additional information such as costs, statistics, or percentages. The note concerning charity service, if it includes charges information, might be worded as follows:

Charges foregone for charity service provided were \$xx,xxx in 19x1 and \$xx,xxx in 19x2. Such amounts have been excluded from revenue.

In addition to this sentence, information about costs, units of service, or statistical data should also be included in the note to describe the relative significance of the amount of charity service provided.

5.6 Costs of charity service may be estimated in various ways. For example, the ratio of charges for charity service to charges for all services may be applied to costs of all patient services. This method is abbreviated as RCCAC (ratio of charges to charges applied to costs). This gross estimation process is not viewed by some as a reliable measure of cost; however, the fact that only a portion of the services provided to a patient may qualify as charity makes a more refined determination virtually impossible. Note disclosure of cost information should describe the cost estimation method used. Disclosing only cost information may also omit important financial considerations related to these services. The note on charity service might provide the following disclosure based on cost:

The cost of charity service provided was approximately \$xx,xxx in 19x1 and \$xx,xxx in 19x2. The cost estimate is based on the proportion of charges attributable to charity service.

This disclosure may be in addition to the disclosure about charges for charity service.

5.7 Units of service or statistical information about the number of patients receiving charity service or the proportion of service provided on a charity basis may also be included in the note on charity service. Disclosure of only statistical information or the proportion of services related to charity may not give a clear picture of the financial value of these services. This type of information may, on the other hand, better describe the breadth of service and the values that are not fully described in financial terms. The following wording could be included in the note to describe the proportion of services provided on a charity basis:

In 19x1, xx% of all services (a percentage of charges) were provided on a charity basis. In 19x2, xx% of services (similarly measured) were charity.

Unit of service or statistical disclosure should include information that describes the relative significance of charity service. For example, a more detailed breakdown of charity patients or services compared to all patients or services may be provided, such as:

In 19x1, xxx inpatients out of xxx and xxx outpatients out of xxx received charity service. In 19x2, xxx inpatients out of xxx and xxx outpatients out of xxx similarly benefited.

Details about the types of services may be included with wording such as:

The largest proportion of services provided on a charity basis was (describe service, such as cancer, emergency services, for the homeless, etc.).

Alternative or additional statistical disclosure such as the following may be included:

In 19x1, of a total of xxx inpatients, xxx received their entire episode of service on a charity basis and xxx received a partial subsidy. In 19x2, of a total of xxx inpatients, xxx full charity and xxx partial charity cases were served.

VI. Valuation and Disclosure of Bad Debts

6.1 Consistent with the discussion of charity service in paragraph 4.1, bad debts are recorded as follows:

(a) Services are recorded at the full established charges amount in revenue, and receivables are recorded as services are rendered.

(b) The receivable amount is adjusted to the amount that a payer has an obligation to pay, with an offsetting amount recorded in a revenue contra account.

(c) The amount of bad debts is estimated, and a provision for bad debts (an expense account) and an allowance for bad debts (a receivable contra account) are recorded.

(d) As receivables are determined to be uncollectible, they are written off against the allowance for bad debts. Documentation concerning the collection effort and result should be retained.

(e) The adequacy of the allowance for bad debts is evaluated regularly with adjustments to increase or decrease the allowance offset by adjustments in the provision for bad debts.

6.2 The bad debt amount is valued at the amount that the payer has an obligation to pay. Recoveries and payments for bad debts are discussed in paragraph 7.3.

6.3 Generally accepted accounting principles have no requirement for a specific disclosure of the amount of bad debts in general purpose external financial statements. Bad debts and other collection expenses are usually included in a general and administrative expense category. Specific disclosure may be appropriate on the face of the operating statement or in the notes.

VII. Classification of Receipts Relating to Charity Service or Bad Debts

7.1 Providers of healthcare services may receive funds to offset the general cost of charity service without relation to specific cases or services. This type of support can be provided by foundations, taxes, or other sources. These payments (or accrued revenue related to firm

commitments of such support) are generally recorded as other revenue. If these amounts are of a sufficient size to be separately disclosed in the operating statement, captions such as the following might be used: "Tax support received for eligible patients," or "XYZ Foundation support for financially needy patients." Whether or not this revenue is separately disclosed on the operating statement, the charity service note should disclose this type of support with wording such as the following:

Funds for the support of charity service were received from (name or describe the source). The amount received was \$xx,xxx in 19x1 and \$xx,xxx in 19x2. These amounts are included in other revenue.

7.2 Only the portion of an account that meets the organization's charity service criteria is recognized as charity. A patient who can afford to pay for a portion of the services provided should be expected to do so. The charity service criteria should identify the portion of the account for which the patient requires financial assistance. Uncollectible amounts that do not meet the charity service criteria are classified as bad debts. Accordingly, part of an account might be paid by a third party, part by the patient, another part might meet the charity service criteria, and any uncollectible remainder would be classified as bad debt. An account might involve any combination of these factors.

7.3 Funds can be recovered for specific accounts that have been written off as charity service or bad debts, such as recoveries by a collection agency. These receipts are added to the appropriate allowance. Thus, the allowance is increased by a provision that considered these actual and expected recoveries. (Section 5 of this statement discusses the valuation of charity service and paragraph 6.2 discusses the valuation of bad debts.)

VIII. Classification and Disclosure of Payment Shortfalls

8.1 There are a variety of government programs (such as Medicaid, Aid to Dependent Children, and other forms of welfare) and other financial assistance arrangements to help defray the healthcare costs of financially needy individuals. These arrangements may cover only specific services, may have limits on the time during which services eligible for assistance must be provided, and may require the patient to make some payments, which are called deductibles or coinsurance. Payments made by these programs, even though less than the provider's full established charges, generally meet the definition of revenue for covered services. Therefore, only the patient's financial responsibility for deductibles, coinsurance, or noncovered services are properly classified as charity service if the patient meets the organization's charity service criteria. If the payment amount by the government program meets a statutory requirement to pay the cost of providing services but is less than the provider's cost of rendering the services, the difference (shortfall) between the payment amount and cost may be disclosed but should not be identified as charity service. Wording such as the following might be used:

In addition to charity service, services are provided under the XYZ program to financially needy patients. The payments received under this program are less than the cost of providing the service. The unpaid cost of this program was \$xx,xxx in 19x1 and \$xx,xxx in 19x2. The cost estimate is based on the charges attributable to providing these services.

IX. Appendix A

Sample Charity Service Disclosures

1. Policy Description

The note may include information, such as the following, about the charity service policy:

The Xxx Hospital provides services to patients who meet the criteria of its charity service policy without charge or at amounts less than its established rates. The criteria for charity service consider (describe criteria, such as family income, net worth, extent of financial obligations for healthcare services, etc.).

2. Quantification

The note may include information, such as the following, quantifying the amount of charity service provided:

- a. Charges (optional and must be accompanied by quantification b or c)

Charges foregone for charity service provided were \$xx,xxx in 19x1 and \$xx,xxx in 19x2. Such amounts have been excluded from revenue.

- b. Cost (including a description of the method used to measure cost)

The cost of charity service provided was approximately \$xx,xxx in 19x1 and \$xx,xxx in 19x2. The cost estimate is based on the proportion of charges attributable to charity service.

OR

c. Units of service or statistical information

In 19x1, xx% of all services (a percentage of charges) were provided on a charity basis. In 19x2, xx% of services (similarly measured) were charity.

A more detailed breakdown of patients or services may be provided (including information about the relative significance of the amount), such as:

In 19x1, xxx inpatients out of xxx and xxx outpatients out of xxx received charity service. In 19x2, xxx inpatients out of xxx and xxx outpatients out of xxx similarly benefited.

Details about the types of services may be included, with wording such as:

The largest proportion of services provided on a charity basis was (describe service, such as cancer, emergency services, for the homeless, etc.).

Alternative or additional statistical disclosure, including information about the relative significance of charity service, such as the following may be included:

In 19x1, of a total of xxx inpatients, xxx received their entire episode of service on a charity basis and xxx received a partial subsidy. In 19x2, of a total of xxx inpatients, xxx full charity and xxx partial charity cases were served.

3. Support received

Funds for the support of charity service were received from (name or describe the source). The amount received was \$xx,xxx in 19x1 and \$xx,xxx in 19x2. These amounts are included in other revenue.

Disclosure of shortfalls can also be made, avoiding indication that the shortfall amount is charity service.

In addition to charity service, services are provided under the XYZ program to financially needy patients. The payments received under this program are less than the cost of providing the service. The unpaid cost of this program was \$xx,xxx in 19x1 and \$xx,xxx in 19x2. The cost estimate is based on the charges attributable to providing these services.

X. Appendix B

ALTERNATIVES FOR PLACEMENT OF REFERENCES TO CHARITY SERVICE NOTE
 SAMPLE NOT-FOR-PROFIT HOSPITALS
 Statement of Operations
 Year Ended December 31, 19XX (000's Omitted)

| | Current Year | Previous Year |
|---------------------------------------|--------------|---------------|
| Patient service revenue--(Note A) | \$ xx,xxx | \$ xx,xxx |
| Other revenue | <u>x,xxx</u> | <u>x,xxx</u> |
| Total revenue | xx,xxx | xx,xxx |
| Less expenses--(Note B) | | |
| Salary and wages | xx,xxx | xx,xxx |
| Employee benefits | xx,xxx | xx,xxx |
| Fees to individuals and organizations | x,xxx | x,xxx |
| Supplies and other expenses | xx,xxx | xx,xxx |
| Purchased services | x,xxx | x,xxx |
| Depreciation | x,xxx | x,xxx |
| Interest | <u>xxx</u> | <u>xxx</u> |
| Total expenses (Note B) | xx,xxx | xx,xxx |
| Income from operations | x,xxx | x,xxx |
| Nonoperating gains and losses, net | x,xxx | x,xxx |
| Increase in unrestricted net assets | \$ x,xxx | \$x xxx |

(A) Placement of reference to charity service note if the note includes information about charges foregone.

(B) Alternatives for placement of reference to charity service note if the note includes information about cost.

NOTE: Reference to the charity service note in more than one place on the operating statement is appropriate if more than one type of information about charity service is included in the note.

NOTE: The operating statement of a for-profit or governmental entity will have different financial statement line item descriptions.

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Footnotes

1. L. Vann Seawell, Hospital Financial Accounting Theory and Practice (Chicago: HFMA, 1975) p. 270.
2. There are a variety of state and local charity service reporting requirements. Description of these ever-changing reporting requirements is beyond the scope of this statement.
3. Financial assistance which may require information about the provision of charity service includes construction assistance under Titles VI or XVI of the Public Health Service Act (usually referred to as the Hill-Burton program), qualification for certificate of need approval in some states, or eligibility for funds from taxes specified to support the provision of charity service.
4. Examples of institutional healthcare providers are hospitals, continuing care retirement communities, skilled nursing facilities, subacute care facilities, multispecialty clinics, and freestanding ambulatory centers.