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The New Revenue Recognition Accounting Standard

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Agenda

- Overview
- New Standard
- Impact of Standard
- Transition Planning

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Overview

Movement to Global Accounting Standards

Phase 1: FASB / IASB Convergence Projects

- Revenue Recognition
- Business Combinations
- Financial Instruments
- Leases
- Fair Value

Revenue Recognition Project

- FASB and IASB are in the final stages of issuing the revenue recognition standard
- New standard will supersede ***substantially all*** existing guidance
- Final standard is expected in May/June 2014

Revenue Recognition Project: Timeline Summary

- **2002**: Project commenced
- **2008**: Discussion paper issued for comment
- **June 2010**: Exposure draft issued
- **Nov. 2011**: Revised exposure draft issued
- **Nov. 2013**: Final FASB discussion of draft
- **May/June 2014**: Final standard expected
- **2017/2018**: Adoption of new standard
- **What happens over the next 2-3 years?**

Implementation Guidance

Revenue Recognition Project: Main Objectives

- More robust, principle-based framework
- Increased comparability across industries and capital markets
- Better disclosures of economics behind the numbers

Revenue Recognition: Current Accounting Guidance

- ~200 industry or transaction specific standards (“rules-based accounting”)
- For-profit
- Not-for-profit
- Governmental

New Standard

Revenue Recognition: 5 Steps

1. Identify the contract with a customer
2. Identify the separate performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the separate performance obligations
5. Recognize revenue when a performance obligation is satisfied

Step 1: Identify the contract with a customer

- A **contract with a customer must exist** to be within the scope of the model.
- Need to make a **qualitative assessment** of the facts and circumstances of the contract
- **Four key criteria**:
  - Commercial substance
  - Contract approval and parties committed
  - Rights identified
  - Payment terms identified

Step 1: Identify the contract with a customer

- **Collectability Threshold**:
  - Entity must conclude that it is ***probable*** that it will collect the consideration to which it will be ultimately entitled to in exchange for the goods and services that will be transferred to the customer.
  - "Probable" definition

What's the ability and intention of the customer to pay?

Step 1: Identify the contract with a customer

- **Collectability Threshold**:
  - Assessment is based on the consideration health care providers ultimately expect to be entitled to (after contractual allowances).
  - Health care providers ***may*** determine they do not have contracts with patients when the amounts billed largely consist of uninsured, self-pay balances.

Step 1: Identify the contract with a customer

- **Contracts that do not meet Step 1**:
  - Cash collected would be recorded as a liability until criteria is met.
  - Consideration received by the entity should not be recognized as revenue until performance is complete ***and*** either:
    1. All the consideration in the arrangement has been collected and is nonrefundable; or
    2. The contract is cancelled and the consideration received is nonrefundable.

Revenue Recognition: 5 Steps

1. Identify the contract with a customer
2. Identify the separate performance obligations in the contract
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Step 2: Identify the separate performance obligations in the contract

- An entity accounts for ***each*** distinct promised good or service as a separate performance obligation.
- Ensures that revenue recognition properly represents the transfer of goods or services to the customer over the term of the contract.

Step 2: Identify the separate performance obligations in the contract

- Account as separate performance obligation ***only*** if:
  1. Customer can benefit from the good or service either on its own or together with other resources that are readily available; ***and***
  2. The good or service is not highly dependent on, or highly interrelated with, other promised goods or services in the contract.
- Example: Surgery and follow-up visits

Revenue Recognition: 5 Steps

1. Identify the contract with a customer
2. Identify the separate performance obligations in the contract
3. Determine the transaction price
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Step 3: Determine the transaction price

- Transaction price is the consideration that the entity is entitled to under the contract, including variable or uncertain consideration.
- If a portion of the transaction price is variable or contingent on the outcome of future events, adjust the transaction price to reflect the uncertainty.
- Use a probability-weighted estimate or the most likely amount expected, whichever is the best predictor.

Step 3: Determine the transaction price

- Revenue should be measured at the amount of consideration to which the entity is entitled (i.e., an amount that is not adjusted for customer credit risk)
- Any corresponding bad debt expense arising from contracts with customers should be prominently presented as an expense
  - ***Supersedes ASU 2011-07***, which required some health care providers to present bad debts as a deduction from patient service revenue

Step 3: Determine the transaction price

- **Variable consideration**:
  - Medicare and Medicaid third party settlements
- **Recognition constraint**:
  - An entity shall include an estimate of variable consideration in the transaction price **to the extent it is probable** that a significant revenue reversal will not occur. A significant revenue reversal will occur if there is a significant downward adjustment on the amount of cumulative revenue recognized.

Revenue Recognition: 5 Steps

1. Identify the contract with a customer
2. Identify the separate performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the separate performance obligations
5. Recognize revenue when a performance obligation is satisfied

Step 4: Allocate the transaction price to the separate performance obligations

- Transaction price is allocated to separate performance obligations based on the relative standalone selling price.
- A residual value technique may be used when there is significant variability or uncertainty in the standalone selling price.

Step 4: Allocate the transaction price to the separate performance obligations

- **Example of Price Allocation**:
  - Patient A pays Provider B $10,000 for surgery and 2 follow up exams (valued at $250 each).
  - Provider B has two separate performance obligations: (1) Perform surgery and (2) Provide follow up exams.
  - Transaction price must be allocated as:
    - Surgery ($9,500) and follow up exams ($500)

Revenue Recognition: 5 Steps

1. Identify the contract with a customer
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5. Recognize revenue when a performance obligation is satisfied

Step 5: Recognize revenue when a performance obligation is satisfied

- Generally will occur at the same time service or good is provided
- When services are provided over time, follow “pattern of transfer”
- Continuous recognition appropriate when customer simultaneously receives and consumes the benefits that the entity performs

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Impact of Standard

Impact of New Revenue Recognition Standard

- **<u>Indigent and self-pay patients</u>**:
  - Exposure draft not clear whether or how health care entities should recognize revenue associated with indigent and self-pay patients
- **<u>Contracts with Medicare / Medicaid</u>**:
  - May use either most likely amount or expected value in estimating variable consideration, whichever is best predictor, while applying “recognition constraint”

Impact of New Revenue Recognition Standard

- **<u>Multiple Contractual Relationships</u>**:
  - One revenue transaction at a hospital can have multiple parties involved
  - Who is the customer?

    “Customer” is the patient

    - Third-party payors make payments on the patient’s behalf.

Impact of New Revenue Recognition Standard

- **<u>Financial Statements</u>**:
  - Revenue recognition (timing, etc.)
  - Classification of bad debt
  - Disclosures

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Transition Planning

When is the new standard coming?

- Final standard expected in May/June 2014
- Effective for ***public entities*** for fiscal years beginning after December 15, 2016
- Effective for ***nonpublic entities*** for fiscal years beginning after December 15, 2017
- Companies can transition to the new standard either retrospectively or as a cumulative-effect adjustment as of the date of adoption

What happens once issued?

- FASB/IASB joint transition resource group:
  - Will inform the IASB and FASB about interpretative issues
  - Will consist of various specialists
- AICPA Revenue Recognition Task Forces (Health Care and many other industries)

Ongoing implementation guidance

Where might you feel an impact?

- Payor contracts
- Controls and processes
- Technology
- Compensation and bonus plans
- Debt agreements/covenants

Preparing for Implementation

- Become familiar with the new standard
- Analyze revenue policies and procedures
- Analyze contracts to identify performance obligations and respective pricing and consider elements of standard when negotiating/drafting new contracts
- Evaluate the potential effect
- Consider transition method

Questions?

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