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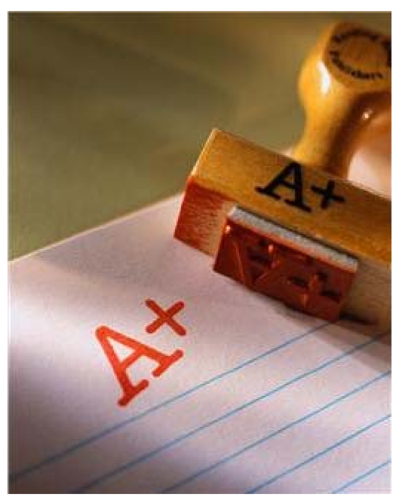
Revenue Recognition

ASU 2014-09 - Revenue From Contracts With Customers

Session Objective(s)

- Discuss and understand:
  - Objective of Changes to Revenue Recognition
  - Impact of Revenue Recognition Standard on Health Care Providers
  - Application of the Standard



ASU 2014-09 – Revenue from Contracts with Customers

- The revenue standard aims to improve accounting for contracts with customers by:
  - Removing inconsistencies and weaknesses in existing standards
  - Provide a robust framework for addressing revenue issues
  - Improve comparability of revenue recognition practices across entities and industries
  - Provide more useful information to financial statement users
  - Simplify preparation of financial statements by reducing requirements

Revenue Recognition (Topic 606)

- Objective
  - Establish principles an entity will apply related to reporting useful information to financial statement users regarding the uncertainty of revenue and cash flows from contracts with customers.
- Core Principle
  - An entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services

Convergence of International Guidance

Concept

Goal of the standard is to provide consistent revenue recognition practices for all industries and service lines consistent with international revenue recognition principles.

- Converged standard on revenue recognition related to contracts with customers was issued by the FASB and IASB in 2014 with subsequent technical implementation guidance provided in 2015 and 2016
- Guidance will be applicable to all entities and industries; supersedes virtually all industry specific guidance
- AICPA has created 16 industry specific taskforces, including healthcare, to deal with implementation
- Significant change to how revenue is recognized with expanded disclosure requirements
- Principles based standard with a ***five step process*** to recognize revenue when, or as, control of assets and the right to services is transferred

Revenue Recognition – Effective Date

Effective for reporting periods beginning on or after:

- December 15, 2017 for public companies (including NFP with conduit debt)
  - ◊ December 31, 2018/June 30, 2019
- December 15, 2018 for private companies and not-for-profit organizations
  - ◊ December 31, 2019/June 30, 2020
- Early implementation permitted for annual periods beginning after December 15, 2016 (the original public company effective date)

AICPA Revenue Recognition Task Force

Overall Status by Industry

Ref.	Industry	Total Number of Identified Implementation Issues	Submitted to AICPA RRWG	Submitted to FinREC	Submitted to FASB TRG (as applicable)	Total # Tech Corrections Submitted to FASB TRG	Posted to AICPA Website for Exposure	Resubmitted to AICPA RRWG	Resubmitted to FinREC	Finalized for Guides
1	A&D	13	13	11	1		10	9	9	9
2	Airlines	15	14	6			5	4		
3	Broker Dealers	9	6	6	1		3	3	1	1
4	Engineering & Construction	9	4	3	1		3			
5	Depository	2	1	1	1		1	1		
6	Gaming	16	12	7	1		7	4	3	1
7	Healthcare	9	8	3	1		2	2	2	2
8	Hospitality	8	4		1					
9	Insurance	3	2	1	1	1	1			
10	Investment Asset Management	9	8	8	1		4	4	4	2
11	Not-for-Profit	4	4	3		1	3	3	3	3
12	Oil & Gas	3	3							
13	Power Utility	11	11	1	1					
14	Software	13	7	6	1		6	1	1	1
15	Telecomm	12	12	7	2		3	3	1	
16	Timeshare	9	6	3			1			
	TOTALS	145	115	66	13	2	51	34	24	19

AICPA Revenue Recognition Task Force

Health Care Entities Revenue Recognition Task Force

	Implementation Issue and Summary	Status
1	Consideration of the following regarding self-pay balances:	
	Application of step 1 (determine if there is a contract) and step 3 (determine the transaction price) for healthcare services provided to self-pay patients, including uninsured patient balances and self-pay patient balances arising from co-payments and deductibles. This implementation issue will discuss evaluating whether a contract exists and what is the transaction price (including consideration of implicit price concessions) To arrangements for health care services provided to self-pay patients and balances arising from co-payments and deductibles.	Finalized to be included in the AICPA Guide Revenue Recognition
1A	**Implicit price concessions** This implementation issue, being submitted to the TRG, provides two views over the initial accounting for implicit price concessions for services provided to uninsured patients and two views for the subsequent accounting for these types of contracts and whether changes in the estimates of variable consideration represent changes in price concessions or impairments.	Submitted to FASB TRG
2	**Application of the portfolio approach to contracts with patients** This implementation issue will discuss how to apply the portfolio approach to revenue from self-pay patients and third party payors.	Finalized to be included in a future edition of the AICPA Guide Revenue Recognition
3	**CCRC: Identifying and satisfying the performance obligation(s) and recognizing the monthly/periodic fees and nonrefundable entrance fees under Type A or "life care" contracts for continuing care retirement communities** This implementation issue will discuss the performance obligations under a typical Type A (life care) continuing care retirement community (CCRC) resident agreement and, given these performance obligations, how a Type A CCRC will estimate a transaction price and recognize nonrefundable entrance fees and monthly/periodic fees received from residents under the new model.	Re-submitted to AICPA RRWG

Health Care Entities Revenue Recognition Task Force

	Implementation Issue and Summary	Status
4	**CCRC: Identifying the performance obligation(s) and recognizing the performance obligation(s) to provide future services and use of facilities** This implementation issue will describe the changes to a continuing care retirement community's calculation of the obligation to provide future services and use of facilities as a result of the new model.	Submitted to AICPA RRWG
5	**Significant financing component - CCRC contracts, and patient and third-party payor amounts in arrears** This implementation issue will discuss how CCRCs assess whether a significant financing component exists in determining the transaction price for its resident contracts, as well as how CCRCs and other healthcare entities will assess whether a significant financing component is applicable to patient and third-party payor amounts in arrears.	Submitted to AICPA RRWG
6	**Disclosure requirements of ASU No. 2014-09** This implementation issue will discuss judgements related to disclosure requirements under ASC 606 for health care entities.	Submitted to AICPA RRWG
7	**Accounting for contract costs** This implementation issue will discuss how health care organizations will account for certain costs of acquiring and fulfilling contracts under the new model.	Submitted to FinREC – September 2015
8	Consideration of FASB ASC 606, Revenue from Contracts with Customers, for third party settlement estimates	

What is principles-based?

- Based on an improved and consistently applied framework
- Clearly states the accounting objective of the standard
- Provide sufficient detail and structure so the standard can be operational and applied consistently
- Minimizes exceptions
- Requires judgment and can result in differences in application

Major Changes in Comparison to Current Guidance

- Focus is on the contract rather than on transactions of certain types or by certain industries
- Constraints on revenue
- Guidance on accounting for costs to obtain and fulfill a contract with a customer (if not addressed in other topics)
- Expanded disclosures

Revenue Recognition Exceptions

- All contracts with customers, <u>except</u>
  - Lease contracts
  - Insurance contracts
  - Financial instruments
  - Guarantees
  - Non-monetary exchanges in the same line of business to facilitate sales to customers
- Certain contracts not with customers are <u>excluded</u>:
  - Contributions
  - Collaborative arrangements

Revenue Recognition Application

Application of New Standard

- Prior to recognizing revenue, the customer's ability to pay and collectability must be assessed and determined to be reasonably assured
- Evaluation of existing contracts may indicate that transaction prices contain both fixed and variable components (such as discounts, contractual allowances, etc.)
- The variable component of the price must be estimated using either the "expected value" or a "most likely" approach
- An *estimate* of the variable component of the transaction price will be **included in the transaction price** when it is probable that this will not result in an "reversal" of the revenue in future periods.

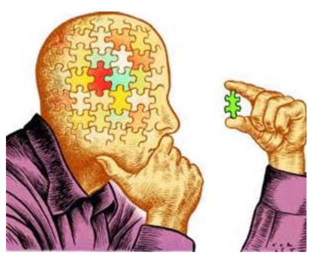
Revenue Recognition Five Step Process

Recognize revenue to depict the transfer of goods or services in an amount that reflects the consideration to which the entity expects to be entitled

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

Step 1 - The critical step-identify the contract

- FASB ASU 2014-09 defines a contract as “an agreement between two or more parties that creates rights and obligations”
- And, a contract must exist to recognize revenue under the standard



Step 1 - Identify the contract

Definition

A contract is an agreement between parties that creates enforceable rights and obligations and may be written, verbal or implied by customary business practices.

Revenue can be recognized only when **ALL** of the following are met:

1) Parties have an "approved" contract
2) The entity can identify each party's rights regarding goods or services to be transferred
3) The entity can identify payment terms for the goods or services transferred
4) Contract has commercial substance (expected change in cash flow)
5) It is ***probable*** that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services to be transferred

Approval and Commitment

- Approved by the parties to the contract
  - Written – patient responsibility, consent forms, etc.
  - Oral or implied - in accordance with customary business practices
- Determine that the patient or other payor is committed to perform their obligation (ability and intent to pay or services)
  - Inability to determine commitment to perform their obligation (payment) results in no contract

Payment terms are identified

- Not required to be fixed or stated
  - Implicit Price Concession
- Must be an enforceable right to payment
- Contract needs sufficient information to enable the entity to estimate the transaction price

Collectability

- Patient's ability and intent to pay the amount entity is entitled
  - Insured or uninsured?
  - Qualify for subsidies (Medicaid)?
  - Qualify for charity care?
- Collection must be probable
  - Probable definition is consistent with existing guidance
- International threshold is "more likely than not"

Step 2 - Identify performance obligations

Definition

A "performance obligation" represents the transfer of goods and services (or a bundle of goods or services) that is distinct.

At the inception of the contract with the patient, the entity will identify as a performance obligation each promise to transfer to a patient either:

1) A good or service that is distinct
2) A series of distinct goods or services that are substantially the same and that have the same patterns of transfer to the patient

Step 2 - Identify performance obligations

A good or service that is promised to a patient is distinct if **both** of the following criteria are met:

- The patient can benefit from the good or service either on its own or together with other resources that are available.
- The promise to transfer the goods or services to the patient are separately identifiable from other promises in the contract. (the promise to transfer the good or service is distinct within the context of the contract).

Note:

- If a promised service is not distinct, the entity should ***combine with other promised goods or services in a contract as a single performance obligation***.

Step 3 - Determining the transaction price

Definition

"The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a patient, excluding amounts collected on behalf of third parties."

Concept

The entity should project a revenue stream considering stand-alone prices as well as the amount of time estimated to be at each level of care.

To determine the transaction price, the entity should consider:

- Variable consideration
- Constraining estimates of variable consideration
- Existence of significant financing component
- Noncash consideration (measured at contract inception)
- Consideration payable to the patient

Step 3 - Determining the transaction price

Constraining Estimates of Variable Consideration

Variable Consideration: The expected value (probability-weighted amount) or most likely amount of consideration to which an entity is entitled

Variable consideration should be included in the transaction price only to the extent that it is probable that a significant reversal in the amount of cumulative revenue will **NOT** occur.

In making this assessment, the following should be considered:

- Uncertainty of the amount of consideration is not expected to be resolved for a long period of time.
- The entity's experience with similar contract types is limited (less predictive).
- The entity has a practice of offering a broad range of price concessions or changing payments terms and conditions.
- Contract has a large number and a broad range of possible consideration.

Step 3 - Determining the transaction price

Variable Consideration Examples

- Explicit price concessions
  - Third party payor adjustments
  - Sliding fee or financial assistance policy adjustments
- Implicit price concessions
  - Discounts on uninsured patients based on probability of collection
- Third Party Payors
  - Qualification under a commercial or governmental payor
  - Amount of reimbursement from a specific payor

Step 4 - Allocation of the transaction price

Concept

Allocation of the "transaction price" to the amount expected for each performance obligation within the patient contract

- Specific considerations:
  - Stand-alone purchase price-the price at which an entity would sell a promised good or service to the patient
  - Allocation of discount
  - Allocation of variable consideration
  - Change in transaction price

Step 4 - Allocation of the transaction price

ASU 2014-09 may be applied on an individual contract basis or a portfolio approach may be taken.

Guidance specifies that the standard should be applied based on the individual contract with the option of a practical expedient.

Practical Expedient:

- The guidance may be applied to a portfolio of contracts (or performance obligations) with similar characteristics **if it can be reasonably expected that the effects on the financial statements would not differ materially from applying this guidance to individual contracts within the portfolio.**
- An entity must use judgement in selecting the composition of the portfolio
- A quantitative analysis is not necessary . . .a reasonable approach to determine the portfolios would be acceptable
- A portfolio approach may be used in industries where a large number of similar contracts exist and applying the model individually may be impractical.

Step 4 - Allocation of the transaction price

Practical Expedient: permits the application of a reasonable approach to determine the portfolios that would be appropriate

- Consider all information (historical, current, forecasted) that is reasonably available to estimate the variable consideration
- Potential Portfolios
  - Types of services (inpatient, ancillary services, ER, physician visit)
  - Uninsured patients
  - Payment plans
  - Individual third party payors (often explicit price concession)
  - Deductibles and coinsurance (high deductible plans)
- Use of a portfolio of data is not the same as applying the portfolio practical expedient

Step 5 - Recognize revenue when performance obligation is satisfied

- Performance obligations are "satisfied" and revenue is recognized as "control" of the assets and services passes to the patient.
- Recognize when (or as) performance obligations satisfied, either:
  - Satisfied ***over time***
  - Satisfied at ***point in time***

Step 5 - Recognize revenue when performance obligation is satisfied

- Satisfaction ***over time*** occurs when one of the following occurs:
  - Patient receives and consumes benefit
  - The entity's performance creates or enhances an asset that the patient controls
  - An asset with an alternative use is not created, and the right to payment is completed

Step 5 - Recognize revenue when performance obligation is satisfied

- If not over time, then ***point in time***:
- Indicators of the transfer of control, among others:
  - Entity has right to payment
  - Customer has legal title
  - Entity has transferred physical possession
  - Customer has the significant risks & rewards of ownership
  - Customer has accepted the asset

Bad Debt, Charity Care and Other Adjustments

- Self Pay – current industry practice
  - Recognize revenue at gross charges
  - Recognize bad debt based on collection history
- Discounts provided to uninsured patients
  - Recognize as revenue deduction
- No revenue recognized for charity care
- ASU 2011-07 –
  - Uncollectible amounts are reflected as a deduction from revenue if revenue is recognized without assessing a patient's ability to pay (charity care)
  - Bad debt is presented as a deduction from patient service revenue

Price Concessions and Bad Debt Expense

- Explicit Price Concession
  - Generally based on contractual reimbursement or established schedules (third party payor, financial assistance policy)
  - Reflected as a contractual adjustment from gross revenue
  - Collection is not pursued
- Subsequent changes in expected collections, in the absence of an intent to provide an implicit price concession, are considered an impairment loss (bad debt)
  - Bad debt will be presented as an **operating expense**

Price Concessions and Bad Debt Expense

- Implicit Price Concession
  - Estimated transaction price based on likelihood of collection from historical experience (e.g. Allowance of 40%)
  - May continue to pursue collection
- Subsequent changes in expected collections are considered changes to the implicit price concession
  - Increase or Reduction in the **transaction price**
  - Exception if any adverse information is obtained regarding the patient's financial condition

Third Party Settlements

- Determination of Transaction Price for third party settlements
  - Medicare and Medicaid cost report settlements
  - RAC, EHR, other audit accruals

- Organizations should use method that is expected to better predict the amount of consideration to which it will be entitled

Accounting policy disclosures

- Qualitative disclosure will significantly expand accounting policy disclosure for revenue contracts
- Key elements will include;
  - Type of contracts
  - Identifying performance obligations
  - Price allocations
  - Satisfaction criteria
  - Related costs

Accounting policy disclosures

Disaggregation of revenue	• Disaggregate revenue into categories that depict how revenue and cash flows are affected by economic factors
Information about contract balances	• Opening and closing balances • Amount of revenue recognized from contract liabilities • Explanation of significant changes in contract balances • Revenue that was a liability at the beginning of the period • Revenue for performance obligations in previous periods
Remaining performance obligations	• Transaction price allocated to remaining performance obligations • Quantitative or qualitative explanation of when amounts will be recognized as revenue
Interim requirements	• All quantitative disclosures in annual and interim *(public entities only)*

Transition to the new standard

- Two methods allowed
  - Full retrospective
  - Modified retrospective
- Both utilize cumulative effects
- Each method has practical expedients which may or may not be applied
  - Accordingly, there will be many ways to adopt

Full retrospective method

- Cumulative effect adjustment on opening retained earnings as of the earliest year presented
- Apply to all existing contracts, however practical expedients are allowed
  - For completed contracts need not restate when contract begins & ends in the same period
  - For completed contracts with variable consideration, may use transaction price at completion of contract
  - For pre-application periods, need not disclose the amounts of the transaction price allocated to remaining performance obligations nor the explanation when entity expects to recognize that amount as revenue

Modified retrospective method

- Can apply the provisions for the period of initial application (don't restate prior years)
- However, additional disclosures required;
  - The amount by which each F/S line item is affected in the current period
  - An explanation of the reasons for significant changes
- Remember that either method is a change in accounting principle
  - For audits, a consistency "emphasis of matter" paragraph should be included in the report

Accountable Care Organizations

- Joint task force including HFMA Principles and Practices Board and AICPA Health Care Expert Panel
- Initial report issued addresses the following with limited specific guidance:
  - Shared savings/shared loss contracts
  - Capitation
  - Bundled Payments
  - Pay-for-performance contracts
  - Risk pools

Self Pay Contract - Example 1

- Services are provided to a patient without assessing the patient's ability to pay at the time of the service
- During the provision of services it is determined the patient does not have insurance and does not qualify for financial assistance
- Standard charges for the services provided are $5,000, which are billed to the patient.
- The Hospital will pursue collection of the entire amount, but expects to collect less than the customary charge for services provided, resulting in variable consideration
- Payment of $1,000 is expected based on historical collection experience.

Self Pay Contract - Example 1 (continued)

- The Hospital concludes it is probable it will collect $1,000
- Collection is considered probable and all other steps are met, therefore the Hospital records revenue and a receivable of $1,000

Standard Charges	5,000
Implicit Price Concession	(4,000)
Transaction Price (expected collection)	1,000
Accounts Receivable	5,000
Allowance for Uncollectible Accounts	(4,000)

- Revenue is reflected at the determined transaction price of $1,000. There is no distinction between gross and net revenue.

Self Pay Contract - Example 1 (continued)

- The Hospital is required to update the estimated transaction price of variable consideration at the end of each reporting period.
- The Hospital has additional information to update its estimate of the transaction price.
  - It is subsequently determined it may collect $1,100, resulting in a reduction in the implicit price concession.
  - The Hospital subsequently collects only $900. The difference between the original estimate and amount collected are reflected as an increase in the implicit price concession
- The intent of the Hospital to provide an implicit price concession results in reflecting as a change in the implicit price concession

Self Pay Contract - Example 2

- Services are provided to a patient without assessing the patient's ability to pay at the time of the service
- During the patient's stay the Hospital determines the patient does not have insurance but qualifies under the financial assistance policy and grants a 75% discount.
- Standard charges for the services provided are $10,000. Upon billing, the charges are discounted by 75% or $7,500.
- The Hospital will pursue collection of the entire undiscounted amount of $2,500.
- Historical experience indicates they will collect 10% of the bill.

Self Pay Contract - Example 2 (continued)

- An explicit price concession is recognized for $7,500
- An implicit price concession is recognized for $2,250
- The Hospital concludes it is probable it will collect $250
- Collection is considered probable and all other steps are met, therefore the Hospital records revenue and a receivable of $250

Standard Charges	10,000
Implicit Price Concession	(2,250)
Transaction Price	7,750
Discount(Explicit Price Concession)	(7,500)
Expected Collection	250
Accounts Receivable	2,500
Allowance for Uncollectible Accounts	(2,250)

- Subsequent changes in estimates and activity for the account are recorded the same as in Example 1.

Self Pay Contract - Example 3

- An uninsured patient schedules elective surgery with a provider that has a policy of performing prior credit assessments
- The provider assesses the patient's ability to pay and reduces the price of the surgery from $5,000 to $4,000. The $1,000 is considered a contractual adjustment and netted against revenue
- 100% of the remaining cost is expected to be received from the patient based on the credit assessment.

Standard Charges	5,000
Explicit Price Concession	(1,000)
Implicit Price Concession	0
Transaction Price (expected collection)	4,000

- An implicit price concession is not intended to be made by the provider. Therefore, any amount of the remaining balance that is not collected represents an impairment loss (bad debt)

Third Party Payor - Example 4

- A Hospital provides services to a patient covered by health insurance and a deductible. The insurance contract results in a reduction of 40% of gross charges, and the patient has a deductible of $1,000.
- Standard charges are $10,000, therefore $4,000 will be reflected as a contractual adjustment.
- $5,000 due under the insurance contract will be recorded as revenue and a receivable.
- Collection of the $1,000 patient deductible will be assessed based on historical experience and the amount expected to be collected will be recorded as revenue and a receivable (assume 40% collection history).

Third Party Payor - Example 4 (continued)

Standard Charges	10,000
Contractual Adjustment (Explicit Price Concession)	(4,000)
Implicit Price Concession	(600)
Expected Collection (Revenue)	5,400

Accounts Receivable	10,000
Allowance for Uncollectible Accounts	(600)
Contractual Allowance	(4,000)

- Subsequent changes to the estimated implicit price concession will be recorded as in Example 1.

Portfolio Approach

- The portfolio practical expedient is allowed if it can be reasonably expected that the effects on the financial statements would not differ materially from applying this guidance to individual contracts within the portfolio.
- In establishing a portfolio, FASB ASC 606 permits the application of a "reasonable approach to determine the portfolios that would be appropriate for its type of contracts"
- Guidance is provided for considerations in grouping contracts with similar characteristics, however, specific guidelines are not established.

Portfolio Approach

- Considerations provided in grouping contracts with similar characteristics into a portfolio:

- Type of service:
  - Inpatient, outpatient, skilled nursing, home health, emergency room, elective procedures, non-elective procedures, physician practice, etc.
- Type of payor:
  - Commercial insurers, Medicare, Medicaid, uninsured, etc.
- Type of patient responsibility:
  - Uninsured self-pay, deductible, co-pay, high deductible plan, etc.

Develop an implementation plan

- Identify potential explicit and implicit price concessions
- Establish portfolios for estimating price concessions
- Evaluate system capabilities for recording and generating information for financial reporting
- Create tools and processes for recording and reporting revenue

Questions?

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