Healthcare Revenue Recognition

Crowe® Healthcare Webinar Series
Today’s Health Care Industry Speakers

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Overview

- New Guidance
  - Broad sweeping or much to do about nothing?
  - Health Care Task Force developing interpretive guidance
Key Discussion Points for Today’s Program

- Convergence
- New Five-Step Model to Recognize Revenue
- Bad Debt Expense
- Contract Costs
- Continuing Care Retirement Communities
- Footnote Disclosure Requirements
- Transition
- Guidance Resources
- Implementation Recommendations
- Crowe Revenue Cycle Analytics (RCA) & Revenue Recognition
Convergence

Why are the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) issuing this new standard?

• Improve comparability among similar transactions
• Increase the usefulness of information for financial statement users via more in-depth financial statement disclosures
• Reduce the number of different standards that a financial statement preparer must refer to for guidance
• Develop a common U.S. GAAP and IFRS standard
New Five-Step Model to Recognize Revenue

What is considered revenue?

Revenue is defined as “inflows and other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity’s ongoing major or central operations.”

-- Accounting Standards Codification (ASC) 606-10-20
New Five-Step Model to Recognize Revenue (continued)

- **Core principle**: 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 or services.
New Five-Step Model to Recognize Revenue (continued)

1. Identify the contract(s) with the customer.
2. Identify the separate performance obligations in the contract(s).
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract(s).
5. Recognize revenue when (or as) the entity satisfies a performance obligation.
New Five-Step Model to Recognize Revenue (continued)

• Identify the contract(s) with the customer.

A contract:
- An agreement between two or more parties that creates enforceable rights and obligations
- May be oral or even implied by the organization's customary business practices.

Under the model, a contract exists when all criteria are met:
- The contract is approved by both parties;
- Each party's rights to transfer the goods or services can be identified;
- The payment terms for the goods or services can be identified;
- The contract has commercial substance;
- It is probable the entity will collect the consideration to which it will be entitled to. In evaluating whether collectability of an amount of consideration is probable, an entity shall consider only the customer's ability and intention to pay that amount when due. The amount of consideration may be less than the price stated in the contact if the consideration is variable because the entity may offer the customer a price concession.

If a contract does not meet the criteria, an entity would continue to reassess
An entity shall assess the goods or services promised in a contract with a customer and shall identify as a performance obligation each promise to transfer to the customer.

- Identify goods or services that are distinct
- Guidance specifies accounting for contracts on an individual basis
- As a practical expedient, an entity may apply this guidance to a portfolio of contracts (or performance obligations) with similar characteristics if the entity reasonably expects that the effects would not differ materiality from applying this guidance to each individual contract within the portfolio. When accounting for a portfolio, an entity shall use estimates and assumptions that reflect the size and composition of the portfolio.
New Five-Step Model to Recognize Revenue (continued)

3. **Determine the transaction price.**

**Transaction price:**
- The amount of consideration in a contract to which an entity expects to be entitled in exchange for transferring goods or services to a customer.

**Variable consideration:**
- If the consideration price can vary, an entity estimates the amount of consideration to which it will be entitled in exchange for the promised goods or services. The estimated amount of variable consideration will be included in the transaction price only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is subsequently resolved.
- The transaction price must be estimated and updated at each reporting date.
Constraining Estimates of Variable Consideration:

- In assessing whether it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur once the uncertainty related to the variable consideration is subsequently resolved, an entity shall consider both the likelihood and magnitude of the revenue reversal. Factors that could increase the likelihood or the magnitude of a revenue reversal include, but are not limited to, any of the following:
  - The amount of consideration is highly susceptible to factors outside the entity’s influence (market volatility, judgment or actions of third-parties, etc.)
  - The uncertainty about the amount of consideration is not expected to be resolved for a long period of time
  - The entity’s experience (or other evidence) with similar types of contracts is limited, or that experience has limited predictive value
  - The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances
  - The contract has a large number or broad range of possible consideration amounts
New Five-Step Model to Recognize Revenue (continued)

4. Allocate the transaction price to the performance obligations in the contract(s).

- The transaction price should be allocated to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the seller expects to be entitled in exchange for transferring the good or service to the customer.

- If more than one performance obligation exists, consideration should be allocated based on the relative stand-alone selling prices of the goods or services at the inception of the contract.
New Five-Step Model to Recognize Revenue (continued)

5. Recognize revenue when (or as) the entity satisfies a performance obligation.

- Basic principle:
  - Revenue is recognized when (or as) performance obligations are satisfied by transferring a promised good or service (that is, an asset) to a customer.
  - Performance obligations may be satisfied either at a single point in time or over a period of time.
  - A good or service is transferred over time and revenue is recognized over time if one of the following criteria is met:
    - The customer simultaneously receives and consumes the benefits provided by the entity’s performance as the entity performs.
    - The entity’s performance creates or enhances an asset that the customer controls as the asset is created or enhanced.
    - The entity’s performance does not create an asset with alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.
New Five-Step Model to Recognize Revenue (continued)

Accounting Standards Update No. 2014-09:

Paragraph 606-10-25-1 = Step 1 = a contract does not exist under the standard since the parties are not able to identify the payment terms; the transaction price for the amount of consideration to be collected is not known or probable.

Paragraph 606-10-25-6 = An entity shall continue to assess the contract to determine whether the criteria in Step 1 are subsequently met (and the entity is able to recognize revenue).
New Five-Step Model to Recognize Revenue (continued)

- Credit risk evaluation
- Payor class assessment
- Transaction price:
  - Customary business practices
  - Variable consideration constraints
- Credit risk evaluation
- Revenue recognition

606-10-55-103 After providing services, the entity obtains additional information about the patient including a review of the services provided, standard rates for such services, and the patient’s ability and intention to pay the entity for the services provided. During the review, the entity notes its standard rate for the services provided in the emergency room is $10,000. The entity also reviews the patient’s information and to be consistent with its policies designates the patient to a customer class based on the entity’s assessment of the patient’s ability and intention to pay. The entity determines that the services provided are not charity care based on the entity’s internal policy and the patient’s income level. In addition, the patient does not qualify for governmental subsidies.

606-10-55-104 Before reassessing whether the criteria in paragraph 606-10-25-1 have been met, the entity considers paragraphs 606-10-32-2 and 606-10-32-7(b). Although the standard rate for the services is $10,000 (which may be the amount invoiced to the patient), the entity expects to accept a lower amount of consideration in exchange for the services. Accordingly, the entity concludes that the transaction price is not $10,000 and, therefore, the promised consideration is variable. The entity reviews its historical cash collections from this customer class and other relevant information about the patient. The entity estimates the variable consideration and determines that it expects to be entitled to $1,000.

606-10-55-105 In accordance with paragraph 606-10-25-1(e), the entity evaluates the patient’s ability and intention to pay (that is, the credit risk of the patient). On the basis of its collection history from patients in this customer class, the entity concludes it is probable that the entity will collect $1,000 (which is the estimate of variable consideration). In addition, on the basis of an assessment of the contract terms and other facts and circumstances, the entity concludes that the other criteria in paragraph 606-10-25-1 also are met. Consequently, the entity accounts for the contract with the patient in accordance with the guidance in this Topic.
New Five-Step Model to Recognize Revenue (continued)

What are the implications for Health Care Entities?

- Re-assessment of revenue recognition accounting policies and procedures; align with your customary business practices.
- Greater analysis and documentation of contract types and their performance obligations
- Consideration of variable constraint estimates, including patient responsibility amounts and assessing their intent and (financial) ability, qualifying patients for assistance programs, price concessions and discounts offered, charity care, etc.
- Assessing current portfolio models for size and composition; it is anticipated most organizations will need to disaggregate their current grouping levels and/or classifications.
- Potential for revenue recognition delays (“outside the model”)
- See the Guidance Section for nine implementation issues by the RRWG
New Five-Step Model to Recognize Revenue (continued)

Application of the portfolio approach

- Requires significant judgments
- Can be useful to predict outcomes (estimate a transaction price)
- Monitor and periodically update for changes in collection patterns / reimbursements
- Assess the effectiveness of the overall portfolio composition; maintain documentation to support that it does not materially differ from applying an individual contract approach.
- Characteristics for grouping individual contracts (performance obligations) can include:
  - Type of service - inpatient, outpatient, emergency room, elective procedures, non-elective procedures, physician practice, skilled nursing, home health, etc.
  - Type of payor - insurance contract (Blue Cross, Aetna, Emblem Health, etc.), governmental programs (Medicare, Medicaid, etc.), uninsured self-pay, etc.
  - Type of patient responsibility - uninsured self-pay, co-pay, deductible, etc. May also consider the size of co-pay or deductible (for example, high deductible)
  - Whether contracts are entered into at or near the same time (same quarter)
  - Geography of service locations or networks
Bad Debt Expense

- **Current guidance:** the collectability assessment does not affect revenue recognition; it only affects the presentation of bad debt expense on the income statement.

- **New standard:** bad debt expense will be classified as an operating expense for all entities; a reduction in the amount of bad debt expense recognized is anticipated. Note: Charity care is not impacted by this new standard.

- **Reminder:** when collection is probable, the amount of revenue recognized will be based on the estimated transaction price.

- **Effect:** This could significantly decrease gross revenue and change the presentation of revenue and bad debt expense in an organization’s financial reporting.
Contract Costs

- The new standard includes specific guidance for accounting for certain costs related to obtaining or fulfilling a contract with a customer.

- Incremental costs of obtaining a prepaid healthcare services contract will be recognized as an asset going forward.

- In many cases, costs which have been expensed in the past will be capitalized.

- Capitalized costs will be amortized in a manner consistent with the pattern of the transfer of goods or services to which the asset is related.
  - Practical expedient to expense cost if the period of amortization is less than one year.

- Impairment of any recorded asset will be subject to an ongoing assessment.
Contract Costs (continued)

- Example situation:
  - A CCRC incurs the following costs to obtain an entrance fee contract that will provide for future services over the life of the resident
  - The CCRC has determined that the costs incurred would be recoverable from the fees generated from the contract
  - Incremental costs to obtain a contract:
    - Sales commission to employees directly related to the contract $10,000
    - External legal fees for due diligence 5,000
    - Actuarial report 1,000
      - Total costs incurred $16,000

- How are these costs treated?
  - Sales commission is capitalized
  - Actuarial report and legal fees are expensed
Contract Costs (continued)

- Example – Amortization and Impairment
  - CCRC has capitalized $10,000 of contract acquisition costs
  - What is the amortization period?
    - Need to consider the pattern of transfer of services:
  - Option 1:
    - Allocate the costs based on transaction price of multiple performance obligations
    - Performance Obligation | Transaction Price Allocation | Expected years
      Independent Living | 50% | 2
      Assisted Living | 20% | 2
      Skilled Nursing | 30% | 2
  - Option 2:
    - Amortize the single contract cost asset using the weighted-average that reflects the “use” of the asset
    - May result in similar pattern of amortization as above but with no specific allocation to individual performance obligations
  - Impairment: Contract termination would result in write-off of remaining unamortized contract costs
Continuing Care Retirement Communities

- Various types of contracts
  - Promises of care
  - Use of facilities
  - Blend

- Contracts that include healthcare services will have the most impact under the new standard
  - Care under this model would be back loaded when the resident needs nursing care
  - Revenue would also be recognized more at the end of the contract to match the expected level of services provided
Continuing Care Retirement Communities (continued)

- The following CCRC issues are being considered by the RRWG as they relate to the transaction price of contracts:
  - Aggregation of fees and recognition of revenue
  - Time value of money – financing component
  - Contract refunds limited to the proceeds from reoccupancy
  - See the Guidance Section for implementation issues by the RRWG
Footnote Disclosure Requirements

It is anticipated health care organizations will experience a significant increase in their footnote disclosures from current practices!

606-10-50-1 The objective of the disclosure requirements is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. To achieve that objective, an entity shall disclose qualitative and quantitative information about all of the following:

a) Its contracts with customers (see paragraphs 606-10-50-4 through 50-16)
b) The significant judgments, and changes in the judgments, made in applying the guidance in this Topic to those contracts (see paragraphs 606-105-50-17 through 50-21)
c) Any assets recognized from the costs to obtain or fulfill a contract with a customer in accordance with paragraph 340-40-25-1 or 340-40-25-5 (see paragraphs 340-40-50-1 through 50-6).
Footnote Disclosure Requirements (continued)

New qualitative and quantitative disclosure requirements:

- Disaggregation of revenue
  - How are the nature, amount, timing and uncertainty of revenue and cash flows impacted by: geographic considerations, types of contracts (fee-for-service, per diem, per case, episodic, etc.), segments and / or lines of service (hospital, physician services, home health, nursing home and senior care, etc.).
  - Nonpublic entities may elect to provide alternate disclosures to comply

- Information about contract balances
  - Opening and closing balances of receivables, revenue recognized and reported
  - Nonpublic entities may elect to provide alternate disclosure to comply

- Enhanced information about performance obligations
Footnote Disclosure Requirements (continued)

New qualitative and quantitative disclosure requirements:

- Enhanced information about remaining performance obligations with an original expected duration of more than one year
  - Nonpublic entities may elect not to provide these disclosures

- Significant judgments and changes in judgments
  - Nonpublic entities may elect not to provide certain of these disclosures

- Assets recognized for contract costs
  - Nonpublic entities may elect not to provide these disclosures
Transition

**Effective date of new standard:**

- Public entities, certain not-for-profit organizations, and certain employee benefit plans: annual or interim reporting periods beginning after Dec. 15, 2017. (Early adoption as of the original effective date of Dec. 15, 2016, is permitted.)

- All other entities: annual reporting periods beginning after Dec. 15, 2018, and interim reporting periods beginning after Dec. 15, 2019. (Early adoption is permitted, but it can be no earlier than the effective date permitted for public entities.)
Transition (continued)

Two accounting methods for adoption:

- Retrospectively apply the new standard to each prior reporting period presented, with the following practical expedients that may be elected:
  - For completed contracts, do not have to restate if they begin and end in same year
  - For completed contracts having variable consideration, may use the transaction price at the date the contract was completed (rather than estimating variable consideration)
  - For all reporting periods presented before the date of initial application, do not have to disclose the amount of the transaction price allocated to remaining performance obligations and the explanation of when the entity expects to recognize that amount in revenue

- Retrospectively apply the new standard with the cumulative effect recognized in the opening balance of retained earnings at the date of initial application:
  - Comparative periods would not have to be restated
  - New rules would apply only to contracts uncompleted at the date of initial application
  - Additional disclosures required about the amount by which each financial statement line item is affected in the current period compared with the guidance that was in effect before the change, along with explanation of the reasons for significant changes
Guidance Resources

Governance:
- FASB’s Transition Resource Group ("TRG")
- AICPA’s Revenue Recognition Task Forces
  - Financial Reporting Executive Committee ("FinREC")
  - Revenue Recognition Working Group ("RRWG"); Health Care Entities Task Force

Accounting standards updates:
- Revenue recognition implementation issues posted on the AICPA Revenue Recognition Center at: [www.aicpa.org/revenuerecognition](http://www.aicpa.org/revenuerecognition)
- Industry specific implementation guidance to be published by the AICPA, including Health Care Entities
- Two working drafts are currently available (Aerospace and Defense & Investment Management)
Guidance Resources (continued)

- AICPA's Revenue Recognition Implementation – RRWG

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Source: [www.aicpa.org/FRC](http://www.aicpa.org/FRC); October 15, 2015
Guidance Resources (continued)

The Health Care Entities Task Force - Implementation Issues.

- **Purpose**: charged with developing revenue recognition implementation issues that will provide helpful hints and illustrative examples for how to apply the new Revenue Recognition Standard.
- **Patient balance focus** (uninsured and/or self-pay)
- **Application of portfolio approach**
- **Disclosure requirements**

Source: [www.aicpa.org/revenuerecognition](http://www.aicpa.org/revenuerecognition); September 21, 2015
Guidance Resources (continued)


Implementation Recommendations

Questions for consideration:

- How does my organization determine if a contract exists with a patient or customer?
- What is the process (and frequency) for monitoring credit risk?
- Are credit risk assessments made at the individual contract or portfolio level and how is this documentation maintained?
- How are credit risk assessments validated?
- What types of variable considerations and constraint factors does my organization experience? How are they identified, monitored, and reported?
- How frequently does my organization assess the appropriateness of the portfolio classifications? How are these classification validated and documented?
- If revenue recognition should be deferred, does my organization have ample resources and reporting protocols to monitor when the unknown factor(s) are resolved for revenue to be recognized?
Implementation Recommendations (continued)

What entities should consider doing now:

- Form an implementation task force
  - Include various departments, such as accounting, finance, billing, legal, tax, and IT.
- Consider training needs
  - The task force and others in the organization to develop expertise in the new standard
- High-level impact assessment
  - Compare current policies and disclosures with new requirements to assess pervasiveness of change implementation.
  - Evaluate existing contracts and their performance obligations;
  - Portfolio model assessment
- Begin making (and documenting) new judgments required
- Select the transition method to use
  - May impact implementation timing and any new systems that may need to be in place
Implementation Recommendations (continued)

What entities should consider doing now:

- Consider disclosure requirements
  - How information will be collected
  - For nonpublic entities, which elections will be made to forgo certain requirements
- Consider possible changes to systems or processes
  - How information will be gathered and reported and internal controls over those processes
- Consider the impact on financial and business practices
  - Discussions needed with creditors and other financial statement users
  - Impact on agreements tied to revenue (for example, incentive compensation agreements)
- Consider tax implications of changes
  - Impact on current and deferred taxes and related cash flows
- Consult with your accounting firm on adopting best practices
Crowe Revenue Cycle Analytics (RCA) & Revenue Recognition

- Crowe RCA is well positioned to adapt to updated Revenue Recognition standards

- Actively working with members of the AICPA’s Health Care Entities Task Force as their implementation guide is being developed

- We anticipate Crowe RCA clients may need to analyze payor portfolios for increased concentrated sample sizes
  - Insurance Provider, Financial Class, & System Insurance Provider Payor Groups
    - Primary vs Secondary Balances
    - True Self Pay vs. Self Pay After Insurance
    - Charity
    - Capitation
    - Portfolios by Self Pay by Credit Score

- Functionally to defer revenue for contracts / portfolio classes that do not qualify for recognition
Closing Remarks

- Broad sweeping changes or much to do about nothing?
Questions?
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