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The new revenue recognition standard

Five questions healthcare organizations should be asking now

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As many financial leaders are already aware, the rules for recognizing revenue are changing.

In 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, "Revenue From Contracts With Customers (Topic 606)."

When the new ASU becomes effective within the next two years, the changes it mandates will affect every healthcare organization in the United States that enters into contracts with patients. Healthcare financial leaders need to gain an understanding of the new rules; determine how these rules affect their recognition, measurement, and disclosure of revenue from contracts with customers; and develop plans and strategies for adopting the new rules as effectively and efficiently as possible.

Seeking answers now to the following questions can lay the groundwork for a more effective and efficient transition when the new standard is fully implemented.

Do you have an understanding of key terminology under the new standard?

Without a thorough understanding of the ASU's context, an organization will not be able to respond successfully. Terminology in the new guidance includes:

- **Transaction price.** The new ASU requires an entity to determine the transaction price, which is the amount of consideration to which the provider expects to be entitled in exchange for transferring promised goods or services to a customer. Under the new standard, revenue recognition will be based on transaction price.
- **Performance obligation.** The ASU defines a performance obligation as a promise to transfer to the customer a good or service (or a bundle of goods or services) that is distinct. "Distinct" is determined by whether the customer benefits from the good or service on its own or together with other readily available resources.
- **Variable consideration.** This includes all consideration that is subject to uncertainty for reasons other than customer credit risk. Examples include discounts, rebates, refunds, credits, incentives, performance bonuses and penalties, contingencies, and price concessions.
- **Implicit price concession.** In situations where services are provided to uninsured patients, the transaction price for revenue reporting purposes is likely to be much less than it would be when contracting with an insured patient. When this is the case, an implicit concession occurs. Often in these cases, hospitals providing services to uninsured patients do so knowing they will collect only a portion of the patient's charges. Under the new guidance, the transaction price may be estimated using a portfolio of contracts, based on an average of amounts historically collected from that patient class.

When does a contract exist?

The ASU requires that all of the following criteria be met in order for it to be determined that a contract exists:

- The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to performing their respective obligations.
- The parties can identify each party's rights with respect to the goods or services to be transferred.
- The parties can identify the payment terms for the goods or services to be transferred.
- The contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract).
- It is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer.

If any of these criteria are not met, an entity cannot determine that a contract exists. In addition, until both a valid contract exists and the transaction price can be estimated, revenue recognition will be deferred.

Will systems or processes need to be changed within the healthcare organization?

Some healthcare organizations will be able to modify their legacy systems to reflect the new revenue recognition guidance, while others might see the accounting change as a catalyst for implementing systems that are better able to manage the complexity of the new standard. Also, an organization may have to adopt new internal controls or modify existing controls to help verify the completeness and accuracy of the information being used for the application of the new guidance.

Significant changes in the timing and the amount of revenue recognized could change key performance indicators. Healthcare financial leaders need to develop an internal and an external communication plan to educate financial statement users about the anticipated impact of the new rules. Affected areas might include debt covenant compliance, sales commissions, bonuses, or other incentive plans. Contracting and pricing practices may need to be reconsidered.

Has the healthcare organization begun making and documenting the new judgments required?

Significant judgments may include the following:

- Should constraints be applied to the transaction price when variable consideration is a factor?
- How will stand-alone selling prices be determined when the transaction price must be allocated among performance obligations?
- When is a performance obligation satisfied?

Which transition option will the healthcare organization use?

ASU 2014-09 provides two methods to apply the changes resulting from the application of the new rules. The FASB allows public and nonpublic entities to elect either option. One option allows an organization to retrospectively apply the new revenue recognition standard to each prior reporting period presented. The other option allows an entity to adopt the new guidance retrospectively with the cumulative effect recognized in the opening balance of retained earnings at the date of initial application. Comparative periods presented would not have to be restated.

The new standard replaces nearly all existing U.S. generally accepted accounting principles (GAAP) rules related to revenue recognition and disclosure. The far-reaching guidance will affect nearly every U.S. organization. Although the impact will be more limited for some organizations than others, executives at all types of organizations need to consider the effects of the new rules on their particular situations.

Learn more

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