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Health Care Providers Spotlight

Navigating the New Revenue Standard

In This Issue:

The Bottom Line

- On May 28, 2014, the FASB and IASB issued their final standard on revenue from contracts with customers. The standard, issued as ASU 2014-09[1] ("the ASU") by the FASB and as IFRS 15[2] by the IASB, outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance.
- The ASU's requirements related to variable consideration may affect how health care providers account for arrangements that contain significant price adjustments (e.g., contractual allowances, discounts, and concessions) and will require substantial estimation and judgment on behalf of management.
- The ASU's guidance on collectibility may affect the timing of revenue recognition when credit risk is not assessed until after services are performed (e.g., emergency room visits).
- In addition to considering the ASU's potential impact on their accounting policies, entities should begin assessing which transition approach — as well as which adoption date, in the case of private companies and some not-for-profit entities — is most appropriate for them. When performing this assessment, entities should weigh factors such as resource requirements and the needs of financial statement users.

The ASU's guidance on collectibility may affect the timing of revenue recognition when credit risk is not assessed until after services are performed.

[1] FASB Accounting Standards Update No. 2014-09, *Revenue From Contracts With Customers.*
[2] IFRS 15, *Revenue From Contracts With Customers.*

Beyond the Bottom Line

This *Heath Care Providers Spotlight* discusses the new revenue model and highlights key accounting issues and potential challenges for health care providers that account for revenue under U.S. GAAP. For additional information about the new standard, see Deloitte's May 28, 2014, *Heads Up*.

Thinking It Through

The ASU supersedes the industry-specific revenue and cost guidance in ASC 954-605[3] and ASC 954-720, respectively. However, the FASB retained a portion of ASC 954-605 to provide guidance on health care providers' recognition of revenue from contracts that are outside the scope of the ASU (i.e., contributions from related fund-raising entities and charity care). In addition, the ASU does not supersede the industry-specific loss contract accounting in ASC 954-440 and ASC 954-450.

Background

The goals of the revenue recognition project are to clarify and converge the revenue recognition principles under U.S. GAAP and IFRSs and to develop guidance that would streamline and enhance revenue recognition requirements while also providing "a more robust framework for addressing revenue issues." The boards believe that the standard will improve the consistency of requirements, comparability of revenue recognition practices, and usefulness of disclosures.

As a result of the ASU, entities will need to comprehensively reassess their current revenue accounting and determine whether changes are necessary.

The ASU retains the overall model originally proposed, which outlines five sequential steps to recognizing revenue:

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.

The ASU states that the core principle of the new revenue recognition guidance is that an "entity shall 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."

Thinking It Through

As a result of the ASU, entities will need to comprehensively reassess their current revenue accounting and determine whether changes are necessary. In addition, the ASU requires significantly expanded disclosures about revenue recognition, including both quantitative and qualitative information about (1) the amount, timing, and uncertainty of revenue (and related cash flows) from contracts with customers; (2) the judgment, and changes in judgment, used in applying the revenue model; and (3) the assets recognized from costs to obtain or fulfill a contract with a customer.

To monitor the implementation of the new standard, the FASB and IASB have created a joint transition resource group responsible for (1) keeping the boards informed of interpretive issues that arise during implementation of the standard and (2) helping the boards determine what action may be needed to resolve diversity in practice. In addition, the AICPA has formed 16 industry task forces, including one focused on health care providers, to discuss industry-specific issues and help develop a new accounting guide that will provide implementation insights and examples.

[3] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

Key Accounting Issues

Variable Consideration

Arrangements in the health care industry often involve substantial amounts of variable consideration, including deductions (e.g., contractual allowances, discounts, concessions) and contingent payments (e.g., incentives). Further complexity arises from pricing that can vary significantly depending on the party or parties financially responsible (e.g., patient, private insurer, Medicare, or such parties in combination).

The ASU requires an entity to determine the transaction price, which is the amount of consideration to which it expects to be entitled in exchange for the promised goods or services in the contract. The transaction price can be a fixed amount or "can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties, or other similar items." When the transaction price includes a variable amount, the entity is required to estimate the variable consideration by using either an "expected value" (probability-weighted) approach or a "most likely amount" approach, whichever is more predictive of the amount to which the entity will be entitled (subject to the "constraint" discussed below).

Under the ASU, some or all of an estimate of variable consideration is included in the transaction price (i.e., the amount to be allocated to each unit of account and recognized as revenue) only to the extent that it is probable[4] that subsequent changes in the estimate would not result in a "significant revenue reversal" (this concept is commonly referred to as the "constraint"). The ASU requires entities to perform a qualitative assessment that takes into account both the likelihood and the magnitude of a potential revenue reversal and provides factors that could indicate that an estimate of variable consideration is subject to significant reversal (e.g., susceptibility to factors outside the entity's influence, long period before uncertainty is resolved, limited experience with similar types of contracts, practices of providing concessions, or a broad range of possible consideration amounts). This estimate and the consideration of the constraint would be updated in each reporting period to reflect changes in facts and circumstances.

Health care providers will need to develop policies to ensure that the measurement approach they select is appropriate for the circumstances and consistently applied.

Thinking It Through

Health care providers will need to develop policies to ensure that the measurement approach they select (i.e., expected value vs. most likely amount) is appropriate for the circumstances and consistently applied. The approach applied to estimate the transaction price may differ from how an entity currently measures the amount of revenue to be recognized, and the recognition of revenue for at least a portion of the estimated transaction price may be deferred if the constraint is not satisfied. In particular, health care providers will have to carefully distinguish concessions (reflected as an adjustment to the transaction price) from collectibility concerns (reflected as bad-debt expense); this distinction could affect the amount and timing of revenue (see the Collectibility section below). Finally, because health care providers often have a large volume of customer contracts, they will need to develop a robust process for updating the transaction price each reporting cycle, as required by the ASU. Accordingly, they may have to make substantial changes to their systems and processes before adopting the ASU.

Collectibility

Health care providers may perform services for which there is a substantial collection risk. For example, an entity may not thoroughly assess a patient's ability to pay for services, or the nature and extent of insurance coverage, before providing services.

[4] Like the term "probable" with regard to the collectibility threshold in step 1, "probable" in this context has the same meaning as in ASC 450-20: the "future event or events are likely to occur." In IFRS 15, the IASB uses the term "highly probable," which has the same meaning as the FASB's "probable."

To recognize revenue under current U.S. GAAP, an entity must assess whether "[c]ollectibility is reasonably assured" in accordance with SAB Topic 13[5] (codified in ASC 605-10-S99-1). Typically, when collectibility is not reasonably assured, an entity may recognize revenue by using an approach such as a cash-based method (i.e., based on cash received). Entities in the health care industry may also apply the guidance in ASU 2011-07[6] (codified in ASC 954-605), which in certain cases requires them to recognize a corresponding bad-debt expense and present it adjacent to the revenue recognized. As a result, the net revenue they recognize is closer to the amount they expect to collect for the services rendered.

ASU 2014-09 establishes a collectibility threshold under which an entity must determine, before accounting for a contract under the ASU, whether "[i]t is probable that the entity will collect the consideration to which it will be entitled." In making this assessment, an entity would consider only the customer's ability and intention to pay that amount of consideration when it is due. The amount of consideration evaluated may be less than the price stated in the contract if the consideration is variable because the entity may offer price concessions. Therefore, for contracts that have a variable sales price, entities would first estimate the consideration due under the contract and would then apply the collectibility threshold to this amount in determining whether the contract qualifies for revenue recognition.

If a contract does not meet the collectibility criterion at contract inception, an entity must continue to reassess the criterion to determine whether it is subsequently met. If the criterion is still not satisfied, the entity is precluded from recognizing revenue under the contract until the consideration received is nonrefundable and either (1) all performance obligations in the contract have been satisfied and substantially all the promised consideration has been received or (2) the contract has been terminated or canceled. If those conditions are not met, any consideration received would be recognized as a liability.

Examples 2 and 3 in the ASU illustrate how this guidance would be applied.

The ASU's collectibility threshold may affect when some health care providers recognize revenue.

Thinking It Through

The ASU's collectibility threshold may affect when some health care providers recognize revenue. Specifically, some entities in the industry may elect (or be required by law) to provide services to patients without first assessing a patient's ability to pay. Currently in these circumstances, an entity may recognize patient service revenue upon the performance of services, along with a substantial provision for bad-debt expense. Under ASC 954-605, the entity must separately present the resulting provision for bad-debt expense as a deduction from patient service revenue in arriving at net patient service revenue.

Under the ASU, it is unlikely that health care providers will continue to recognize revenue upon the performance of services in these circumstances. Instead, their recognition of revenue would be constrained at least until they have assessed patients' ability to pay and may be further delayed as a result of doubts about collectibility. When a health care provider determines that the collectibility threshold has been satisfied, the amount of revenue to be recognized would be based on the estimated transaction price, which would include adjustments for variable consideration (e.g., discounts and concessions). Therefore, a substantial portion of what is reflected as bad-debt expense and currently presented on the face of the income statement as an adjustment to net revenue may be reflected as an adjustment to the transaction price under the ASU. Also, even in instances involving concessions that are currently reflected in revenue, the timing of recognition may change as a result of the collectibility threshold requirements.

[5] SEC Staff Accounting Bulletin Topic 13, "Revenue Recognition."

[6] FASB Accounting Standards Update No. 2011-07, *Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities* — a consensus of the FASB Emerging Issues Task Force.

Contract Costs

Some health care providers, such as continuing care retirement communities, may incur contract acquisition costs. The ASU contains criteria for determining when to capitalize costs associated with obtaining and fulfilling a contract. Specifically, entities are required to recognize an asset for incremental costs of obtaining a contract (e.g., sales commissions) when those costs are expected to be recovered (as a practical expedient, a recognized asset with an amortization period of less than a year can be expensed as incurred). Costs of fulfilling a contract (that are not within the scope of other standards) would be capitalized only when they (1) are directly related to a contract, (2) generate or enhance resources that will be used to satisfy performance obligations, and (3) are expected to be recovered. The ASU also requires entities to expense certain costs, such as those related to satisfied (or partially satisfied) performance obligations. Capitalized costs would be amortized in a manner consistent with the pattern of transfer of the goods or services to which the asset is related (which may extend beyond the original contract term in certain circumstances).

Thinking It Through

Health care providers may need to consider the impact of this guidance on their current cost capitalization practices, if any. Some contracts in the industry may not qualify for the practical expedient (i.e., exemption from capitalization) because of their duration, including expected renewals. For example, some health care providers are currently required, under ASC 954-720, to expense certain contract acquisition costs (e.g., commissions) related specifically to prepaid health care services and continuing care contracts. Costs related to contracts of this nature are not likely to qualify for the practical expedient under the ASU. As a result, some health care providers may be required to capitalize qualifying costs and thus may need to use judgment in determining (1) which acquisition costs are incremental to a contract with a customer (e.g., questions may arise regarding complex commission structures), (2) the period over which capitalized costs will be amortized (i.e., periods of expected contract renewals would be included), and (3) the approach to monitoring the resulting assets for impairment on an ongoing basis (this may be challenging when there is a large volume of underlying contracts).

Disclosures

The ASU requires entities to disclose both quantitative and qualitative information that enables "users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers." The ASU's disclosure requirements are significantly more comprehensive than those in existing revenue standards. For additional information about the new disclosure requirements, see Deloitte's May 28, 2014, *Heads Up*.

Effective Date and Transition

The ASU is effective for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2016, for public entities. Early application is not permitted (however, early adoption is optional for entities reporting under IFRSs). Nonpublic entities can use the same effective date as public entities (regardless of whether interim periods are included) or postpone adoption for one year from the effective date for public entities. A not-for-profit entity that has issued (or is a conduit bond obligor for) securities that are traded, listed, or quoted on an exchange or an over-the-counter market must comply with the effective date required of public entities.

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Entities have the option of using either a full retrospective or a modified approach to adopt the guidance in the ASU. Retrospective application would take into account the requirements in ASC 250 (with certain practical expedients). Under the modified approach, an entity recognizes "the cumulative effect of initially applying [the ASU] as an adjustment to the opening balance of retained earnings . . . of the annual reporting period that includes the date of initial application" (revenue in periods presented in the financial statements before that date is reported under guidance in effect before the change). Under the modified approach, the guidance in the ASU is only applied to existing contracts (those for which the entity has remaining performance obligations) as of, and new contracts after, the date of initial application. The ASU is not applied to contracts that were completed before the effective date (i.e., an entity has no remaining performance obligations to fulfill). Entities that elect the modified approach must disclose an explanation of the impact of adopting the ASU, including the financial statement line items and respective amounts directly affected by the standard's application.

Thinking It Through

The modified transition approach provides entities relief from having to restate and present comparable prior-year financial statement information; however, entities will still need to evaluate existing contracts as of the date of initial adoption under the ASU to determine whether a cumulative adjustment is necessary. Therefore, entities may want to begin considering the typical nature and duration of their contracts to understand the impact of applying the ASU and to determine the transition approach that is practical to apply and most beneficial to financial statement users.

Health care providers will most likely be required to perform dual tracking of revenue balances during the ASU's retrospective period.

Transition Considerations

Increased Use of Judgment

Management will need to exercise significant judgment in applying certain of the ASU's requirements, including those related to estimating the transaction price. It is important for health care providers to consider how the standard specifically applies to them so that they can prepare for any changes in revenue recognition patterns.

Retrospective Application

The ASU allows entities to apply the standard retrospectively and use certain optional practical expedients at their discretion. As a result, health care providers may need to assess contracts that commenced several years before the ASU's effective date. In addition, health care providers will most likely be required to perform dual tracking of revenue balances during the retrospective period given the potential difficulty of retroactively recalculating revenue balances when the ASU becomes effective.

Systems, Processes, and Controls

To comply with the ASU's new accounting and disclosure requirements, health care providers will have to gather and track information that they may not have previously monitored. The systems and processes associated with such information may need to be modified to support the capture of additional data elements that may not currently be supported by legacy systems. Further, to ensure the effectiveness of internal controls over financial reporting, management will want to assess whether it should implement additional controls. Health care providers may also need to begin aggregating essential data from new and existing contracts since many of these contracts will most likely be subject to the ASU.

Note that the above are only a few examples of changes health care providers may need to make to their systems, processes, and controls; such entities should evaluate all aspects of the ASU's requirements to determine whether any other modifications may be necessary.

Income Taxes

Federal income tax law provides both general and specific rules for recognizing revenue on certain types of transactions (e.g., long-term contracts and arrangements that include advance payments for goods and services). These rules are often similar to the method a taxpayer uses for financial reporting purposes and, if so, the taxpayer employs the revenue recognition method it applies in maintaining its books and records (e.g., cash basis, U.S. GAAP, IFRSs). Although the Internal Revenue Code (IRC) does not require entities to use any particular underlying financial accounting method to determine their taxable income (such as U.S. GAAP), entities must make appropriate adjustments (on Schedule M) to their financial accounting pretax income to determine taxable income under the IRC.

Additional record keeping will be required when entities are not permitted to use the standard's revenue recognition method for tax purposes.

The ASU may change the timing of revenue recognition and, in some cases, the amount of revenue recognized for entities that maintain their books and records under U.S. GAAP or IFRSs. These changes may also affect taxable income. Thus, it will be important for tax professionals to understand the detailed financial reporting implications of the standard so that they can analyze the tax ramifications and facilitate the selection of any alternative tax accounting methods that may be available.

If a change in a tax accounting method is advantageous or expedient (including circumstances in which the book method has historically been used), the taxpayer will most likely be required to obtain approval from the relevant tax authorities to use the new method. Similar requirements may arise in foreign jurisdictions that maintain statutory accounting records under U.S. GAAP or IFRSs. Additional record keeping will also be required when entities are not permitted to use the standard's revenue recognition method for tax purposes.

Thinking Ahead

Although the ASU is not effective until annual reporting periods beginning after December 15, 2016 (with a maximum deferral of one year for nonpublic entities and some not-for-profit entities that apply U.S. GAAP), health care providers should start carefully examining the ASU and assessing the impact it may have on their current accounting policies, procedures, systems, and processes.

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