GUIDE FOR HEALTHCARE PROVIDERS

ASC 606, Revenue Recognition

bakertilly
now, for tomorrow.

TOPICS

INTRODUCTION

ASC 606 Revenue Recognition

Revenue is a key performance indicator for every organization and a lifeline to achieving success. It is no surprise that executives are working hard to understand the new revenue recognition accounting standard and how it will affect their unique organizations. In order to apply the new standard, organizations must document their decision making process with significant financial statement disclosures required for those decisions.

Even companies that do not anticipate a change in top line revenue may experience significant differences in their accounting and billing processes to reach that number. For many, implementing the new standard will result in substantial modifications to their processes and internal controls over financial reporting.

We recognize adopting the new standard will require a high level of effort for healthcare providers. The standard is complex and calls for increased judgment, documentation and disclosures. It is our pleasure to provide this comprehensive guide to help you understand revenue recognition under the new standard.

ASC 606: WHAT AND WHEN

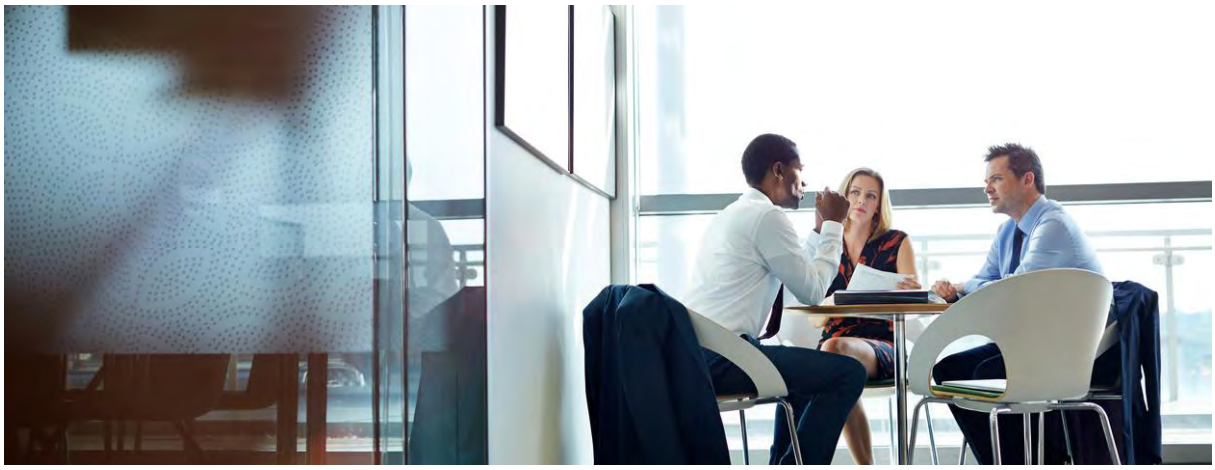
What is ASC 606?

ASC 606 replaces existing industry specific revenue recognition accounting standards with a universal standard for revenue recognition that will be applied across all industries. There are no scope outs for specific types of organizations; however there are certain types of transactions which have been scoped out including leases, insurance contracts, financial instruments, guarantees and nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers.

It will require healthcare providers to evaluate revenue recognition in a new way. At a minimum, existing policies and procedures related to revenue recognition will be required to be revisited and revised to incorporate the implementation of the new standard.

In basic terms, the new standard requires organizations to determine what they will be paid for the services provided to patients prior to the recognition of revenue. Given the complexity of reimbursement for healthcare providers, this can create significant challenges.

ASC 606 affects virtually every organization that prepares financial statements in accordance with generally accepted accounting principles (GAAP).



When is it effective?

For public entities (including conduit bond obligors):
Annual periods beginning after Dec. 15, 2017, including interim reporting periods within that period.

All other entities:
Annual periods beginning after Dec. 15, 2018 and interim reporting periods within annual reporting periods beginning after Dec. 15, 2019.

ASC 606 CORE PRINCIPAL

Entities 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.

THE FIVE-STEP METHOD

ASC 606 provides a structure through which all revenue transactions should be assessed, as follows:

Step one	**Identify the contract(s) with customer**
Step two	**Identify the performance obligation(s) in the contract**
Step three	**Determine the transaction price**
Step four	**Allocate the transaction price to the performance obligation(s) in the contract**
Step five	**Recognize revenue when (or as) the entity satisfies a performance obligation**

IDENTIFYING THE CONTRACT

Contract requirements

The first step in applying ASC 606 is to identify the contract(s) with the patient. To do so, healthcare providers must evaluate indicators of the existence of the contract. Certain requirements must be present for there to be a contract. These requirements are:

- Approval and commitment
- Identification of the rights
- Identification of the payment terms
- Commercial substance to the contract
- Probability of collection

Probable
It must be probable that the organization will collect substantially all of the consideration in exchange for the good or service provided.

Collectability threshold
A patient's ability and intent to pay must be assessed prior to revenue recognition. If collectability is not probable, a contract does not exist.

Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral or implied based on an organization's customary business practices.

Past experience

It is possible to make a determination regarding collectability based on past experience with the patient or class of similar patients, however consideration also has to be given to current facts and circumstances.

Potential step one implementation issues

- At what point do you have an enforceable contract with the patient and does this vary significantly depending on the type of services provided?
- Do you have the information necessary to make the determination as to collectability prior to recognizing revenues?
- Does your organization have significant differences in the net consideration received from the varying types of self-pay balances, including uninsured patients versus patients with copays and deductibles?
- Does the type of service provided significantly impact the net consideration that will be received? (i.e., elective services versus emergency services, inpatient, outpatient, skilled nursing, etc.)
- Do your internal policies, procedures and systems provide adequate information for you to make hese required determinations?

IDENTIFYING THE PERFORMANCE OBLIGATIONS

Once an organization has determined that it has a contract with a customer as defined in ASC 606, the entity must determine what the performance obligations are.

A performance obligation is a promise in a contract with a customer to transfer a good or service to the customer.

If a good or service is not distinct, it should be combined with other promised goods and services until the entity identifies a bundle of goods and services that are distinct.

Goods or services are considered distinct if they meet the following criteria:

- **Capable of being distinct**
  In other words, the patient can benefit from the good or service either on its own or together with other resources that are readily available to the patient.
- **Distinct within the context of the contract**
  Distinct means the promise to transfer the good or service is separately identifiable from other promises in the contract.

Potential step two implementation issues

- What are your performance obligation(s) for the varying types of services a patient can receive during the performance of the contract identified in step one?
- What is the triggering event for when the performance obligation is complete (i.e., is there an expected length of stay for certain services)?
- For in-house patients, what information is available to determine the remaining performance obligations at the end of each reporting period?
- Do your internal policies, procedures and systems allow for you to identify all of the performance obligations in a contract prior to the recognition of revenue?

DETERMINING THE TRANSACTION PRICE

According to the ASC 606 glossary, transaction price is defined as:

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

To determine the transaction price, an organization should consider:

- Variable consideration
- Constraining estimates of variable consideration
- The existence of a significant financing component
- Noncash consideration
- Consideration payable to the customer

Variable consideration

Contracts with patients often include a degree of variability in the transaction price. Variability can arise as a result of discounts, refunds or credits, and they can be either explicitly stated in the contract or implied based on the organization's customary business practices. In accordance with ASC 606, there are two allowable methods for estimating variable consideration which include the expected value or the most likely amount.

- **The expected value** is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if any organization has a large number of contracts with similar characteristics.
- **The most likely amount** is the single most likely amount in a range of possible consideration amounts (i.e., the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract generally has two possible outcomes (e.g., an organization either achieves a performance bonus or does not).

Price concession

Healthcare providers should decide whether they are providing price concessions or variable consideration in the contract. A price concession can be explicit or implicit. Discounts and other similar items would be variable consideration and may be explicitly stated in the contract.

Explicit price concession are relatively easy to assess; however determining if you are proving an implicit price concession may be more difficult. In making this assessment, an organization should consider if the patient has an expectation based on your customary business practices published policies or statements that you will accept an amount less than the price stated in the contract. Some factors to consider when assessing if an implicit price concession has been provided are as follows:

- Does the organization perform a credit assessment of patients prior to providing care? In some cases, this may be performed prior to providing care, while in others it may not be performed until after the care is provided due to legal or regulatory requirements related to providing emergency care.
- Does the organization continue to provide care even when historical experience indicates that it is not probable they will collect substantially all of the discounted charges in the contract?

The variable consideration or price concessions should be included in your estimate of the transaction price for a contract and should be at a level of precision that would ensure there are not significant revenue reversals in future periods.

Constraining estimates of variable consideration
While ASC 606 requires entities to estimate how much revenue will be recognized in connections with a contract, it also requires you to consider constraints on such revenue. Organizations should recognize revenue only to the extent that there will not be significant revenue reversals in the future. Some items to consider related to significant revenue reversals are as follows:

- Current economic conditions
- Extent of experience with similar patients or portfolios of similar patients
- How long it generally takes to collect the consideration from similar patients
- Collection history with similar patients between periods

Application methods
ASC 606 allows for two acceptable application methods for determining the transaction price which are the contract-by-contract basis or the portfolio approach. Under the contract-by-contract basis you would determine the contract price for every contract you enter into with a patient.

Given the volume of services provided to patients daily, this could be quite cumbersome for certain healthcare providers. Therefore, ASC 606 allows organizations to use the portfolio approach as a practical expedient for determining the transaction price. The portfolio approach can only be used if the effect of using this method does not result in a materially different financial impact. This approach is best for situations in which you have a large volume of similar contracts with patients, as this will reduce the complexity and cost of applying the standard to each patient contract. Some factors to consider when determining potential portfolios include the following:

- Type of service: Inpatient, outpatient, skilled nursing, etc.
- Type of payer: Insurance contract, governmental, uninsured, self-pay deductible or copay, etc.
- Timing: Entered into, at or near the same time

Subsequent changes in transaction price
Subsequent changes in transaction price are recorded in revenue unless there is a specific event that indicates the patient no longer has the ability or intent to pay, which is considered an impairment and more representative of a bad debt. For example, after making your initial assessment of the patient's ability and intent to pay, you find out the patient lost their job and is filing for bankruptcy. The write-off of this amount would be considered an impairment of the transaction price or bad debt.

Potential step three implementation issues

- How do you determine implicit price concessions within your contracts with patients?
- Are there significant differences in the implicit price concessions for the varying types of self-pay balances, including uninsured patients versus patients with copays and deductibles?
- If your organization is planning to use the portfolio approach, how many portfolios exist within your organization?
- How will you determine if subsequent changes in the transaction price are changes in variable consideration estimates or bad debt?
- How will you determine if subsequent changes in the transaction price are changes in your initial estimate of variable consideration or impairments?
- Do you have material third-party settlement estimates? If so, what is your historical approach for calculating those estimates, and how will your methodology change under ASC 606?

ALLOCATING THE TRANSACTION PRICE AND RECOGNIZING REVENUE

The fourth step in the revenue recognition process under ASC 606 is to allocate the transaction price to the performance obligation(s) in the contract. If the contract with the patient is determined to have performance obligations that will be recognized over time then the transaction price is allocated to each performance obligation and recognized over time as you satisfy the performance obligation. The methodology used to allocate the transaction price should be determined at contract inception.

The final element in ASC 606 is recognizing revenue as the entity satisfies the performance obligations.

Potential steps four and five implementation issues

- **What is the appropriate allocation method for the transaction price of a contract with performance obligations over time?**
- **Do your internal policies, procedures and systems allow for you to identify the information required to make these determinations?**

INTERNAL CONTROL OVER FINANCIAL REPORTING AND AUDITOR EXPECTATIONS

Changes to accounting under ASC 606 will require scrutiny from healthcare providers and their auditors as the new standard is implemented. Auditors will be placing increased emphasis on the internal control over financial reporting issues in connection with annual audits covering the initial year of ASC 606 implementation.

Because ASC 606 is a principles based standard, there are many more management estimates and judgments required compared to previous accounting standards. The time and effort necessary to implement the new standard due to these judgments will be substantial. Furthermore, many organizations may need to make changes to their systems and processes to ensure the appropriate information is available in a timely fashion.

ABOUT BAKER TILLY

Baker Tilly Virchow Krause, LLP (Baker Tilly) is a nationally recognized, full-service accounting and advisory firm whose specialized professionals connect with clients and their businesses through refreshing candor and clear industry insight.

With approximately 3,000 employees across the United States, Baker Tilly is ranked as one of the 15 largest accounting and advisory firms in the country. Headquartered in Chicago, Baker Tilly is an independent member of Baker Tilly International, a worldwide network of independent accounting and business advisory firms in 147 countries with 30,000 professionals. The combined worldwide revenue of independent member firms is $3.2 billion.

Baker Tilly's healthcare practice is comprised of tax, audit and advisory professionals that work with more than 2,000 hospitals, health systems and health plans developing new strategies for growth. The team has a vast array of financial, operational and strategic expertise covering the full spectrum of advisory services, including value-based service management, risk readiness, managed-care contracting and revenue cycle management. Connect with a Baker Tilly healthcare specialist at **bakertilly.com/healthcare.**

Connect with us:

bakertilly.com/asc606

cpa@bakertilly.com

800 362 7301

LinkedIn: Baker Tilly Virchow Krause, LLP

Twitter: @BakerTillyUS

bakertilly
now, for tomorrow.