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A High-Level Overview of How the New Accounting Standard Update on Revenue Recognition Impacts the United States Healthcare System

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By

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II. Abstract

In May of 2014 the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued a long-awaited joint updated standard on revenue recognition, ASU 2014-09 – Revenue from Contracts with Customers. While almost all entities will be affected to some extent by the new standard, particularly the changes in required disclosures, this research seeks to examine the impact the new standard will specifically have on the healthcare industry. By highlighting areas of significant challenge a better understanding will be gained of the impact health care service entities will experience as they transition to a new standard.

III. Purpose

With the implementation of a new standard for the recognition of revenue established by the FASB and the IASB there are likely to be far-reaching and lasting consequences for many disparate industries. One of such industries is the healthcare industry which is largely privatized in the United States unlike in many other countries. In an industry as significant as healthcare it is important that financial functions are maintained correctly daily so operational functions may continue uninterrupted. For this reason, anticipating any possible problems that may arise due to the implementation of the new revenue recognition guidelines is essential. This study serves to examine various articles and overviews that address what the effects of this lasting change on revenue will be and combine the authors' results into a cohesive presentation. The final report is a guide for healthcare providers to identify and manage these problems before the implementation deadline in latter part of 2018.

IV. Background

Revenue is one of the most important measures that are used by investors in today's economy to assess a company's performance and prospects. As demonstrated in Figure 1, revenue recognition affects many different aspects of a company rather than solely its financial statements (Ernst and Young, 2016). It is an overarching concept that if artificially inflated or deflated can serve to significantly change the fortunes of a company in ways that are different than what the natural effect would have been.

Figure 1

Because it is such an important measure of a company's success it is a frequently debated topic among accountants. One of the largest points of discussion lately has been the concept of revenue recognition. Revenue recognition is the point when a company must properly recognize earned revenues. Because companies may seek to artificially inflate or deflate their revenues, it is essential that revenue recognition is highly regulated. The FASB and the IASB released a new joint update for the rules and regulations on revenue recognition in May of 2014 (Marshall & Dimattia, 2017). This update was intended to institute a set of principles for use in reporting relevant information to users of financial statements about the nature, timing, and uncertainty of revenue resulting from contracts with customers (Financial Accounting Standards Board

(FASB), 2014). The Accounting Standard Update provides a robust framework for addressing revenue recognition issues.

There are several reasons why the FASB and IASB felt the need to issue an update on such an intricate concept as revenue. The new standard will improve the comparability of similar transactions between companies and industries, it will increase the usefulness of information for financial statement users with more in-depth financial statement disclosures, it will reduce the number of various standards that financial statement preparers must refer to for guidance, and it will allow for a common standard among U.S. generally accepted accounting principles (GAAP) and IFRS standards (Cerney, Murray, & Spaanstra, 2015). As mentioned, these changes will prove to be beneficial not only to the preparers of the financial statements as they will have more direct guidance, but the stakeholders of the financial statements who will have a better understanding of the true revenue flow of a company. The timeline for the implementation of this new standard states that public entities must adopt for annual reporting periods occurring after December 15, 2017, while nonpublic entities must adopt for annual reporting periods beginning after December 15, 2018 (Pulver & Jackson, 2017).

Due to the new standard requiring extensive interim and annual disclosures, the significant judgement and estimation involved with determining the amount of revenue to recognize required by company management will be highlighted substantially more than it currently is in financial statements. While historically the disclosures about revenue were limited, the new disclosures have been designed to match the new five step model for recognizing revenue and will standardize the information that users of the financial statements are receiving (Moody, Famiglietti & Andronico, 2014). Unlike the previous revenue recognition guidelines, the new standard states that “the transfer of control of the goods or services to the customer drives the amount and pattern of revenue recognition”, which differs from the previous model of recognizing revenue when the risks and rewards transfer to the customer (KPMG, 2016, p. 2). The standard provides companies with a single model for use in accounting for revenue arising from contracts with customers, and it supersedes the current revenue recognition guidance, including the industry-specific guidance (Altman, Anderson, Dzlczkowski, & Jobe, 2016). While the new update will prove to be useful in increasing the visibility investors have into a company’s financial state, it will not come without its issues, and for that The American Institute of Certified Public Accountants has formed sixteen industry task forces to help develop a new Revenue Recognition Guide that will provide interpretive guidance for how to apply the new standard to industry-specific transactions (American Institute of Certified Public Accountants (AICPA), 2018).

The core principle underlying the new guidance in Accounting Standards Codification (ASC) 606 is to “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” (Marshall & Dimattia, 2017, p. 4). The FASB and IASB released a five-step process with the new guidance for an entity to follow when applying the core principle to its revenue generating transactions, as illustrated below in Figure 2.

Figure 2

An entity should consistently apply the guidance in ASC 606 to similar contracts and in similar situations. The five steps listed above are intended to provide a set of guidelines through which companies may determine whether certain events qualify as revenue and when that revenue must be recognized. Step one of the five-step model revolves around identifying that a contract exits with a customer. A contract is defined as being “an agreement between two or more parties that creates enforceable rights and obligations” (Financial Accounting Standards Board (FASB), 2016, p. 1). There are five defined criteria to determine whether an agreement is a contract: the contract must be commercially meaningful, both parties must be legally committed, both parties’ rights must be identifiable, the terms of the payment must be identifiable, and the collection of payment by the seller must be likely to occur. Determining whether a contract exists requires significant judgment; for example, determining whether payment is likely to occur from a patient can be challenging. This is indicative of the enhanced judgement that will be required under the new guidance, as was previously discussed. If all five parts of an existing contract are not met, the revenue should be recognized when the money is collected in a non-refundable manner and the business with the customer is concluded (Vandenberghe, Kitchen, Adkisson, & Pinkstaff, 2017).

Step two of the five-step method pertains to identifying the performance obligations of the contract. The performance obligations are those goods or services that the seller is obligated contractually to provide to the buyer. However, a single contract may involve the transfer of multiple performance obligations. Businesses should determine how many separate performance obligations are contained in a contract by identifying the distinct obligations. If a business would regularly sell a good or service on its own and that good or service does not substantially modify or require another good or service to be of value, then it is considered to be a distinct obligation (Vandenberghe, Kitchen, Adkisson, & Pinkstaff, 2017).

Step three of the five-step model revolves around determination of the transaction price. The transaction price is considered to be "the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (such as sales tax)" (Financial Accounting Standards Board (FASB), 2014, p. 5). There are various approaches a company can take to determine its transaction price but for this study the most relevant is the variable consideration model. This model considers the fact that monies received are not always guaranteed to be retained, as consideration can vary due to future events such as price concessions or discounts. In light of this, there are two primary methods of predicting the transaction price using the variable consideration model. The first is the most likely amount that identifies each possible price as a separate possibility and selects the one with the highest probability. The second is the expected value where weighted probability-based values are assigned to each distinct possible price and a weighted average price is computed. This is another point in the new revenue recognition regulations where a new reliance upon the judgement of the provider is necessary since it is up to the provider of the good or service to determine what they believe will be the most likely price (Vandenberghe, Kitchen, Adkisson, & Pinkstaff, 2017).

Step four of the five-step model deals with allocating the revenues derived from the contract to each individual obligation. Generally companies should use the stand alone price normally assigned for these obligations when selling these contracted amounts individually. If they are not usually sold individually, it is the company's responsibility to create a reasonable estimate for which the obligations would sell in an independent transaction. This is yet another instance of a new portion of this revenue recognition rule which is reliant upon the judgement of the company recognizing the revenue. If there is a discount or another type of price decrease, then the company is expected to create a proportional designation of the prices of each individual obligation contained in the contract based on their normal prices. If the contract takes place over multiple accounting periods, the company should not adjust the prices used for the purposes of the contract but instead maintain those prices within the confines of the contract as they were in the period in which the contract was created (Vandenberghe, Kitchen, Adkisson, & Pinkstaff, 2017).

The final step of the five-step process is to recognize the revenue as it is earned. Once the previous four steps have been applied and an event is judged to be revenue, the company receiving said revenue must then determine the method of how it will be recognized. The two options of revenue recognition are at one point in time or over a period. It again falls upon the judgement of the company to examine their specific contract and evaluate which of these two categories is more appropriate (Vandenberghe, Kitchen, Adkisson, & Pinkstaff, 2017).

While the changes with the release of the new update are sure to have varying effects on all industries and companies, the implementation issues posed within the healthcare industry are unique because of the nature of the business of healthcare. In certain countries health care is a service that is government-operated and government-funded. In contrast, the U.S. healthcare system resides primarily within the private sector with the government serving as the largest purchaser of health care services (Garner & O'Hara, 2015). As a result, U.S. GAAP prior to the Accounting Standard Update on Revenue Recognition contained specific guidance and information relating to industry-specific revenue recognition principles for hospitals and other health care provider organizations.

Health care service revenue transactions may have certain characteristics that are atypical for commercial revenue transactions. For example a significant portion of services is usually paid for by third parties such as governmental programs or health insurance carriers most often under arrangements that provide for the payment of amounts less than the entity's established rates (Garner & O'Hara, 2015). Also, "some providers may provide services to patients who lack third-party coverage, whose financial circumstances may make it doubtful that the entity will ever collect the consideration to which it would normally be entitled" (Garner & O'Hara, 2015, p. 3). Consequently, over the years a significant body of industry-specific revenue guidance was developed. With the new revenue recognition guidance replacing all the prior guidelines the healthcare industry will have to completely revise its revenue recognition practices to adapt to the new standard. Throughout the process of adopting and implementing the new standard, hospitals and health care providers will face difficulty changing their current revenue recognition practices. This research intends to highlight some of the top problem areas to be expected during and after implementation.

V. Methodology

The aim of this study was to examine numerous documents that evaluated the new rules regarding revenue recognition and to consolidate their contents into one document. A review of documents from several major accounting firms including KPMG, PricewaterhouseCoopers, Ernst and Young, and Deloitte was performed with a comparison developed of the key points of the articles. Furthermore the text of the new regulatory rule was also closely examined to ensure full understanding in the context of the healthcare system. Finally common themes were expounded upon to demonstrate many of the issues that could possibly be presented as a result of the recent regulatory update.

VI. Findings and Discussion

Research of industry-relevant articles revealed several reoccurring themes of projected problems with the revenue recognition implementation of issues for healthcare entities. Included are the existence of an enforceable contract, the collectability threshold, variable consideration with pricing, bad debt expense, performance obligations, and the timing of revenue.

The first recurring theme noted in this study was the problem with determining the existence of an enforceable contract within the healthcare industry. Healthcare providers will need to consider the specific facts and circumstances involved in determining whether and when an agreement with a patient creates legally enforceable rights and obligations (KPMG, 2016). As mentioned previously ASC 606 defines a contract as an agreement between two parties that creates legally binding obligations. Contracts can be oral, written, or implied by a company's customary business practices; however, enforceability is a matter of law.

Healthcare providers will need to consider the specific facts and circumstances in determining whether agreements with a patient create what would be considered a legally enforceable contract. This is paramount because entities are generally unable to recognize revenue if an enforceable contract does not exist. This will create issues with patients who receive medically necessary services before their information is collected (i.e. a contract established through acknowledging the existence of their third-party payer) such as a case where emergency services are rendered to an unconscious patient (KPMG, 2016). Professional judgement will be required to make a determination as to whether revenue may be recognized as it might not have met the criteria for an enforceable contract (Arnold, 2014).

The second reoccurring theme throughout the literature was the timing of revenue within the healthcare industry. Entities recognize revenue when a performance obligation is satisfied through the transfer of goods or services to a customer either at a point in time or over a period. (KPMG, 2016). However certain criteria must be met for a performance obligation to be satisfied over time. Due to the nature of the healthcare industry providers are likely to continuously transfer healthcare services over time to in-patients (i.e. over the time spent for in-patient care) because the patient is simultaneously receiving and consuming the services provided by the healthcare provider (i.e. the care provided). For this reason revenue for performance obligations satisfied over time in healthcare must be recognized based on a measure of progress that allows for a faithful and truthful depiction of the transfer of services over the term of the performance obligation (i.e. the in-patient stay) (Vandenberghe, Kitchen, Adkisson, & Pinkstaff, 2017).

Healthcare providers will need to consider alternative revenue recognition methods, such as recognizing actual charges incurred in consideration of the total expected (or actual) charges that a patient will incur during their in-patient stay as a measure of progress to recognize revenue for in-patient healthcare services under the new standard (Garner & O'Hara, 2015). This may prove to be difficult to implement in practice. Often times the amount of time the patient will spend in in-patient care can be hard to determine (especially with complicated diagnoses or procedures), so this will be yet another area where healthcare providers will have to lean on their own judgment – as well as historical hospital stay lengths – to determine the correct amount of revenue to recognize and when to recognize.

The third recurring theme in the research was the decrease in provision for bad debt expense under the new standard. Compared to previous GAAP many healthcare providers will experience a significant decline in revenue (before provisions for bad debt); as well as, a significant drop in the bad debt expense for services provided to uninsured patients and insured patients with co-payments and deductibles (Kes, 2017). Previous GAAP required a health care provider to record revenue using the amount that they billed for a service, even if question existed on the amount expected to be collected. For example a hospital may charge $1,000 for a procedure but end up billing an uninsured patient much less; this difference would be recorded on the income statement as a provision for bad debt expense and would be included in the calculation of net income (O'Connor, 2017). This type of implicit price concession is no longer allowed under ASC 606 as the new update eliminates those types of industry-specific presentation rules as aforementioned. This will lead to a major change in how health care organizations present their revenues. Essentially bad debt expense will no longer be a separate line item on a health care organization's financial statements and instead total revenues will already include what amount the company doesn't expect to collect. For instance, under the new guidelines, if a hospital has a list price of $1,000 for a procedure but only charges $800 to an insurance company then the hospital would consider the $200 difference as an explicit discount and recognize revenue as $800 billed to insurance company (O'Connor, 2017).

The fourth recurring issue is disagreement over what specific actions are designated as separate performance obligations in the healthcare industry. Under the new standard promised goods or services must be distinguished if they represent separate performance obligations. Since there is freedom for providers to now choose what they will designate as a distinct performance obligation, management discretion will determine how they will be separated. Many providers are likely to err on the side of indicating a higher number of performance obligations allowing them to declare higher amounts of revenue more frequently. This is especially prevalent for in-patient care, since there is a period where the patient is receiving constant care and attention. This period must be reliably separated into distinct units (performance obligations) that can be measured so that the provider can consistently and honestly recognize revenue. The most recommended method for providers to achieve this objective is by examining each service or good provided and determining whether: a) it is valuable and useful on its own to the patient with only what the patient has outside of the transaction and b) it is valuable and useful within the contract without the addition of any other goods or services offered within the contract. If both conditions are true then healthcare providers may reliably assume that it is a distinct performance obligation thus creating revenue and recognizing it as such (KPMG, 2016).

The fifth recurring issue pertaining to the new revenue recognition guidelines is the evaluation of collectability of debts by a healthcare provider. Historically, providers had the option of recording revenues for all patients at their fully-charged values (as discussed in bad debts), regardless of the ability or lack thereof of a patient to pay their debts. However, under the new revenue recognition rules providers must record revenues at their most probable collectible levels. Healthcare institutions are also expected to exercise more due care than before to evaluate the realistic collectability for individual patients using demographic information, patient history, and history of similar patients (Pulver & Jackson, 2017). Providers are expected to develop portfolios describing individual types of patients with homogenous transactions that will create a generalized expected cash receipt for patients based on pre-determined factors. Providers are also expected to evaluate third-party payers' involvement with patients in their judgements for the collectability of debts. If patients do not use a third-party payer system, healthcare providers should lower their expectations of revenues accordingly (Vandenberghe & Kitchen, Changes coming for health care revenue recognition , 2014). However, should patients use third-party payers, providers should instead adjust their expectations based on the likelihood of variable considerations and possible adjustments of price at a future time. Since there is a fair amount of judgement reserved for providers in the situation of determining collectability, it is expected that providers will use conservative estimates and err on the side of underestimating revenues rather than overestimation.

The last recurring theme throughout the research, and possibly the most important, was the idea of variable consideration. Healthcare providers will now need to apply judgement to determine whether they have implicitly provided a price concession (KPMG, 2016). Under previous GAAP specific industry guidance stated that healthcare providers could record gross patient service revenue at established charges when the service to the patient was provided and the estimated amount not to be collected was recorded as bad debt. However, under the new standard the provision for bad debts is presented as an expense, and determining whether or not there is an implicit price concession in the contract and estimating the transaction price may substantially affect the amount of revenue and bad debt recognized (Fast, 2018).

The new standard requires that healthcare providers estimate the amount of variable consideration by evaluating all information available to them (Ernst and Young, 2016). Variable consideration can result from discounts, implicit price concessions, and other similar practices (Ernst and Young, 2017). Variable consideration may be based on historical experiences from similar patients. However, determining which patients are similar can be challenging considering there is a wide variety of contracts and payment terms. Healthcare providers need to consider both the sufficiency of the data they are relying on; as well as, the homogeneity of the data to ensure that the data is useful in predicting an outcome. Healthcare providers will need to be more detailed with the historical information they rely on, including distinguishing self-pay individuals from third-party insured individuals, taking into consideration deductibles and copays, and thinking about services not covered by insurance.

The most significant aspect of variable consideration that will require the judgement of healthcare providers and prove to be difficult in implementation is the implicit price concessions. Implicit price concessions do not have to be specifically communicated or offered by a healthcare provider to be considered an implicit price concession. For example, a hospital treats an uninsured patient (and does not assess the patient’s ability to pay beforehand) and the hospital bills the patient $10,000. Under previous GAAP guidance the hospital would recognize the $10,000 as revenue. Although the hospital will pursue collection they can only expect to collect $1,000 based off historical data. Under the new revenue recognition guidance the hospital will recognize the $1,000 as revenue, instead of the $10,000, because the $9,000 difference is an implicit price concession due to the hospital lacking to check the patient's ability to pay beforehand. Subsequently, if the hospital collects less than the $1,000 they expected the patient service revenue would be decreased by the same amount (an increase in the implicit price concession). If the lack of collectability was due to a patient-specific event (such as the patient losing their job or filing for bankruptcy), then the difference in collectability would be recorded as bad debt expense as that would not be considered an increase in the implicit price concession (KPMG, 2016). This process is considerably different from how healthcare providers currently operate and will require a significant amount of time and judgement in the implementation process.

VII. Conclusion

After reviewing the existing literature on the topic, it is clear the implementation of the new revenue recognition guideline for healthcare entities is not going to be easy. There are significant challenges facing the healthcare industry in regard to the new update, especially dealing with the changing of the classification of bad debt expense and the consideration of implicit price concessions. The new standard could have far-reaching effects not only changing the amount and the timing of revenue recognition but also potentially requiring changes in a healthcare entity's core systems and processes used to account for revenue. Healthcare organizations may need to design and implement new internal controls or modify existing controls to address the risk that will result from new processes, estimates, disclosures, and judgements. This will undoubtedly involve substantive involvement by more than those just involved in the accounting function.

Furthermore, healthcare entities who prepare their financial statements in accordance with GAAP will be affected by the new guidance. The accounting policies and procedures for revenue recognition will need to be revised to reflect the five-step revenue recognition process. Also, each healthcare entity will be significantly affected by the disclosure requirements in the new guidance due to it substantially increasing the detail of revenue related information that will now be disclosed in the financial statements. As the adoption deadline for private companies (which includes most healthcare organizations) is less than a year away, management should be well on their way in assessing how it will affect their operations and resulting financial statements and developing an implementation strategy.

VIII. Recommendations for Further Research

Although this document examines various possible problems that may arise for the healthcare field due to the new revenue recognition regulation updates, the study does not provide practical solutions for these complications. Each of these individual problems present potential new studies that may be conducted to provide insights into actions healthcare providers may take to properly and ethically implement the new revenue recognition regulations. The topic of variable consideration is especially significant to expound upon, since it was a common theme throughout the other potential complications and will be particularly difficult for the healthcare industry to implement. If a unified method of determining expected revenues could be established it would provide clarity and standardization across the field.

Moreover it is important to understand that an increasing amount of relevant literature should become available as the new regulation is fully implemented at the end of 2018. Once this occurs and actual results of its implementation become available a reevaluation should be performed to address issues that may arise from the implementation. The anticipated problems discussed here should also be reevaluated at that time since a higher level of understanding will be accessible.

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