READY FOR ASC 606?

Implementation Questions for Private Healthcare Organizations Ahead of Dec. 15 Deadline

For private entities, the moment of reckoning is approaching for compliance with the new revenue recognition standard, *Revenue from Contracts with Customers*, or ASC 606. While the compliance deadline for public organizations has already passed, private entities must apply the new revenue standard to annual reporting periods beginning after Dec. 15, 2018.

And for healthcare entities, the standard requires unique considerations for mitigating risk. Outside forces, like the move to value-based care and developments in technology, are charging healthcare organizations to break down silos across—and beyond—the traditional continuum to drive more precise, improved patient outcomes and shared value.

This presents challenges, including measuring clinical and operational results and determining the transaction price for a healthcare service.

SPECIAL CONSIDERATIONS FOR Healthcare Organizations

Healthcare organizations should keep the following questions and considerations in mind when assessing the new standard's impact.

Has your business gone through an M&A process or consolidation recently, or are you considering one?

In response to outside pressures, vertical and horizontal M&A activity is rippling through the industry. This has created additional industry-specific challenges to ASC 606 compliance and a greater emphasis on managing risk. Vertical consolidation leads to bundling more diverse revenue streams, including everything from physician practice groups and acute-care hospitals to home health agencies and skilled nursing facilities. As such, thorough, transparent footnote disclosures will be important to helping readers of the financial statements understand the organization's diverse revenue streams.

Does my reporting to financial stakeholders (lenders, investors, debt-issuers, etc.) need to change?

Lenders or debt issuers may require healthcare organizations to report on certain metrics, such as coverage ratios, that new ASC 606 requirements may impact. Organizations should proactively address any changes in reporting with their financial stakeholders to determine mutually acceptable solutions ahead of any changes needed to consolidated financial statements for ASC 606 compliance.

Are your contracts with patients consistent across facilities within the system?

In many instances, different facilities—even those that offer the same services—may use slightly different contract models or may have adjusted contracts over time to better serve patients. When this happens, it's important to ensure the organization conducts a rigorous assessment of each contract type to ensure services are accounted for and reported properly under ASC 606 guidance. In some instances, different contracts for the same service may have created different revenue recognition and reporting requirements.

Do you offer care management services or care coordination within your system?

Under ASC 606, care management or coordination services are accounted in different ways. If the coordination is, itself, a significant service in the determination of the nature and extent of each of the individual services provided to the patient, and each of the services are highly dependent upon and integrated with the other services, then the patient is not in a position to decide whether to purchase individual distinct services.

CHALLENGES UNDER VALUE-BASED CARE

Have you established a clear method for recognizing revenue from value-based contracting arrangements?

Under value-based contracting paradigms, healthcare revenue is a variable consideration, since many contracts allow payment amounts to be adjusted retroactively, based upon outcomes. This uncertainty in final contract value is an added complexity under ASC 606. Under the new revenue recognition provisions, revenue is recognized only where it is **probable** that there will not be a significant adjustment (reversal) once the uncertainty is resolved. Many healthcare organizations—and integrated health systems in particular—will need to establish clear visibility into clinical and operational metrics throughout the system to accurately estimate outcomes and report on revenue under ASC 606.

Have you established sufficient clarity to be able to accurately audit clinical and operational metrics underlying your financial reporting?

Clinical and operational metrics used to track progress within healthcare organizations have historically been a secondary consideration. Under value-based contracting, however, this is not the case, making Step 5 under ASC 606—recognizing revenue when the entity fulfills performance obligations—more of a challenge. As revenue under value-based contracting is directly tied to the quality of care outcomes—measured by clinical and operational metrics, i.e. medication adherence, readmission rates, etc.—organizations need to prepare for these measures to be audited. To mitigate audit risk, financial leaders within healthcare organizations should ensure they are sufficiently comfortable with the accuracy and applicability of the metrics they're using to measure clinical and operational success.

CHALLENGES FOR LONG-TERM CARE

Are you able to separate out the portions of long-term care contracts that pertain to leasing from those that pertain to care?

Under ASC 606, leasing contracts are excluded from consideration. Many long-term care contracts contain both clinical care and leasing provisions, and therefore need to be accounted for under two different sets of revenue recognition guidance—ASC 606 for non-lease provisions and GAAP guidance (ASC 842) for lease provisions. Being able to clearly delineate between the two is important in ensuring revenue recognition in financial reports conforms to the new guidelines.

Can you consolidate reporting by grouping patient contracts into portfolios to expedite processing and reporting?

ASC 606 allows for a portfolio approach as a practical expedient to account for patient contracts as a collective group rather than individually. To take advantage of this provision, contracts must share similar characteristics such as the type of service, type of payer, size of payments or timing of contracts. To fully capitalize on their data, healthcare organizations will also want to ensure there is sufficient homogeneity of data and contract structure, and to consider whether it makes sense to apply a portfolio approach system-wide or on a facility-by-facility basis.

Are you able to clearly identify between services delivered at a specific point in time versus those delivered over time?

For long-term care providers, revenue from certain services can be recognized immediately, while other services may be classified such that revenue can only be recognized over time. Ancillary services—barber or beauty care—are considered point-in-time services from a revenue recognition standpoint. Conversely, the delivery of inpatient care services is often treated as delivered over time, meaning revenue must be recognized over the full period of time for which care is delivered.

Determining Where to Start

Use this checklist as a starting point to prioritize steps toward compliance ahead of the deadline. Remember to communicate regularly with your investors, lenders, analysts and other stakeholders to set proper expectations.

STEP 1: Understand, Scope and Plan

- ☐ Understand the new standard's requirements. Confirm your understanding with your auditor.
- ☐ Determine what, if any, new information needs to be gathered to comply with the standard.
- ☐ Assess whether your organization's existing systems, internal controls and processes are adequate or if new systems and tools are required.
- ☐ Look beyond financial reporting to determine how the new standard may affect other aspects of your business, including marketing, sales and pricing.
- ☐ Assess the tax implications of the new standard. If your organization uses U.S. GAAP to determine revenue recognition for income tax purposes, the changes in timing of revenue recognition may result in changes to your current taxable income. It may also impact your organization's deferred taxes.
- ☐ Enlist the help of external experts, if necessary.

STEP 2: Technical Analysis and Assessment

- ☐ Divide your revenue into similar revenue streams and assess the impact of the standard on your revenue streams.
- ☐ Perform a detailed analysis of the accounting impact of individual transactions in the revenue streams identified. This detailed analysis should include the cost-capitalization rules and should confirm and/or further your initial assessment.

  Decide on one of the available transition methods and consider discussing these approaches with your financial statement users and peer organizations, if relevant.

  - ☐ **Full Retrospective:** Under this approach, entities may avail themselves of certain practical expedients.
  - ☐ **Modified Retrospective Cumulative Effect:** If this method is selected, entities must disclose which results would have been under prior U.S. GAAP in the year of adoption.
  - ☐ Confirm your decisions with your auditor.

STEP 3: Consider Changes to Existing Processes

- ☐ If your assessment has determined that new information will be needed, determine the changes needed to ensure that information is gathered accurately and on a timely basis.
- ☐ Prepare for estimates and judgments. In some situations, you may be required to make more estimates and use more judgment than under current guidance, such as estimates related to variable consideration. These matters should be highlighted for users through increased disclosure requirements.
- ☐ Depending on your analysis of the standard's potential impact on your business, consider possible changes to your organization's standard contracts.
- ☐ Consider discussing changes with lenders to revise debt covenants impacted by revenue, such as EBITDA and times-interest earned ratios.
- ☐ Consider possible changes to compensation arrangements driven by revenue, such as sales commissions, if the timing or pattern of your organization's revenue recognition changes under the new guidance.
- ☐ Revise your documented processes and controls to ensure they are sufficient to prevent or detect misstatements under the new guidance.

STEP 4: Implementation and Testing

- ☐ Run applicable historical transactions through new systems and business processes to calculate the effect on prior periods or the cumulative effect upon adoption date.
- ☐ Allow time for your auditor to test your restated accounts or cumulative adjustment.
- ☐ Prepare new disclosures and ensure auditor concurrence.

STEP 5: Stay Up-to-Date with New Guidance

- ☐ Monitor the activities of the American Institute of CPAs (AICPA).
- ☐ Stay informed on SEC developments, including any amendments the Commission may make to its own staff interpretations on revenue recognition.

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