On May 28, 2014, the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) issued substantially converged final standards on revenue recognition. These final standards are the culmination of a joint project between the Boards that has spanned many years. The FASB’s Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers (Topic 606), was issued in three parts: (a) Section A, “Summary and Amendments That Create Revenue from Contracts with Customers (Topic 606) and Other Assets and Deferred Costs—Contracts with Customers (Subtopic 340-40);” (b) Section B, “Conforming Amendments to Other Topics and Subtopics in the Codification and Status Tables;” and (c) Section C, “Background Information and Basis for Conclusions.”

ASU 2014-09 provides a robust framework for addressing revenue recognition issues and, upon its effective date, replaces almost all existing revenue recognition guidance, including industry-specific guidance, in current U.S. generally accepted accounting principles (GAAP) (hereinafter referred to as legacy GAAP). While there has not been an indication from the Securities and Exchange Commission staff, we expect significant changes will be made to Staff Accounting Bulletin Topic 13, Revenue Recognition (also part of legacy GAAP for public entities), which could include it being superseded. As a result of these wholesale changes, when the new guidance is implemented, there should be improved comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets. Given the broad applicability and potentially significant ramifications of the guidance in the ASU, the FASB provided significantly delayed effective dates for its guidance. The ASU is effective in 2017 for calendar year-end public entities, which includes: (a) public business entities, (b) not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or an over-the-counter market and (c) employee benefit plans that file or furnish financial statements to the SEC. For all other calendar year-end entities, the ASU is effective in 2018.

Upon the effective date of ASU 2014-09, virtually all of the revenue recognition-related guidance previously applied by health care organizations is superseded. The only health care specific revenue-related guidance that has been retained in legacy GAAP relates to: (a) loss contracts for continuing care retirement communities
(CCRCs) and prepaid health care services, (b) charity care and (c) contributions from related fundraising entities. Applying the new guidance to health care organizations could significantly affect the timing and amount of revenue recognized. Certain aspects of a health care organization’s revenue recognition that could be substantially affected by the new guidance include:

- **Third-party payors: Variable consideration.** Variable consideration includes discounts, incentives and other contingent amounts that must be considered in estimating the transaction price. It is common for health care organizations to offer contractual and other discounts to patients and third-party payors. The ASU requires entities to estimate variable consideration using one of two prescribed methods and to reflect the estimate in the transaction price. However, the estimated variable consideration included in the transaction price is constrained to the amount for which it is probable that a significant reversal of cumulative revenue recognized will not occur when the underlying uncertainty is resolved. Estimating the variable consideration the organization expects to be entitled to from third-party payors using one of the prescribed methods and applying the constraint on variable consideration to health care revenue subject to audit and subsequent adjustment could change the timing and amount of revenue recognized by a health care organization.

- **Self-pay patients: Variable consideration and collectibility.** At contract inception and upon significant changes in facts and circumstances, the ASU requires an entity to evaluate whether collection of the transaction price is probable. To perform this evaluation, an entity first has to estimate the transaction price, which includes the effects of any variable consideration. In estimating the variable consideration related to contracts with self-pay patients, a health care organization must consider any discounts from standard rates that: (a) it intends to offer the self-pay patient or (b) the self-pay patient has a valid expectation of receiving based on the organization’s customary business practices, published policies or specific statements. Once the transaction price has been estimated, the entity evaluates the likelihood of collecting that amount. For this purpose, only the self-pay patient’s ability and intent to pay the transaction price is considered. If the entity cannot conclude that collection of the transaction price is probable, revenue recognition is delayed. If the entity concludes that collection of the transaction price is probable, subsequent adjustments to amounts recognized as a result of applying ASC 606 may be necessary if circumstances change. For example, the net receivable from the self-pay patient may need to be adjusted due to a deterioration in the patient’s ability and intent to pay. This adjustment would be reflected in bad debt expense (and not as a reduction in revenue).

This approach to collectibility and discounts could affect how some health care organizations recognize and present revenue, particularly in light of the changes some health care organizations were required to make in connection with ASU 2011-07, *Health Care Entities (Topic 954): Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities*. The ASU includes an example addressing revenue recognition considerations for an uninsured patient treated in a hospital emergency room.

- **Fees of continuing care retirement communities.** The ASU requires entities to identify the performance obligations (i.e., promises to transfer goods or services to a customer that meet certain conditions) within the customer contract and to allocate the transaction price to those performance obligations using their standalone selling prices. The ASU also requires entities to adjust the transaction price to reflect the time value of money if the customer contract has a significant financing component. For purposes of determining when a performance obligation is satisfied (and revenue recognized), the ASU requires
entities to determine whether the performance obligation is satisfied at a point in time or over time. In addition, certain costs incurred to obtain a customer contract must be capitalized and amortized under the ASU.

CCRCs enter into contracts with their residents that span several years and include a variety of potentially separate performance obligations. There are several questions that arise under the ASU related to these contracts, the answers to which will affect how CCRCs recognize revenue for the entrance fees and other fees due from the residents as well as certain related costs. Those questions include, but are not limited to:

- Which of the goods and services provided by the CCRC under the contract represent performance obligations?
- Is it appropriate to treat a series of distinct goods or services provided by the CCRC that meet certain conditions as one performance obligation?
- Does a CCRC contract include a performance obligation (i.e., rental of a residence) that should be accounted for as a lease?
- Are the performance obligations satisfied at a point in time or over time?
- How should standalone selling prices be estimated for goods and services not historically sold separately?
- How should variable consideration be estimated for refundable entrance fees?
- How should the time value of money be considered in the transaction price?
- Should the costs to acquire continuing care contracts be capitalized?

Given the nature of continuing care contracts and the number of questions to be addressed under the ASU, CCRCs are expected to be among the health care organizations whose revenue recognition is most significantly affected by the new guidance.

- **Bundled payment arrangements.** Bundled payment arrangements entered into by health care organizations are increasing in both frequency and complexity. The nature of these arrangements, often designed to address complex medical conditions that require treatment by multiple (sometimes unrelated) health care providers, pose a number of potential challenges. Considerations relating to such arrangements that will affect how revenue is recognized under the ASU include: (a) identifying the performance obligations under the arrangement, (b) allocating the transaction price to the performance obligations and (c) estimating variable consideration that the health care organization expects to be entitled to under the arrangement.

- **Shared savings arrangements.** Many health care providers have entered into shared savings arrangements, including Accountable Care Organization (ACO) arrangements with the Centers for Medicare & Medicaid Services and insurance companies. Considerations relating to such arrangements that will affect revenue recognition under the ASU include: (a) identifying the performance obligations in the contract, including quality and cost saving targets, (b) determining whether the performance obligations are satisfied at a point in time or over time and (c) assessing how the constraint on variable consideration could limit the revenue recognized under the contract.

The AICPA has organized several industry-specific task forces, including one focused on health care, to help develop a new *Accounting Guide on Revenue Recognition* that is expected to provide helpful hints and illustrative examples on how to apply the ASU.
Believe it or not, this just scratches the surface of how a health care organization’s revenue recognition could be affected by the new guidance. For a comprehensive discussion about the guidance in the ASU, including its scope, core principle and key steps, implementation guidance, presentation and disclosure requirements and effective date and transition provisions, refer to our white paper, *Revenue recognition: A whole new world*.

All health care organizations' revenue recognition policies will be affected by the new guidance. The degree to which the recognition (e.g., timing) and measurement (e.g., amount) of a particular organization's revenue will be affected depends on its own facts and circumstances. However, one thing is certain – the new guidance will require health care organizations to evaluate whether any changes are needed to their current revenue and financial reporting processes and systems to comply with the new guidance. This will undoubtedly require substantive involvement by more than just those involved in the organization's accounting function. Even though delayed effective dates are provided in the ASU, it is not too early to start having conversations about that evaluation process, particularly if you plan on electing the retrospective transition method and (or) you have multiyear contracts. Don’t hesitate in getting this conversation started now by contacting your McGladrey representative or either Pat Kitchen, partner and Great Lakes health care assurance practice leader (312.634.7109), or Dan Vandenbergh, partner and national health care industry practice leader (612.376.9267).