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healthcare financial management association

Issue Analysis

Accounting For RAC Audit Adjustments and Exposures

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ABOUT P&P BOARD ISSUE ANALYSES

The Healthcare Financial Management Association's Principles and Practices (P&P) Board writes issue analyses to provide short-term practical assistance on emerging issues in healthcare financial management. To expedite information to the industry, issues analyses are not sent out for public comment. Therefore, they are factual, but not authoritative. The purpose of this issue analysis is to provide some clarity to the healthcare industry on certain accounting and reporting issues resulting from Recovery Audit Contractor (RAC) audits. Consultation on these matters with independent advisers, including independent auditors as well as legal and compliance experts, is highly recommended.

SUMMARY

The issue analysis provides accounting guidelines for healthcare finance leaders who must respond to RAC audits and adjustments, including the following situations:

- A healthcare entity receives a notification of RAC audit adjustments.
- A healthcare entity suspects it may have billed for and/or been paid for services that are potentially non-reimbursable.
- A healthcare entity is concerned about potential RAC adjustments for issues that have not yet been identified.
- A healthcare entity receives notification of a RAC audit adjustment recovery.

The issue analysis also contains a helpful Q&A section that provides detailed answers to specific RAC accounting questions.

INTRODUCTION

In 2005, Congress directed the Department of Health and Human Services (DHHS) to conduct a three-year demonstration program using Recovery Audit Contractors (RACs) to detect and correct improper payments in the Medicare fee for service program. The demonstration program targeted paid claims in New York, Massachusetts, Florida, South Carolina, and California and ended in March 2008. The Tax Relief and Healthcare Act of 2006 required a permanent and nationwide RAC program to be implemented by 2010. Therefore, the accounting implications are now of interest to all providers.

In many ways, RAC audits are the same as other third-party payer audits. Most healthcare providers have extensive experience with third-party audits of billings and payments, and have established procedures for handling the audits and the accounting for denials. What is different with the RAC audits is that they are based on terms, processes, and timelines that, unlike other third-party payer audits, have been set unilaterally; they are very intensive audits often involving significant resources to handle and meet a large volume of requests in a short period of time; and the audit response and appeal processes are complex. The RAC audits have resulted in significant amounts of payment reductions (“take-backs”) for many providers.

ACCOUNTING FOR RAC AUDIT ADJUSTMENTS

A. When a healthcare entity receives a notification of RAC audit adjustments:

- a. When a healthcare entity receives notification from the Centers for Medicare & Medicaid Services (CMS) or the Medicare Administrative Contractor (MAC) regarding a RAC audit adjustment for a take-back related to Medicare reimbursed claims, there is a known amount of identifiable risk of disallowance or significant modification to a previously recorded revenue stream. As such, the receipt of written notification of RAC audit take-backs of Medicare reimbursed claims generally represents persuasive evidence that the criteria for revenue recognition, in accordance with AS 954-605-25, have not been met. Accordingly, the organization should evaluate whether the findings identified represent changes to prior period estimates or the correction of prior period errors – see Section E. If, based on the relevant facts and circumstances, the organization concludes that the findings represent changes in prior period estimates, the healthcare entity should accrue for the amount of RAC audit take-back. An accrual for a RAC audit take-back should be recorded as a charge to the income statement, generally as contractual discount expense, and a liability on the balance sheet, in the period in which notification is received. This process is similar to the methods used for accounting for specific receivables and payables related to estimated and final reimbursement settlements

from government third-party payers in accordance with AS 954-310 – *Health Care Entities-Receivables* and AS 954-405 – *Health Care Entities – Liabilities*.

Typically, disbursements made to CMS or the MAC for the RAC audit adjustments have been made through the process of withholdings by CMS or the MAC from subsequent Medicare claims reimbursements. As there is usually a delay in the actual take-back and based on the above-mentioned persuasive evidence about revenue recognition, the healthcare entity should record the liability upon receipt of the RAC audit adjustment notification. The healthcare entity should release the liability when the amount is paid and/or withheld from subsequent Medicare claims reimbursement.

The RAC audit program may have a limited look-back period and there are statutes of limitation that apply. If the RAC identifies audit adjustments for services that fall outside of the permitted time frames, the healthcare entity should follow the appropriate procedures for documentation and communication to CMS, as provided by CMS. The healthcare entity should follow the guidance as described in Section A.b and/or Section B below as necessary with respect to the recognition of adjustments related to RAC audit findings.

- b. When a healthcare entity disagrees with the RAC audit findings (e.g., whether a certain clinical procedure or treatment is billable to a government third-party payer), the healthcare entity may consider, in estimating net revenue adjustments, RAC audit adjustments that may be successfully appealed because the health care organization has persuasive evidence that the revenue recognition criteria have been met (i.e., based on the relevant facts and circumstances and the success rate the organization has seen during the appeals process related to similar claims).
- B. When a healthcare entity suspects it may have billed for and/or been paid for services that are potentially nonreimbursable:
- a. When the RAC audit process identifies systematic clinical operations or billing practices that result in take-backs, or the healthcare entity becomes aware through other means that it has been billing services to governmental agencies or other third-party payers that should not be billed, the entity should implement changes to its clinical operations and/or billing practices to address the issues identified. These changes in practice should mitigate the potential for future take-backs related to the

specific issues identified.

Related to services that have been previously billed that based on new information should perhaps not have been billed, the organization should seek assistance from legal and compliance experts to determine its obligation to notify the government agency or other third-party payer and to rebill claims and/or refund overpayments that may have been made. Additionally, the organization should evaluate whether the revenue recognition criteria have been met related to such services and whether the findings identified represent changes to prior period estimates or the correction of prior period errors – see Section E. If the organization concludes that the findings represent changes in prior period estimates, the healthcare entity may accrue for the amount of RAC audit take-back based on the relevant facts and circumstances.

C. When a healthcare entity is concerned about potential RAC adjustments for issues that have not yet been identified:

- a. Healthcare providers frequently ask if they should establish reserves for potential RAC audit adjustments for issues that have not yet been identified. The accounting standard for recognizing revenue, AS 954-605-25, states that in general, gross patient service revenue is recorded in the accounting records on an accrual basis at the healthcare provider's established rates, regardless of whether the healthcare entity expects to collect that amount. The provision for contractual adjustments (that is, the difference between established rates and third-party payer payments) and discounts (that is, the difference between established rates and the amount collectible) are recognized on an accrual basis and deducted from gross patient service revenue to determine net patient service patient service revenue. Amounts realizable from third-party payers (which would include payments realized from government agencies for Medicare claims as noted in Section A.a) for healthcare services are usually less than the provider's full established rates for those services. Estimates of contractual adjustments, other adjustments (such as those specifically identified as noted in Section A.a or estimated based on specific identification as noted in Section B.a), and the provision for uncollectible accounts shall be reported in the period during which the services are provided even though the actual amounts may become known at a later date. In establishing reserves against receivables, care should be exercised to ensure that reserve estimates based on specific identification do not duplicate reserves that have already been made otherwise.

Generally, there is insufficient basis for extrapolating one healthcare entity's RAC audit experience to another healthcare entity unless it can

be demonstrated that the operating procedures and billing practices are essentially identical. General reserves should not be recorded as the amount of a general reserve would not be supported by hospital-specific billing.

Although general reserves should not be recorded, there may be facts and circumstances for an individual healthcare entity that could support specific reserves for RAC or other governmental audits. Auditing guidance found in SOP 00-1, *Auditing Health Care Third-Party Revenue and Related Receivables*, addresses reserves that consider both the entity's historical experience and potential future adjustments. Paragraph 29 of SOP 00-1 reads: "...the hospital is subject to potential billing adjustments including errors (for example, violations of the three-day window, discharge and transfer issues, and coding errors). Even though specific incidents are not known, it may be reasonable for the hospital to estimate and accrue a valuation allowance for such future retrospective adjustments, based on relevant historical experience." Prior to the recording of reserves for potential future adjustments, appropriate consultation should take place with legal and audit advisors.

- b. Though valuation allowances should not be established for issues that are unknown, it should be noted that typically, net patient revenues and receivables are valued based on historical collection experience. Once a healthcare entity has relevant experience with RAC audit adjustments, this experience should automatically be incorporated in the provider's historical collection experience data that support its contractual adjustments and discounts methodologies for determining the net realizable value of patient revenue and receivables. Applying historical experience to accounts receivable will result in taking into account a healthcare entity's revenue valuation as noted in the recognition provisions stated in AS 954-605-25 as well as stated in AS 954-310.

D. When a healthcare entity receives notification of a RAC audit adjustment recovery:

When a healthcare entity receives notification of a RAC audit adjustment recovery due to a successful appeal for amounts that had previously been reserved for, it is important to understand the options that are available to CMS.

- a. If the successful appeal decision is final, there is a known amount receivable. As such, when a healthcare entity receives the written notification of the recovery, it should record a receivable and the related

gain, typically as a reduction in contractual discounts. The receivable for the recovery should be recorded in the current open period, in accordance with the accounting for receivables and revenue recognition per AS 954-310 and AS 954-605-25.

The receivable established following the notification of recovery of RAC audit adjustments will be reversed when cash reimbursement related to the recovery has been received from CMS or the MAC.

- b. If CMS can contest the decision, no receivable should be recorded for the notification amount and no related gain should be recognized as it is not a known amount with certainty. This accounting treatment is based on the recognition provisions related to a contingent gain per AS 450-30-Contingencies-Gain Contingencies-Measurement, since it is not certain yet whether CMS will appeal and ultimately overturn the decision.

Once a determination can be made that further appeals cannot or will not be pursued by CMS or the MAC, if no appeal has been filed, then a receivable and the related gain should be recorded for the recovery, in accordance with the accounting for receivables and revenue recognition per AS 954-310 and AS 954-605-25.

If cash reimbursement related to a recovery is received prior to the expiration of time limits for CMS to file an appeal, no gain or revenue recognition should be recorded, as the cash reimbursement related to the recovery is not yet finally settled. Upon receipt of such cash reimbursement, the amount should be recorded as a liability in the current open period, similar to recognition provisions related to unearned revenue under AS 954-430 – *Health Care Entities – Deferred Revenue*. Once a determination can be made that appeals cannot or will not be pursued by CMS or the MAC, only then should the liability be released and the related gain recognized.

- E. Usually, adjustments recorded for RAC activity constitute changes in estimates and adjustments should be recorded in the current period in accordance with the recognition provisions of AS 954-405-25. However, if management determines that previous estimates of realizable revenue were not correctly calculated based on information available at the time and therefore resulted in an accounting error, the healthcare entity should report and disclose the correction of an error in accordance with the provision of AS 250-10 – *Accounting Changes and Error Corrections – Overall*.

F. For RAC audit adjustments related to healthcare entities that participate in the Periodic Interim Payment (PIP) program:

- a. Some healthcare entities receive biweekly payments from Medicare under PIP for certain services, based on a prescheduled amount of reimbursement. For such organizations, the timing of revenue recognition is the same as described for each situation above.
- b. Typically with PIP providers, settlement for additional claims or for take-backs of claims is accomplished through the cost report settlement process. Special steps should be taken to ensure that RAC audit adjustments and any subsequent favorable appeals are settled once and only once.

APPENDIX

The following questions and response were used during the P&P Board deliberations in developing this issue analysis. The P&P Board believes that these questions and responses will bring additional perspective and insights that will be valuable to readers.

Question 1

Is it appropriate for a provider to record a revenue reserve at the date the services are rendered for Medicare revenue that it believes CMS will “take back” as a result of future adjustments and/or findings?

Response to Question 1

Yes. A provider should make a reasonable estimate of the amounts it expects to receive from third-party payers and such estimates shall be recorded in the period that the related services are rendered. ASC 954-605-25-6 states, “[Estimates of contractual adjustments, other adjustments, and the allowance for uncollectibles shall be reported in the period during which the services are provided even though the actual amounts may become known at a later date. AAG HCO(2008), paragraph 5.03].

Additionally, ASC 605-15-25, which addresses, in part, product sales that are subject to potential future pricing adjustments such as rebates or chargebacks, can, by analogy, provide insight into accounting for the revenue adjustments described above. To recognize revenue upon shipment of the product (assuming all other revenue recognition criteria have been met), an entity must be able to reasonably estimate any potential future adjustment to the price of a product sale that is subject to such adjustment. Various conditions must be met for revenue to be recognized, including:

- (a) The seller’s price to the buyer is substantially fixed or determinable at the date of sale, and
- (b) The amount of future returns can be reasonable estimated.

If a company determines that the price of the product is not determinable upon shipment because the company cannot estimate chargebacks, rebates, or other similar adjustments to the price charged for the product, revenue would have to be deferred until the price can be determined.

Whether the price is determinable depends on the provider’s ability to reasonable estimate future adjustments to the amount billed for the service. The current reimbursement system has been in place for many years; accordingly, many providers have detailed and sufficient historical information regarding revenue adjustments

which they use to estimate future adjustments. Based upon the specific facts and circumstances and available evidential matter, a provider may conclude that the price is substantially fixed or determinable at the date of sale and that the amount of future adjustment can be reasonably estimated. Accordingly, in such cases it would appear reasonable that Providers recognize revenue at the date the service is provided.

SOP 00-1, which is applicable to audits of health care organizations falling within the scope of the Health Care Organizations Audit and Accounting Guide, also provides relevant guidance and states "Management is responsible for assuring that revenues are not recognized until their realization is reasonably assured. As a result, management makes a reasonable estimate of amounts that ultimately will be realized, considering – among other things- adjustments associated with regulatory reviews, audits, billing reviews, investigations and other proceedings. Estimates that are significant to management's assertions about revenue include the provision for third-party payer contractual adjustments and allowances." [SOP 00-1, paragraph 10]

If an allowance is recorded it should be supported by relevant evidential matter. "The fact that information related to the effects of future program audits, administration reviews, regulatory investigations or other actions does not exist, does not lead to a conclusion that evidential matter supporting management assertions is not sufficient to support management's estimates." [SOP 00-1, paragraph 17] Additionally, "the fact that an entity currently is not subject to an audit or investigation does not mean that a recorded valuation allowance for potential billing adjustments is not warranted. Nor do emerging industry trends necessarily indicate that an accrual for a specific entity is warranted." [SOP 00-1, paragraph 28]

"Amounts that ultimately will be realized by an entity are dependent on a number of factors, many of which may be unknown at the time the estimate is first made. Further, even if two entities had exactly the same clinical and coding experience, amounts that each might realize could vary materially due to factors outside of their control (for example, differing application of payment rules by fiscal intermediaries, timeliness of reviews, and quality of documentation). As a result, because estimates are a matter of judgment and their ultimate accuracy depends on the outcome of future events, different entities in seemingly similar circumstances may develop materially different estimates." [SOP 00-1, paragraph .30]. Both estimates may be determined to be reasonable in light of the differing assumptions and facts and circumstances.

Question 2

Should a third-party's (e.g., CMS) audit findings be recorded as a change in estimate or a correction of an error?

Response to Question 2

Because of the complexities associated with the revenue estimation process as described in the **Response to Question 1**, the audit findings (e.g., recoveries/take backs) should generally be treated as changes in estimate unless they meet the criteria of an error or prior period adjustment as set forth in ASC 250-10, *Accounting Changes and Error Corrections*. The audit findings should be carefully reviewed and management should assess whether the findings were errors, such as mathematical mistakes, systemic input errors, oversight or misuse of available information, misapplication of known contract terms, etc. or whether the findings represent changes in estimates related to variances interpretations of regulation and contracts, clarification provided through new information and experience providing for improved judgment, etc. Due to the complexities involved in billing medical services, such conclusions will likely require a significant amount of judgment. Management should also review its accounting and reporting policies and processes to determine if such policies and processes did, or should have, considered the need for an allowance for such audit findings. If the policy and estimation process should have given consideration to the possibility of such findings (i.e., revenue was not reasonably assured) but did not use available information to estimate and record an allowance (or the organization did not even have a policy or process), it may be determined that such omission is an error.

Question 3

If a provider records an allowance related to expected Medicare reimbursement payments to ensure it does not overstate revenue reasonably assured of being earned, how should the liability be classified in the balance sheet?

Response to Question 3

As discussed in **Response to Question 1**, the revenue recognition guidance in ASC 954-605 should be considered when recording an allowance related to assuring that revenues are not recognized until they are reasonably assured. The initial allowance should be recorded as a contra (other deduction/adjustment) to revenue in the income statement and a liability in accordance with ASC 954-405 [*Health Care Entities – Liabilities*] and ASC 210-10 [*Balance Sheet – Liabilities*] in the Provider's balance sheet. Additionally, Staff Accounting Bulletin (SAB) Topic 13, A4, Question #1 provides guidance regarding the balance sheet classification of fees that have not been earned because they do not meet the fixed or determinable condition for revenue recognition. While this SAB Topic is written in the context of annual mem-

bership fees, the guidance is highly analogous to the service revenues described above (in part because little guidance regarding service revenues exists). The SAB Topic indicates that such amounts should be classified as a monetary liability in the balance sheet. This guidance provides support for the classification of the revenue adjustments as liabilities in the balance sheet (as noted in the response to Question 1 above, there is no expectation that the revenue will be earned and therefore a deferred revenue classification is not appropriate).

When the receivables are collected, using all available information management must continue to assess whether the estimated allowance is required and whether such allowance continues to be sufficient. That is, management must determine if:

- (a) The amounts received represent payments for revenue that is reasonably assured, or
- (b) There is still insufficient information to recognize the amounts received as revenue because the revenue is still not reasonably assured.

Scenario (a) – If management determined that the amounts received represent payments for services/revenue that is now reasonably assured, then management would record a change in estimate to increase (credit) revenue in the period such a determination was made and in the same period the allowance would be reduced (debit).

Scenario (b) – If management concluded that there was still insufficient information and evidence to determine that the amounts received represented revenue that was reasonably assured, then the allowance would continue to be carried and should be continually assessed to determine its adequacy using the revenue recognition criteria in ASC 954-605.

Question 4

If a provider recorded revenue that was reasonably assured of being earned based on the available information and facts and circumstances at the date the service was delivered but then undergoes a RAC audit which results in recoveries /take backs, how should such audit results be recorded in the financial statements?

Response to Question 4

If a provider recorded revenue that was reasonably assured of being earned based on the available information and facts and circumstances at the date the service was delivered but then undergoes an audit which results in recoveries/take backs, the Provider should follow the guidance in **Responses to Questions 2 and 3**. Any allowances established should be recorded as a contra (other deduction/adjustment) to revenue in the income statement and a liability in accordance with ASC 954-405 [*Health Care Entities – Liabilities*] and ASC 210-10 [*Balance Sheet – Liabilities*] in the

Provider's balance sheet.

Question 5

If a provider objects to the findings of the RAC auditor and plans to appeal the RAC audit adjustment (using the Medicare appeals process) what impact does such an objection have on the financial statements?

Response to Question 5

A provider should continually assess whether the amounts received from CMS represent amounts that have been earned. RAC audit findings represent strong evidential matter of revenue that does not meet the revenue recognition criteria (see Questions 3 and 4). However, if based upon all available evidence, a provider believes that such amounts have been earned because sufficient evidential matter exists to support the revenue recognition criteria (i.e., a provider believes its appeal will be successful), the Provider may conclude that no or limited adjustment to its revenue reserves is required based upon the RAC audit findings.

2009-11 Principles and Practices Board Members

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