The New World of Healthcare Revenue Recognition, ASC 606 - BIGGER THAN ACCOUNTING

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With you today

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Learning Objectives

- Understand ASC 606 Planning Considerations
- Identify Tax Planning Considerations
- Outline other Healthcare ASC Considerations
ASC 606 and Healthcare Trends - Perfect Storm

- Population Shift/Aging
- Legislation
- ‘Amazon-ing’ of Healthcare and Patient Consumerism
- Resources
- Technology
- Security
- Demographics
- Value based care/ Risk
IMPLEMENTATION "LESSONS LEARNED"
Companies often:

- Overlook required changes to their commission expense accounting
- Struggle with figuring out whether revenue should be recognized over time or a point in time
- Struggle to prepare required disclosures
- Overlook the need to have an active dialogue with their auditors
PREPARING FOR ADOPTION
There’s a reason why FASB has given companies such a long runway to prepare.

Companies often:

• **Wait too long** to get started
• **Fail to build a project plan** with dates and project leads
• **Assume they already know the end result** or that it will not change
• **Oversimplify** certain aspects of the new standard

**Note:** *All companies should go through the 5-step model, regardless of what they think their end result will be.*
5-PHASE PROCESS FOR ADOPTION

PHASE 1 - SCOPING AND GAP ANALYSIS
Take an inventory of revenue streams identifying those to be impacted. Prepare a “gap analysis” of ASC 605 vs. ASC 606 for those revenue streams addressing:

- Transition Method/Issues
- Contract Costs
- 5 Steps of ASC 606
- Disclosures

PHASE 2 - TECHNICAL ANALYSIS
Determine specific application of issues identified in Phase 1, including method of determining standalone selling price, pricing controls, identifying specific contracts costs to be capitalized, amortization periods and methodologies and lookback periods for revenue contracts and contract costs. Identify broad systems and business process requirements.

PHASE 3 - SYSTEMS CONFIGURATION AND BUSINESS PROCESSES
Reconfigure systems and business processes based on Phase 2 findings.

PHASE 4 - TESTING/TRANSACTION AUDITING INTERNAL CONTROLS
Run historical transactions through parallel systems and business processes reconfigured for ASC 606. Auditors to perform detail transaction testing.

PHASE 5 - FINANCIAL REPORTING AND DISCLOSURES
Assess results of Phase 4, record ASC 606 adoption entries and develop disclosures including contract liability rollforwards, summary of remaining performance obligations, etc.
ADPTION TIMETABLE: DEC. 31, 2019 YEAR-END

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- TRANSITION METHOD/ISSUES
- 5 STEPS OF ASC 606
- CONTRACT COSTS
- DISCLOSURES

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**Phase 1 - Scoping and Gap Analysis**

Take an inventory of revenue streams identifying those to be impacted. Prepare a “gap analysis” of ASC 605 vs. ASC 606 for those revenue streams addressing:

- Transition method/Issues
- Contract costs
- 5 Steps of ASC 606
- Disclosures

**Phase 2 - Technical Analysis**

Determine specific application of issues identified in Phase 1, including method of determining standalone selling price, pricing controls, identifying specific contracts costs to be capitalized, amortization periods and methodologies and lookback periods for revenue contracts and contract costs. Identify broad systems and business process requirements.

**Phase 3 - Systems Configuration and Business Processes**

Reconfigure systems and business processes based on Phase 2 findings.

**Phase 4 - Testing/Transaction Auditing Internal Controls**

Run historical transactions through parallel systems and business processes reconfigured for ASC 606. Auditors to perform detail transaction testing.

**Phase 5 - Financial Reporting and Disclosures**

Assess results of Phase 4, record ASC 606 adoption entries and develop disclosures including contract liability rollforwards, summary of remaining performance obligations, etc.
ASC 606
Accounting Method Implications

Common tax method: “Just follow books”
• More efficient, avoids book/tax differences
• May be correct, may not – tax requirements frequently differ from GAAP

If “tax follows books” and then books changes course, the options are:
• Tax stays put (no change);
• Tax shifts to follow the new book treatment; or
• Tax shifts to something completely different

Options depend on
• Was the former “book method” consistent with tax law?
• Is the new “book method” consistent with tax law?
• Is there a more optimal method (different from old/new book) that is appropriate?
ADVANCE PAYMENT EXAMPLE

On January 1, 20X1, ABC Corp (a publicly traded entity implementing ASC 606 in 2018) and Customer enter into a three-year agreement for ABC Corp to provide:

- Software License, which is distinct, for $6,000 (stand alone selling price)
- Ongoing Software Maintenance Services, which are distinct, for $3,000 (stand alone selling price)

Total price of $9,000 for software license and maintenance services is paid upfront on January 1, 20X1
ADVANCE PAYMENT EXAMPLE

Current GAAP treatment recognizes license and maintenance revenue ratably over the three year period – e.g., $3,000 each year

<table>
<thead>
<tr>
<th>Current GAAP</th>
<th>20X1</th>
<th>20X2</th>
<th>20X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>License</td>
<td>$2,000</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Maintenance</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Total Revenue</td>
<td>$3,000</td>
<td>$3,000</td>
<td>$3,000</td>
</tr>
</tbody>
</table>

Under new standard, taxpayer will recognize right to use software license at a point in time, and recognize transfer of maintenance service over time

<table>
<thead>
<tr>
<th>ASC 606</th>
<th>20X1</th>
<th>20X2</th>
<th>20X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>License</td>
<td>$6,000</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Maintenance</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Total Revenue</td>
<td>$7,000</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
</tbody>
</table>
ADVANCE PAYMENT EXAMPLE

➢ For tax purposes, assume ABC Corp historically recognize advance payments on the 1-year deferral method of Rev. Proc. 2004-34. Therefore, the income would generally be recognized as follows:

<table>
<thead>
<tr>
<th>Tax (Under Current GAAP)</th>
<th>20X1</th>
<th>20X2</th>
<th>20X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>License</td>
<td>$2,000</td>
<td>$4,000</td>
<td>$0</td>
</tr>
<tr>
<td>Maintenance</td>
<td>$1,000</td>
<td>$2,000</td>
<td>$0</td>
</tr>
<tr>
<td>Total Revenue</td>
<td>$3,000</td>
<td>$6,000</td>
<td>$0</td>
</tr>
</tbody>
</table>

➢ Under ASC 606, ABC Corp cannot defer the license performance obligation and must request IRS consent to comply with the new standard in 2018:

<table>
<thead>
<tr>
<th>Tax (Under ASC 606)</th>
<th>20X1</th>
<th>20X2</th>
<th>20X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>License</td>
<td>$6,000</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Maintenance</td>
<td>$1,000</td>
<td>$2,000</td>
<td>$0</td>
</tr>
<tr>
<td>Total Revenue</td>
<td>$7,000</td>
<td>$2,000</td>
<td>$0</td>
</tr>
</tbody>
</table>
ASC 606
Accounting Method Implications

➢ Rev. Proc. 2018-29 – provides a brand new automatic consent method change #231 to change the method of accounting for revenue recognition to (a) identify performance obligations, (b) to allocate transaction price to performance obligations, and/or (c) to consider performance obligations satisfied

- Year of change must be same year as ASC 606 implementation for books

- Proposed ASC 606 method of accounting must be otherwise permissible under the Internal Revenue Code.

- Option of section 481(a) adj. or cut-off basis
ASC 606
Accounting Method Implications

Rev. Proc. 2018-29 Considerations:
• Taxpayers need to evaluate tax implications of ASC 606 immediately to determine whether tax method changes will be necessary - any missed opportunities to file in the year of ASC 606 implementation will result in non-automatic method changes in the future, along with the $9,500+ filing fee.

• Rev. Proc. 2018-29 does NOT apply to changes involving identifying contracts or determining the transaction price (including the inclusion and exclusion of variable consideration).

• Does not apply to changes involving the revised section 451 rules under the tax reform bill; the government anticipates that it will issue further guidance to address these issues separately in the future.
ASC 606
Action Steps

➢ Don't wait - look at revenue recognition methods for tax at the same time you are evaluating for GAAP purposes

➢ Tax professionals should initiate discussions with taxpayers and auditors and begin gathering facts related to what will be changing for book purposes
   ❑ Request and evaluate financial statement ASC 606 memo

➢ Review options for changing tax methods
   ❑ Evaluate most beneficial method for tax
   ❑ Assess need to file method change to keep book and tax methods the same

➢ Establish method for tracking tax methodology going forward if different from book treatment

➢ Reach out to NTO for assistance with technical positions
OTHER CONSIDERATIONS

• Healthcare Merger Activity
  • Profitability Impact
  • Business Value
  • Due Diligence
• Lessons Learned
• Risk and Control Considerations
Profitability Impact

• Excerpts from Filings

• **Impact of $24.8 Implicit Price Concessions ($multi-billion dollar company)**
  
  In January 1, 2018, the Company adopted Accounting Standards Codification Topic 606, Revenue from Contracts with Customers (ASC 606). Results for reporting periods beginning after January 1, 2018 are presented under ASC 606, while comparative information has not been restated and continues to be reported under the accounting standards in effect for those periods. The impact of applying ASC 606 to the quarter ended March 31, 2018 was a $24.8 million implicit price concession, directly reducing net revenues, which previously would have been recorded as a provision for losses on accounts receivable.

• **Impact of $500,000 from private pay ($2,000,000 annual revenue company)**
  
  Under the modified retrospective implementation method, the Company recorded a one-time cumulative effect adjustment at January 1, 2018 to reflect the aggregate effect of all open tests performed prior to January 1, 2018 as if revenue had been recognized under ASC 606. The cumulative effect adjustment was recorded increasing the opening balance of Accounts Receivable by $500,000.
Business Value

{Pre - ASC 606 Adjustment

EBITDA $15.0M x Buyer's Multiple 8 = Enterprise Value $120.0M

Post - ASC 606 Adjustment

EBITDA $12.5M x Buyer's Multiple 8 = Enterprise Value $100.0M

EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization
Due Diligence

- **Timing - Sell-side (or pre-sale) diligence**
- **Review different contracts and funding sources to identify all revenue streams**
- **Review contracts with clinical, operations and legal group to determine if an enforceable right to payment exist**

<table>
<thead>
<tr>
<th>AUDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Performed in accordance with the numerous standards (e.g., Generally Accepted Auditing Standards, PCAOB, COSO, GAAP, etc.)</td>
</tr>
<tr>
<td>Give an opinion on the financial statements</td>
</tr>
<tr>
<td>Includes testing of underlying transactions (invoices, bank reconciliations, contracts)</td>
</tr>
<tr>
<td>Includes use of model audit programs and checklists</td>
</tr>
<tr>
<td>Financial statements must be presented within strict guidelines</td>
</tr>
<tr>
<td>Primarily balance sheet focus</td>
</tr>
<tr>
<td>Primarily historical focus</td>
</tr>
<tr>
<td>Adjustments proposed based on materiality thresholds</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>SELL-SIDE DUE DILIGENCE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Performed under the AICPA Consulting standards, act in an advisory capacity providing issues-based findings, observations, and recommendations</td>
</tr>
<tr>
<td>Do not provide assurance or opinion</td>
</tr>
<tr>
<td>Methodology, but no programs or checklists used</td>
</tr>
<tr>
<td>Deliverables are tailored to client’s needs and the particular transaction</td>
</tr>
<tr>
<td>P&amp;L focused</td>
</tr>
<tr>
<td>Historical focus always with the thinking of how it will affect the future</td>
</tr>
<tr>
<td>No materiality thresholds (i.e., an adjustment viewed as immaterial for an audit could be material for Q of E due to EBITDA multiples)</td>
</tr>
</tbody>
</table>
Perfect Storm

• Noise with new standard and reimbursement changes
• Additional estimates needed.
• M&A Environment
• Fraudulent Reporting
• Challenges
Additional Lessons Learned /Reminders

- Digging in Will Identify Issues
- Identification of All Revenue Streams
- Recording of Value-Based Reimbursement
- Quality Measures Reporting
- Private Pay – Switching from Cash Basis Versus Accrual Basis
- Identification of Side Agreements
- Cost Reporting and Regulatory Requirements
- Identifying Separate Performance Obligations - Timing
- Bad Debt Classification
- In-Network and Out-of-Network Providers and Identifying Contracts
- Third Party Provider Reports and Systems
Migration to “Value Based Care”

The Movement to “Value-Based Care” (VBC)  
Via Payor Contracts and “Accountable Care” Models

Different metrics, initiatives and contract models in Medicaid, Medicare Advantage, Commercial products

• Variable Consideration establishes two methods in determining the transaction price - Expected Amount vs. Most Likely
• Constraint - requires that variable consideration only be included in the transaction price to the extent that it is “probable that a significant reversal...will not occur.”
Additional Lessons Learned /Reminders

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- Recording of Value-Based Reimbursement
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Step 1- Identify the Contract

Five criteria under ASC 606-10-25-1 must be met in order for there to be a contract with a patient/customer:

1. Parties to the contract have approved the contract
   a. In writing or orally, or in accordance with other customary business practices
2. The party can identify each party’s rights regarding services to be transferred
3. The entity can identify the payment terms for the goods or services
4. The contract has commercial substance
5. Probable that the entity will collect substantially all of the consideration
Additional Lessons Learned /Reminders

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- Identification of All Revenue Streams
- Recording of Value-Based Reimbursement
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Controls to Consider

- Implementation
  - Scope of the contract review
  - Identification of Internal Expertise
  - Identification of Revenue Streams
  - Portfolio approach approval (3 requirements)
    - Contracts or Performance Obligations have Similar Characteristics
    - Not Materially Different than Individual Contract
    - Estimates and Assumptions Properly Reflect the Size and Composition of the Portfolio
Controls to Consider

- Controls
  - Controls over Revenue Cycle (as always)
    - Front-end
    - Charge Capture
    - Back-End and Reporting
  - Management review controls of contracts through the entire 5 step model
  - Presentation and disclosure controls
  - Controls over third-party reports and systems
Healthcare industry leadership

INDUSTRY ASSOCIATION & EVENT PARTICIPATION

- Healthcare Financial Management Association (HFMA)  HFMA is the nation’s premier membership organization for healthcare finance leaders. BDO has membership and involvement with regional and local chapters throughout the U.S;
- National Investment Center, The National Investment Center for the Seniors Housing & Care Industry (NIC) is a 501(c)(3) organization whose mission is to facilitate informed investment in the long-term care space. Members of national Healthcare group are active members of NIC, and BDO is the only accounting firm sponsor of NIC’s national conference (held in October) and regional conference (held in March);
- American Hospital Association
- American Health Lawyers Association
- California Hospital Association
- Columbia Business School Healthcare Conference
- Harvard Business School Healthcare Conference
- HealthLeaders Media
- J.P. Morgan Annual Healthcare Conference
- LeadingAge
- McDermott, Will & Emery Litigation, Compliance & Investigations Healthcare Conference
- Medical Group Management Association
- New England Journal of Medicine Catalyst Research Program
- Pediatric SuperGroup Conference
- Polsinelli Dealmakers Conference
- Wharton Healthcare Conference
- Women in Bio
- Healthcare Business Women’s Association

BDO KNOWS HEALTHCARE: THE BLOG OF THE BDO CENTER FOR HEALTHCARE EXCELLENCE & INNOVATION

The BDO Knows Healthcare blog (http://healthcareblog.bdo.com) is a resource and discussion platform focused on critical issues impacting the industry and re-defining the future of care. Our posts explore how reimbursement and regulatory changes re-shaping provider and payer business models, covering both the financial and clinical implications and drawing on our depth of experience in healthcare finance, operations and clinical practice. We will also touch on the myriad compliance and risk management challenges healthcare organizations face, as well as M&A and capital strategies.
The BDO Center for Healthcare Excellence & Innovation

DRIVING THE FUTURE OF HEALTHCARE

We help clients redefine their strategies, operations, and processes based on both patient-centric demands and rigorous best practices - responding to the industry’s new market disrupters, cost pressures, and outcome-based reimbursement models.

Our Team:
- Healthcare Executives
- Investment Bankers
- Forensic Technologists
- Clinical Practitioners
- Economists & Statisticians
- Regulatory Specialists
- Valuation Professionals
- Auditors
- Tax Accountants
- Turnaround / Restructuring Advisors
- IT Specialists / Data Analysts
- Real Estate Planners & Advisors