Healthcare Mid-Year Accounting & Auditing Update

June 14, 2023

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Meet the Presenters

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Learning Objectives

- Develop an understanding of the accounting & financial reporting matters most significant to the healthcare industry in 2023

- Gain insights & lessons learned from organizations tackling significant accounting & reporting matters like revenue recognition, lease accounting, cloud-based computing, & CARES Act Provider Relief Funds

- Obtain an update of other matters impacting financial statement audits, Single Audits, & internal controls/risk management relevant to the accounting & reporting functions

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Agenda

- Standards Update – Newer Items Expected to Impact Healthcare Organizations
  - Lease Update – *Common Control Arrangements*
  - Current Expected Credit Losses (CECL)
  - Reference Rate Reform
- Reflection on Fiscal Year 2022 Audits
- Previously Issued Standards – Key Insights and Reminders
  - Cloud Computing Arrangements
  - Goodwill & Impairment Reminders

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Lease Update – Common Control Arrangements

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ASU 2023-01, *Common Control Arrangements*

Addresses two issues

1. Terms & conditions to be considered for arrangements between entities under common control in determining whether a lease exists, &, if so, the classification & accounting for that lease
2. The accounting for leasehold improvements under Accounting Standards Codification 842 when the lease term in a common control lease is shorter than the useful life of the leasehold improvements

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ASU 2023-01, *Common Control Arrangements*

Background

- ASC 840 required entities to classify & account for related-party leases based on the arrangement's economic substance when transaction terms were significantly affected by the fact that the lessee & lessor are related
- ASC 842 updated ASC 840's requirements for related-party leases. ASC 842 requires entities to classify & account for related-party leases based on an arrangement's legally enforceable terms & conditions (consistent for leases between unrelated parties)

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ASU 2023-01, *Common Control Arrangements*

More on Issues & Concerns

Legally Enforceable	In many common control arrangements, lease contracts can be made verbally, & lease terms may be explicit or implicit outside of a formal lease contract, *e.g.*, a management or operating agreement may create enforceable rights & obligations related to leases without specifically contemplating those leases
	Concerned that they are required to determine whether implicit legally enforceable terms & conditions exist, which may require legal counsel/diversity in practice in the extent of diligence that an entity is expected to undertake to evaluate the legal enforceability of written terms &/or identify implicit terms in common control arrangements
Leasehold Improvements	The amortization period for leasehold improvements depends on whether ownership of the leased asset transfers to the lessee at the end of the lease term or the lessee is reasonably certain to exercise a purchase option. If either condition is met, the leasehold improvement should be amortized over its useful life
	In other lease arrangements, a leasehold improvement should be amortized over the shorter of its useful life or the remaining lease term. As ASC 842 was originally drafted, it would be inappropriate to conclude the amortization period for a leasehold improvement exceeds the lease term

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ASU 2023-01, *Common Control Arrangements*

Relief – Legally Enforceable Concerns

- ASU 2023-01 creates a new practical expedient for related-party arrangements between entities under common control
- The practical expedient may be applied on an arrangement-by-arrangement basis
- If elected, in determining if a lease exists, an entity would consider whether ***written terms & conditions*** convey the ***practical right to control*** the use of an identified asset for a period of time in exchange for consideration
- An entity would not be required to determine whether those written terms & conditions are legally enforceable. If an entity determines that a lease exists, the lease should be classified & accounted for based on those written terms & conditions
- If no written terms & conditions exist, an entity is prohibited from applying the practical expedient & would continue to apply the existing ASC 842 requirements
  - Entity would need to consider legally enforceable terms & conditions (oral & implicit) for purposes of determining whether a lease exists &, if so, the associated classification & accounting of a lease. Consistent with ASC 842, if no legally enforceable terms & conditions exist, the arrangement would not be a lease & other GAAP would apply

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ASU 2023-01, *Common Control Arrangements*

Relief – Leasehold Improvement Concerns

- The ASU amends ASC 842 to require that leasehold improvements for leases between entities under common control be
  - Amortized over the improvement's useful life to the common control group (regardless of the lease term) as long as the lessee controls the use of the underlying asset through a lease. If the lessor obtained the right to control the use of the underlying asset through a lease with another entity not within the same common control group, the amortization period may not exceed the amortization period of the common control group
  - Accounted for as a transfer between entities under common control through an adjustment to equity (net assets for an NFP entity) when the lessee no longer controls the use of the underlying asset
- If after the commencement date the lessee & lessor become within the same common control group or are no longer within the same common control group, any change in the required amortization period for leasehold improvements shall be accounted for prospectively as a change in accounting estimate in accordance with ASC 250, Accounting Changes and Error Corrections
- When the useful life of leasehold improvements to the common control group exceeds the related lease term, a lessee shall disclose the following information
  - The unamortized balance of the leasehold improvements at the balance sheet date
  - The remaining useful life of the leasehold improvements to the common control group
  - The remaining lease term

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ASU 2023-01, *Common Control Arrangements*

- Transition Entities adopting ASU 2023-01 concurrently with ASC 842 may follow the same transition requirements used to apply ASC 842 or may elect to use either of the prospective approaches described below
- An entity that has already adopted ASC 842 would be allowed to apply ASU 2023-01 using one of the following methods
  - Prospectively to all new leasehold improvements recognized on or after the date that the entity first applies ASU 2023-01
  - Prospectively to all new & existing leasehold improvements recognized on or after the date that the entity first applies ASU 2023-01, with any remaining unamortized balance of existing leasehold improvements amortized over their remaining useful life to the common control group determined at that date
  - Retrospectively to the beginning of the period in which the entity first applied ASC 842, with any leasehold improvements that otherwise would not have been amortized or impaired recognized through a cumulative-effect adjustment to the opening balance of retained earnings at the beginning of the earliest period presented in accordance with ASC 842

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Current Expected Credit Losses (CECL)

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ASU 2016-13, *Financial Instruments—Credit Losses*

- Introduced CECL: Current Expected Credit Loss
- Very hot topic in other industries, *e.g.*, financial services
- Often overlooked or minimized in healthcare
- Summary concept
  - Effectively replaces the "incurred loss" model with a "current expected credit loss" (CECL) model when measuring impairment of a wide-ranging scope of financial assets
- The standard is effective for fiscal years beginning after December 15, 2022, *e.g.,* January 2023 for all but SEC filers that are not smaller reporting entities (who adopted earlier)

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ASU 2016-13, *Financial Instruments—Credit Losses*

Financial instruments in scope

- Trade receivables
- Contract receivables
- Loan receivables
- Financial guarantees
- Reinsurance recoverable
- Held-to-maturity debt securities
- Loan commitments
- Lease receivables

What makes the CECL impairment model more complex than the current model is that the estimate of expected credit losses considers not only historical information, but also current & future economic conditions & events over the life of the financial instrument that could impact expected losses. Such lifetime expected credit losses require immediate recognition under the CECL impairment model

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ASU 2016-13, *Financial Instruments—Credit Losses*

Financial instruments not in scope

- Loans made to participants by defined contribution employee benefit plans
- Policy loan receivables of an insurance entity
- Pledges receivable of a not-for-profit entity
- Loans & receivables between entities under common control
- Operating lease receivables

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ASU 2016-13, *Financial Instruments—Credit Losses*

- Disclosure Considerations

Accounts Receivable

We receive payments for services rendered from federal and state agencies (under the Medicare and Medicaid programs), managed care health plans, commercial insurance companies, employers and patients. We recognize that revenues and receivables from government agencies are significant to our operations, but do not believe there are significant credit risks associated with these government agencies. We do not believe there are any other significant concentrations of revenues from any particular payer that would subject us to any significant credit risks in the collection of our accounts receivable. Days revenues in accounts receivable were 53 days, 49 days and 45 days at December 31, 2022, 2021 and 2020, respectively. Changes in general economic conditions, patient accounting service center operations, payer mix, payer claim processing, or federal or state governmental health care coverage could affect our collection of accounts receivable, cash flows and results of operations.

Accounts Receivable

Substantially all of the Company's accounts receivable is related to providing healthcare services to patients. These services are paid for primarily by federal and state governmental authorities, managed care health plans, commercial insurance companies, workers' compensation programs, and employer-directed programs. The Company's general policy is to verify insurance coverage prior to the date of admission for patients admitted to its critical illness recovery hospitals and rehabilitation hospitals. Within the Company's outpatient rehabilitation clinics, insurance coverage is verified prior to the patient's visit. Within the Company's Concentra centers, insurance coverage is verified or an authorization is received from the patient's employer prior to the patient's visit.

The Company performs periodic assessments to determine if an allowance for expected credit losses is necessary. The Company considers its incurred loss experience and adjusts for known and expected events and other circumstances. In estimating its expected credit losses, the Company may consider changes in the length of time its receivables have been outstanding, changes in credit ratings for its payors, requests from payors to alter payment terms due to financial difficulty, and notices of payor bankruptcies or payors entering receivership. Because the Company's accounts receivable is typically paid for by highly-solvent, creditworthy payors, such as Medicare, other governmental programs, and highly-regulated commercial insurers on behalf of the patient, the Company's credit losses have been infrequent and insignificant in nature. Amounts recognized for allowances for expected credit losses are immaterial to the consolidated financial statements.

Likely more clarification / elaboration for healthcare trade receivables.

Implication for other financial instrument credit losses could be significant

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Reference Rate Reform

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ASU 2020-04 & Reference Rate Reform

- In 2020, FASB issued Accounting Standards Update (ASU) 2020-04, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting*
- Provides temporary, optional expedients & exceptions for applying GAAP to held-to-maturity securities, contracts, hedging relationships, & other transactions affected by reference rate reform, most notably to
  - Simplify contract modification accounting
  - Allow hedging relationships to continue without designation upon a change in certain critical terms
  - Allow a change in the designated benchmark interest rate to a different eligible benchmark interest rate in an existing fair value hedging relationship & allow flexibility in the accounting method for the effect of that change
  - Simplify or temporarily suspend the assessment of hedge effectiveness for cash flow hedges
  - Suspend the assessment of certain qualifying conditions for fair value hedges for which the shortcut method for assuming perfect hedge effectiveness is applied

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ASU 2020-04 & Reference Rate Reform

	Current Accounting	Optional Relief
Contract Modifications	High volume of modifications results in burdensome accounting evaluations	Simplified accounting evaluations scaled for high volume of modifications
Hedge Accounting	Hedge accounting discontinued when contracts are modified	Hedge accounting preserved when contracts are modified
	Hedge accounting discontinued if hedging relationships are not highly effective during the temporary transition period	Hedge accounting preserved during the temporary transition period, with any hedge breakage/ineffectiveness visible in the financial statements

Under optional relief, the contract is not remeasured or reassessed but assumed to be a contract continuation

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ASU 2020-04 & Reference Rate Reform

Due to the unique nature of LIBOR sunset, ASU 2020-04 had an unusual effective date. The relief was set to expire for contracts entered into or evaluated after December 31, 2022, which was one year after the then-expected LIBOR cessation date. However, on March 5, 2021, LIBOR's regulator announced that certain USD LIBOR tenors will continue to be published until June 30, 2023. FASB recently issued ASU 2022-06, which extends the available relief to December 15, 2024

Rate	Sunset Date
Overnight	June 30, 2023
1 week	December 31, 2021
1 month	June 30, 2023
2 month	December 31, 2021
3, 6, & 12 month	June 30, 2023

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Reflections on Fiscal Year 2022 Audits

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Reflections on December 31, 2022 Audits

Audit Opinion & Related Matters

Impairments, Debt Compliance, & Going Concern Matters

Leases

Provider Relief Funds & Other Government Assistance

Other Industry Considerations

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INDEPENDENT AUDITOR'S REPORT

To the [Identify the body charged with governance.]
of [Name of Nonprofit Health Care Entity]

Opinion

We have audited the accompanying financial statements of [Name of Nonprofit Health Care Entity] (a nonprofit organization), which comprise the statement of financial position as of [Date] and [Years], and the related statements of activities and cash flows for the years then ended, and the related notes to the financial statements.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of [Name of Nonprofit Health Care Entity] as of [Date] and [Years], and the changes in its net assets and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Basis for Opinion

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of [Name of Nonprofit Health Care Entity] and to meet our other ethical responsibilities in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Responsibilities of Management for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about [Name of Nonprofit Health Care Entity] 's ability to continue as a going concern within one year after the date that the financial statements are available to be issued.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with generally accepted auditing standards will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements, including omissions, are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.

In performing an audit in accordance with generally accepted auditing standards, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of [Name of Nonprofit Health Care Entity] 's internal control. Accordingly, no such opinion is expressed.
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.

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- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about [Name of Nonprofit Health Care Entity] 's ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control related matters that we identified during the audit.

Supplementary Information

Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The [Identify supplementary information.] is presented for purposes of additional analysis and is not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole.

[Firm's Signature]

[Location of Firm (City, State)]

[Report Date]

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INDEPENDENT AUDITOR'S REPORT

To the [Identify the body charged with governance.]
of [Name of Nonprofit Health Care Entity]

Opinion

We have audited the accompanying financial statements of [Name of Nonprofit Health Care Entity] (a nonprofit organization), which comprise the statement of financial position as of [Date] and [Years] , and the related statements of activities and cash flows for the years then ended, and the related notes to the financial statements.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of [Name of Nonprofit Health Care Entity] as of [Date] and [Years] , and the changes in its net assets and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Basis for Opinion

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of [Name of Nonprofit Health Care Entity] and to meet our other ethical responsibilities in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Responsibilities of Management for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about [Name of Nonprofit Health Care Entity] 's ability to continue as a going concern within one year after the date that the financial statements are available to be issued.

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of [Name of Nonprofit Health Care Entity] 's internal control. Accordingly, no such opinion is expressed.
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.

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- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about [Name of Nonprofit Health Care Entity] 's ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control related matters that we identified during the audit.

Supplementary Information

Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The [Identify supplementary information.] is presented for purposes of additional analysis and is not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional

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PHE ended on May 11, 2023

- But the PRF journey continues

Types of Findings – Single Audits with PRF Assistance Listing Included

Questioned Costs
Other Findings
Significant Deficiencies
Material Weakness
Other Matters
Modified Opinion

0% 10% 20% 30% 40% 50% 60% 70% 80% 90% 100%

Yes No

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Other Industry Considerations

- Increasing Costs/Inflation
- Workforce Shortages & Succession Planning
- Decreased Reimbursement/Alternative Reimbursement Methods
- Reimbursement Opportunities, *e.g.*, SSI alignment
- 340B
- Telehealth
- Cybersecurity & Business Continuity
- Evolving Reporting, *e.g.*, Environmental, Social, & Governance
- Crypto Assets
- Board Oversight Topics

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Cloud Computing Arrangements

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Cloud Computing

Evaluate the accounting for fees paid by a customer in a cloud computing arrangement (CCA)

Amends the definition of a hosting arrangement & requires a customer in a hosting arrangement that is a service contract to capitalize certain implementation costs as if the arrangement was an internal-use software project

Entities that enter into hosted CCA service arrangements will apply the existing internal-use software guidance to determine which implementation costs are eligible for capitalization

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ASU 2018-15, *Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract*

What is a hosting arrangement?

An arrangement where the customer accesses the vendor's software over the internet or a dedicated line. The software is hosted on the vendor's (or a third party on behalf of the vendor) infrastructure

What is a cloud computing arrangement (CCA)?

A hosting arrangement that does <u>not</u> transfer a license to the hosted software to the customer

This ASU does NOT change the accounting for *software licensing arrangements* (which includes hosting arrangements that <u>do</u> transfer a license to the hosted software to the customer)

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Does the Arrangement Transfer a License?

A hosting arrangement transfers a license to the hosted software to the customer only when both

Right to take possession

- The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty

Feasible for customer or third party to host

- It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software

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Capitalizable & Non-Capitalizable Costs

Capitalizable

- Integration (developing interfaces between the hosted software & the company's other systems)
- Customization, either of the company's other systems or of the hosted software
- Configuration, either of the company's other systems or of the hosted software, data conversion, or migration
- Installation
- Architecture & design
- Coding

Non-Capitalizable

- Testing
- Training
- Business process reengineering

→ Deferred implementation costs are expensed over the term of the hosting arrangement, which is the fixed, non-cancelable term of the arrangement, plus any reasonably certain renewal periods

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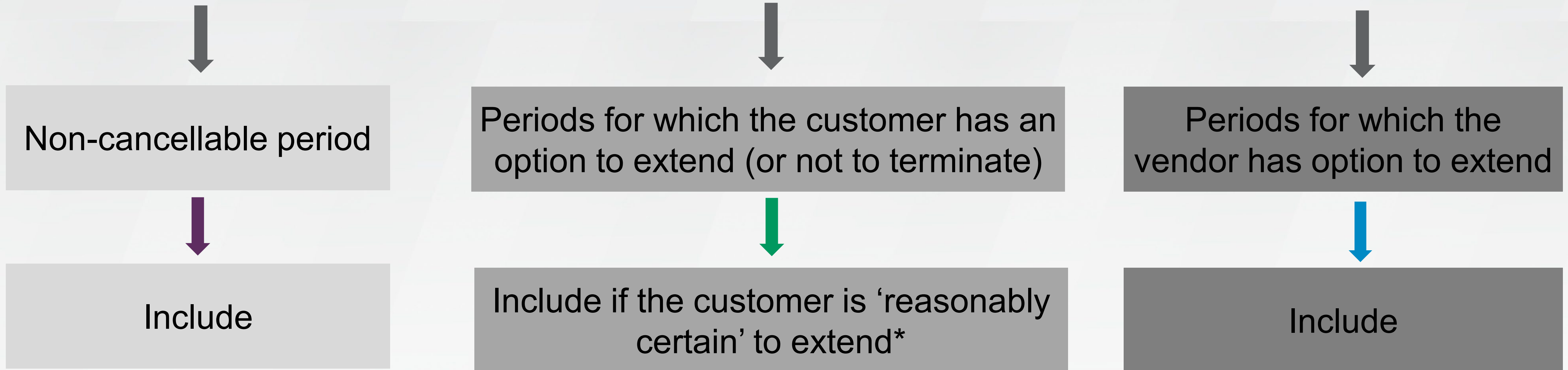
Determining the Recognition Period



"Periodically reassess" the recognition period

'Reasonably certain' assessed consistent with new leases guidance

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Presentation & Disclosures

Financial statement presentation

Balance sheet	Include deferred costs in same line item as would present prepayment of fees for the CCA
Income statement	Include expense related to capitalized implementation costs in same line item as the CCA fees paid to the cloud service provider
Cash flow statement	Cash payments for implementation costs classified consistent with how the fees for the CCA are classified (generally operating activities)

Disclosure requirements

Nature of the hosting arrangement

Disclosures as if the deferred costs were a separate, major depreciable asset class

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Goodwill& Impairment Reminders

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ASU 2019-06 – Extending Private Company Alternatives for Goodwill & Intangibles to NFP Entities

Goodwill accounting alternative

- Annual testing of goodwill for impairment is not required
- Amortize goodwill on a straight-line basis over 10 years (or a period less than 10 years if able to demonstrate that another useful life is more appropriate)
- Upon adoption of the accounting alternative
  - must make an accounting policy election to test goodwill for impairment at either the entity level or the reporting-unit level
  - Goodwill of the entity (or the reporting unit) is tested for impairment if an event occurs or circumstances change indicating that the fair value of the entity (or the reporting unit) may be below its carrying amount

Intangible asset accounting alternative

- For transactions occurring after adoption of the alternative
  - A not-for-profit entity should subsume into goodwill & amortize customer-related intangible assets that are not capable of being sold or licensed independently from the other assets of a business & all noncompetition agreements acquired
- A not-for-profit entity that elects the intangible asset accounting alternative is required to adopt the alternative to amortize goodwill

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ASU 2017-04 – *Simplifying the Test for Goodwill Impairment*

Effective Dates

Prospectively for annual & interim periods in fiscal years beginning after

- December 15, 2019 for public business entities that file with the SEC
- December 15, 2020 for PBEs that do not file with the SEC
- December 15, 2021 all other entities

Early adoption permitted for all entities

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Main Provisions

Step 2 Eliminated	▪ No longer required to calculate implied fair value of goodwill if Step 1 indicates impairment
Step 0 Qualitative Assessment	▪ Implied new starting point ▪ More-likely-than-not assessment maintained
Step 1 Assessment	▪ Failing will result in impairment ▪ Carrying value > FV = goodwill impairment
Other Provisions	▪ Eliminates requirement for reporting unit with zero or negative carrying amount to perform a qualitative assessment

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ASU 2021-03, *Intangibles—Goodwill & Other (Topic 350)*

- Provides private companies & NFPs with an accounting alternative to perform the goodwill impairment triggering event evaluation as of the end of the reporting period
  - Not required to monitor for goodwill impairment triggering events during the reporting period
  - Instead, evaluate facts & circumstances as of the end of each reporting period to determine whether a triggering event exists &, if so, whether it is more likely than not that goodwill is impaired
- Not required to also elect other private company/NFP accounting alternatives for goodwill
- No incremental disclosure requirements beyond the accounting election
- Effective years beginning after December 31, 2019

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