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 Definitions

► Financial Accounting Standards Board (FASB)
► American Institute of Certified Public Accountants (AICPA)
► Electronic health record (EHR)
► The 10th revision of the International Statistical Classification of Diseases and Related Health Problems (ICD-10)
► Office of Management and Budget (OMB) Circular
► US Generally Accepted Accounting Principles (US GAAP)
► Net patient service revenue (NPSR)
► Accounting Standards Codification (ASC)
► Technical Practice Aid (TPA)
► Not-for-profit (NFP)
► International Accounting Standards Board (IASB)
► Financial Reporting Executive Committee (FinREC)
► Health maintenance organizations (HMOs)
► Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index
► Continuing care retirement communities (CCRCs)
► Securities and Exchange Commission (SEC)
► Public Company Accounting Oversight Board (PCAOB)
► Centers for Medicare & Medicaid Services (CMS)
Objectives

Our objectives are to:

- Gain an understanding of the key Accounting Standards Updates (ASUs), FASB projects and other accounting and auditing matters that are currently impacting or will impact health care organizations in the near future.
- Cover practical matters relative to adoption of the new ASUs and other industry initiatives.
- Understand the resources available to assist in further understanding the specifics related to the matters discussed within this presentation.
Agenda

- Introductions
- Significant industry considerations
- Recent accounting pronouncements
- Revenue recognition project
- Lease project
- Financial instrument project
- Not for profit financial reporting project
- Definition of a public entity
- Insurance project
- Acquisition accounting
- Controls
- OMB Circular A-133 Single Audit Developments
Introductions
Gregg Ferlin, VP of Finance – Community Foundation of Northwest Indiana, Inc.

Gregg Ferlin is Vice President of Finance for Community Foundation of Northwest Indiana, Inc. (CFNI), a healthcare system consisting of three hospitals, a physician entity and a continuing care retirement community. He has more than 25 years of experience in finance and accounting in areas such as reporting, internal control, treasury management, debt financing, investments, system implementation, process re-engineering and efficiency improvement.

Prior to joining CFNI, Mr. Ferlin worked in a number of diverse industries including, retail, restaurant, real estate, distribution, manufacturing, technology and franchising, with firms ranging in size from venture capital and private equity backed start-ups to Fortune 100 companies.

Mr. Ferlin holds a B.S. with a major in Accountancy from the University of Illinois and is a certified public accountant in the state of Illinois.
Chrissie Erdmann, Audit Senior Manager, EY

- Chrissie is a senior manager in EY’s Midwest Assurance Health Science Practice and with over ten years of experience conducting financial statement audits of health science clients.
- Chrissie has extensive experience in the following areas: coordinating internal audit department involvement throughout various phases of audits, planning and conducting accounting and auditing update education sessions for clients, and assisting clients with bond offerings and related required procedures.
- Chrissie has a Bachelors in Accounting and a Masters of Accounting Science from the University of Illinois Urbana-Champaign. She is a member of the American Institute of Certified Public Accountants.
- Chrissie has taken an active role within the firm’s education processes by teaching classes of audit training for interns and new hires to the firm.
- Certain of Chrissie’s clients served include: NorthShore University HealthSystem, Alexian Brothers Health System, Advocate Health Care Network, Franciscan Sisters of Chicago Service Corporation, Northwestern Medical Faculty Foundation, Springfield Clinic, DuPage Medical Group, Midwestern University and Beacon Health System.
Brian Pavona, Audit Senior Manager, EY

Brian is a Senior Manager in EY’s Midwest Health Sciences Assurance Practice with over ten years of experience providing assurance services to public and privately-held companies with a focus on the health sciences sector including academic medical centers, multi-hospital systems and clinics, physician groups, pharmaceutical companies, and other health care private equity-backed organizations.

Brian has extensive experience auditing critical reserves, investments, debt offerings and financings, lease accounting, joint-ventures, intangibles, and acquisition accounting. Brian has extensive knowledge gained from helping clients to implement and enhance internal controls, including SOX 404 compliance and information systems general controls.

Brian has a Bachelors in Business Administration and a Masters in Accounting, both from the Stephen M. Ross School of Business at the University of Michigan (Ross). He has served as a student instructor at Ross and also teaches courses at EY. He is a member of the American Institute of Certified Public Accountants, the Illinois CPA Society, and Healthcare Financial Management Association (First Illinois Chapter). He is also a member of the Big Shoulders Fund Chairman’s Advisory Council.

Certain of Brian’s clients served include Actient Pharmaceuticals, Advocate Health Care Network, Community Foundation of Northwest Indiana, Inc., Mayo Clinic, National Surgical Hospitals, Northwestern Memorial HealthCare, NorthShore University HealthSystem, NantPharma, and Sagent Pharmaceuticals, Inc.
Polling question

Are the following topics relevant to your organization:

- Acquisition accounting
- OMB Circular A-133 Single Audit Developments
- Financial instrument project

The results of the above will assist in us planning our time for today’s presentation.
Significant industry considerations – 2013 audit
Industry considerations play a significant role in a company’s financial condition, results of operations, cash flows and ability to continue as a going concern. Industry considerations for health care, include but are not limited to:

- Health care reform, provider considerations
- Other Medicare and Medicaid trends
- Recovery Audit Contractors (RACs)
- Uninsured and underinsured patients
- International Classification of Diseases, 10th revision (ICD-10)
- Incentive payments for meaningful use of electronic health records (EHRs)
## Significant 2013 industry considerations

### Health care reform, provider considerations

<table>
<thead>
<tr>
<th>Considerations</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>► In June 2012, the Patient Protection and Affordable Care Act (PPACA), as</td>
<td>► Revenue cycle management processes, admissions processes, patient</td>
</tr>
<tr>
<td>amended by the Health Care and Education Reconciliation Act of 2010, was</td>
<td>flow processes, information technology (IT) and operational systems</td>
</tr>
<tr>
<td>upheld by the Supreme Court. Many of the provisions of the PPACA will take</td>
<td>could be affected.</td>
</tr>
<tr>
<td>effect or be phased in over the next several years. Providers need to consider</td>
<td>► Heavy reliance on government reimbursement (Medicare and Medicaid)</td>
</tr>
<tr>
<td>the following potential effects:</td>
<td>could cause a strain on operating results.</td>
</tr>
<tr>
<td>► Increased patient volume and a changing patient mix (growing government</td>
<td></td>
</tr>
<tr>
<td>payor portion, particularly Medicaid)</td>
<td></td>
</tr>
<tr>
<td>► Incentivizing primary care and care management and other aspects of</td>
<td></td>
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<tr>
<td>reform that could change networks and relationships (e.g., pay for quality)</td>
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<tr>
<td>► Payment bundling requirements, including models to reimburse providers for</td>
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<tr>
<td>an episode of care across the acute inpatient and post-acute care settings</td>
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<tr>
<td>to redirect incentives toward outcomes rather than volumes</td>
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</tr>
<tr>
<td>► Annual decreases to the market basket update for inpatient and outpatient</td>
<td></td>
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<td>payment systems</td>
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<tr>
<td>► A reduction in Medicare disproportionate share hospital (DSH) payments</td>
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<tr>
<td>and decreased funding for Medicaid DSH hospital program beginning in</td>
<td></td>
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<tr>
<td>federal fiscal year 2014</td>
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</tbody>
</table>
Significant 2013 industry considerations

Other Medicare and Medicaid trends

<table>
<thead>
<tr>
<th>Considerations</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>► On 1 March 2013, President Obama signed an order to initiate the automatic spending cuts provided by the Budget Control Act of 2011. Known as sequestration, the cuts include Medicare spending reductions of up to 2%, which began on 1 April 2013.</td>
<td>► Providers receive a significant portion of its revenues from government health programs, principally Medicare and Medicaid, which are highly regulated and subject to frequent and substantial changes.</td>
</tr>
<tr>
<td>► Aside from health care reform and sequestration, other legislative actions are also increasing unreimbursed Medicare and Medicaid costs, including:</td>
<td>► The structure of government programs and reimbursement levels are subject to change, which could have an adverse effect on an entity’s ability to adequately estimate amounts due to/from government programs.</td>
</tr>
<tr>
<td>► The American Taxpayer Relief Act of 2012 includes numerous changes to the Medicare program. Among them, it will require an adjustment for four years beginning in federal fiscal year 2014 to recoup overpayments associated with the transition to Medicare severity diagnosis-related groups (MS-DRGs), which is estimated to reduce Medicare inpatient prospective payment system (IPPS) payments by $10.5 billion.</td>
<td>► Historical contractual and collection rates may no longer be indicative of expected future collections. Contractual allowances on accounts receivable may be misstated if the provider does not have an understanding of the various government programs and changes thereto.</td>
</tr>
<tr>
<td>► The Middle Class Tax Relief and Jobs Creation Act of 2012 reduced the percentage of bad debt amounts that Medicare reimburses from 70% to 65% beginning in federal fiscal year 2013.</td>
<td></td>
</tr>
<tr>
<td>► The Middle Class Tax Relief and Jobs Creation Act of 2012 and the American Taxpayer Relief Act of 2012 provide for additional Medicaid DSH reductions in federal fiscal years 2021 and 2022 estimated at $4.2 billion.</td>
<td></td>
</tr>
</tbody>
</table>
**Significant 2013 industry considerations**

### Recovery Audit Contractors (RACs)

<table>
<thead>
<tr>
<th>Considerations</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Since the inception of the permanent RAC program in 2010, the Centers for Medicare and Medicaid Services (CMS) have collected $3.16 billion in overpayments from hospitals and providers. However, according to the American Hospital Association’s RACTrac Results for 2012, nearly 75% of all appealed claims are still in the appeals process and 72% of completed appeals have been successful.</td>
<td>A provider could be at risk for refunding payments to the government based upon government programs that audit billings.</td>
</tr>
<tr>
<td>Effective 15 April 2013, CMS modified the additional document request (ADR) guidelines to limit the amount of requests from a single claim type (e.g., inpatient, outpatient, psych) to 75% of the total ADR cap.</td>
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</tbody>
</table>


## Significant 2013 industry considerations

### Uninsured and underinsured patients

<table>
<thead>
<tr>
<th>Considerations</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>► Economic hardships, layoffs, reduced employer-sponsored employee benefits and more workers forgoing coverage due to high premiums has resulted in a shift in payor mix from insured and commercial payors to private pay, thus steadily increasing the uninsured and underinsured patient populations and health care providers’ bad debts over the last several years.</td>
<td>► Health care providers are seeing fewer revenue-generating patients due to the shift to private pay.</td>
</tr>
<tr>
<td>► With the passage of health care reform legislation, including the introduction of health insurance exchanges and the expansion of Medicaid, uncompensated care is expected to decline. However, according to a February 2013 forecast from the Congressional Budget Office, the number of uninsured patients will continue to rise for the next two years until the provisions of the Patient Protection and Affordable Care Act (PPACA) take full effect.</td>
<td>► While many of the provisions of the PPACA were protected from the impact of the 1 March 2013 sequester of budgetary resources, the provisions included in the PPACA will continue to strain federal budgets for the next 10 years and beyond. It is impossible to predict how future legislative and budgetary decisions could impact this funding.</td>
</tr>
</tbody>
</table>
### Significant 2013 industry considerations

**International classification of diseases, 10th revision (ICD-10)**

<table>
<thead>
<tr>
<th>Considerations</th>
<th>Risks</th>
</tr>
</thead>
</table>
| ► On 1 October 2014, the US will move from the ICD-9 system of disease classification to ICD-10. The ICD-10 system will expand the number of available codes from 24,000 to more than 155,000. Although the new coding system will enable better documentation of specific diagnostic information, the changes will significantly impact people, processes, resources and technology across the entire health care spectrum. | ► The transition to ICD-10 is highly complex, and providers and payors will need to plan for the significant changes.  
► If the ICD-10 codes are not properly implemented, the revenue cycle will be negatively impacted and could adversely impact billings and collections.  
► Implementation will involve installing new code sets, re-mapping interfaces and re-creating every report/extract used by provider staff in clinical, reimbursement and financial analysis. |
## Significant 2013 industry considerations

### Incentive payments for meaningful use of electronic health records (EHRs)

<table>
<thead>
<tr>
<th>Considerations</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>► The American Recovery and Reinvestment Act (ARRA) includes $19 billion to</td>
<td>► High up-front costs and ongoing maintenance costs, coupled with</td>
</tr>
<tr>
<td>establish a nationwide network for EHRs. Providers will receive incentive</td>
<td>decreased IT budgets from the recent economic recession, may</td>
</tr>
<tr>
<td>payments if they can demonstrate the implementation and meaningful use</td>
<td>deter some providers from implementing EHRs.</td>
</tr>
<tr>
<td>of EHRs. Hospitals will be subject to reductions in future market basket</td>
<td>► Increased sharing of information can cause confidentiality, privacy</td>
</tr>
<tr>
<td>increases if they do not demonstrate meaningful use of EHRs. EHRs include</td>
<td>and security concerns.</td>
</tr>
<tr>
<td>clinical documentation, testing and imaging results, computerized</td>
<td></td>
</tr>
<tr>
<td>provider-order entry, and decision support. EHRs provide cost and time</td>
<td></td>
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<tr>
<td>efficiencies and improve the quality of care. Specific benefits include:</td>
<td></td>
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<tr>
<td>► Collaboration between providers, patients and payors</td>
<td></td>
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<tr>
<td>► Efficiency costs by reducing length of stay, duplicative visits, medical</td>
<td></td>
</tr>
<tr>
<td>errors and administrative burdens</td>
<td></td>
</tr>
<tr>
<td>► Improved patient safety and health care quality</td>
<td></td>
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</tbody>
</table>
Recent accounting pronouncements
ASU 2011-08
Testing Goodwill for Impairment

► Optional qualitative assessment to determine if traditional two-step approach is necessary
► Effective for all fiscal years beginning after 15 December 2011, with early adoption permitted
► May change how a company tests for impairment, but should not change timing of annual assessment
► Goal is to reduce cost and complexity of testing goodwill for impairment
► Does not apply to other intangible assets
► Additional disclosures regarding the qualitative factors that were considered
ASU 2011-08
Testing Goodwill for Impairment

Key points:
- Qualitative assessment of whether it is more likely than not (a greater than 50% chance) that a reporting unit’s fair value is less than its carrying amount
- Includes an unconditional option to use or bypass the qualitative assessment for any reporting unit in any period
- Eliminates option to carry forward fair value calculations from prior years.
- Generally requires significant documentation in year one
ASU 2011-08
Testing Goodwill for Impairment: How the impairment tests compare

<table>
<thead>
<tr>
<th>Current</th>
<th>New guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Step 1</strong></td>
<td><strong>Step 1</strong></td>
</tr>
<tr>
<td>Compare fair value of reporting unit to carrying value, including goodwill*</td>
<td>Compare fair value of reporting unit to carrying value, including goodwill*</td>
</tr>
<tr>
<td><strong>Step 2</strong></td>
<td><strong>Step 2</strong></td>
</tr>
<tr>
<td>Determine amount of goodwill impairment, if any</td>
<td>Determine amount of goodwill impairment, if any</td>
</tr>
</tbody>
</table>

A reporting unit with a zero or negative carrying value is required to perform the qualitative assessment in place of this step of the impairment test. If the company concludes that it is more likely than not that impairment exists after performing the qualitative assessment, it would proceed directly to Step 2 of the impairment test.
ASU 2011-08
Testing Goodwill for Impairment: Changes in qualitative factors

<table>
<thead>
<tr>
<th>Current guidance</th>
<th>New guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>► Legal factors/business climate</td>
<td>► Macroeconomic conditions</td>
</tr>
<tr>
<td>► Adverse regulator action</td>
<td>► Industry/market considerations</td>
</tr>
<tr>
<td>► Unanticipated competition</td>
<td>► Overall financial performance</td>
</tr>
<tr>
<td>► Loss of key personnel</td>
<td>► Cost factors</td>
</tr>
<tr>
<td>► Sale of a reporting unit</td>
<td>► Entity-specific events</td>
</tr>
<tr>
<td>► Assessed asset group recoverability</td>
<td>► Sustained decrease in share price</td>
</tr>
<tr>
<td>► Impairment of goodwill in subsidiary financial statements</td>
<td>► Other events</td>
</tr>
</tbody>
</table>

None of these factors by themselves is determinative. Rather, a company should consider the significance of each adverse factor as well as the existence of any positive or mitigating events.
Polling question

Do you plan to use the qualitative assessment in the current year to begin your process of evaluating goodwill for possible impairment?

A. Yes

B. No

C. Not applicable
ASU 2012-01
Continuing Care Retirement Communities — Refundable Advance Fees

► Clarifies that an entity should classify an advance fee as deferred revenue when a continuing care retirement community has a resident contract that provides for payment of the refundable advance fee upon re-occupancy by a subsequent resident, which is limited to the proceeds of re-occupancy. Refundable advance fees that are contingent upon re-occupancy by a subsequent resident but are not limited to the proceeds of re-occupancy should be accounted for and reported as a liability.

► For public entities (including conduit bond obligors), this ASU is effective for fiscal periods beginning after 15 December 2012. For nonpublic entities, this ASU is effective for fiscal periods beginning after 15 December 2013. Early adoption is permitted.

► Adoption should be applied retrospectively by recording a cumulative-effect adjustment to opening retained earnings (or unrestricted net assets) as of the beginning of the earliest period presented.
Optional qualitative assessment to determine if traditional two-step approach is necessary, similar to qualitative assessment for goodwill.

Effective for all fiscal years beginning after 15 September 2012, with early adoption permitted.

May change how a company tests for impairment, but should not change timing of annual assessment.

Using the new qualitative assessment will require significant judgment.

Companies that use the qualitative assessment will have to consider positive and negative evidence that could affect the significant inputs used to determine fair value.
Update requires not-for-profit entities (NFPs) to classify cash receipts from the sale of donated financial assets that upon receipt were directed without any NFP-imposed limitations for sale and were converted nearly immediately into cash as cash flows from operations.

ASU 2012-05 is effective prospectively for fiscal years and interim periods within those years, beginning after 15 June 2013. Retrospective application to all prior periods presented upon the date of adoption is permitted. Early adoption from the beginning of the fiscal year of adoption is permitted.
Requires a reporting entity that is jointly and severally liable to measure the obligation as the sum of the amount the entity has agreed with co-obligors to pay and any additional amount it expects to pay on behalf of one or more co-obligors.

Effective for fiscal years and interim periods within those years, beginning after 15 December 2013.

The guidance should be applied retrospectively to all prior periods presented for those obligations resulting from joint and several liability arrangements that exist at the beginning of an entity’s fiscal year of adoption. Early adoption is permitted.
The primary impact to most provider care entities is expected to be the expanded disclosure requirements.

Entities are required to disclose:

- The nature of the arrangement, including:
  - How the liability arose
  - The relationship with other co-obligors
  - The terms and conditions of the arrangement
- The total outstanding amount under the arrangement, which shall not be reduced by the effect of any amounts that may be recoverable from other entities
- The carrying amount, if any, of an entity’s liability and the carrying amount of a receivable recognized, if any
ASU 2013-04
Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation is Fixed at the Reporting Date

 Entities are required to disclose (continued):

 The nature of any recourse provisions that would enable recovery from other entities of the amounts paid, including any limitations on the amounts that might be recovered

 In the period the liability is initially recognized and measured or in a period the measurement changes significantly:

 The corresponding entry

 Where the entry was recorded in the financial statements
NFPs should recognize all personnel services received from all affiliates (both for profit and not for profit) that directly benefit the recipient NFP and for which the affiliate does not charge the recipient NFP.

Services would be measured at the cost of the personnel providing those services recognized by the affiliate, unless cost would not be representative of the value of the service received.

In these circumstances, the entity would be permitted to make an election to measure the service at fair value.
Not-for-profit, business-oriented health care entities would report the increase in net assets associated with these personnel services as an equity transfer, regardless of whether those services are received from a not-for-profit or for-profit affiliate.

The guidance is effective for annual periods beginning after 15 June 2014, and interim and annual periods thereafter. It should be applied prospectively, with modified retrospective application permitted. Early adoption is permitted.
Revenue recognition project
Revenue recognition project
Overview

► June 2010 – First revenue recognition Exposure Draft (ED) issued jointly by the FASB and IASB
► November 2011 – Revised ED issued
► Final standard expected in Q4 2013
► Proposed standard would replace the majority of existing US GAAP and IFRSs for revenue recognition—virtually every industry would be affected
  ► Clear need for implementation guidance
► Would require companies to make more estimates and use more judgment than under current guidance
► Effective for annual periods beginning after 15 December 2016 (1 January 2017 for CYE public company)
Summary of model

Core principle—Recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services

<table>
<thead>
<tr>
<th>Step 1: Identify the contract(s) with the customer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Step 2: Identify the separate performance obligations in the contract</td>
</tr>
<tr>
<td>Step 3: Determine the transaction price</td>
</tr>
<tr>
<td>Step 4: Allocate the transaction price to the separate performance obligations</td>
</tr>
<tr>
<td>Step 5: Recognize revenue when each performance obligation is satisfied</td>
</tr>
</tbody>
</table>
Potential impact – health care

- The standard will most significantly impact health care entities in two ways:
  - Estimating variable consideration
  - Assessing collectibility
- AICPA revenue recognition task force
  - Calls began last month
  - No outputs expected until 2015 or later
Step 3: Determine the transaction price
Variable consideration

- Transaction price may vary because of bonuses, royalties, rebates, incentives, milestone payments, etc.
- Assuming company has sufficiently reliable data on which to base an estimate, the transaction price would be estimated using the technique that will better predict the amount the company will receive:

<table>
<thead>
<tr>
<th>Expected value</th>
<th>Most likely amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>▶ Sum of the probability-weighted amounts in a range of possible outcomes</td>
<td>▶ The single most likely amount in a range of possible outcomes</td>
</tr>
<tr>
<td>▶ Most predictive when the transaction has a large number of possible outcomes</td>
<td>▶ Most predictive when the transaction will produce few outcomes</td>
</tr>
<tr>
<td>▶ Can be based on a limited number of discrete outcomes and probabilities</td>
<td></td>
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</tbody>
</table>
Step 3: Determine the transaction price
Constraint on variable consideration

► While variable amounts are included in the transaction price, companies would evaluate whether to constrain the cumulative amount of revenue recognized if the amount of consideration is variable

► Objective of the constraint on revenue recognition is for a company to recognize revenue at an amount that should not be subject to significant revenue reversals
  ► Re-assess as facts and circumstances change
  ► Boards did not define a level of confidence that would need to be achieved, other than it would be relatively high

► A company would meet that objective if it has sufficient experience or evidence that supports its assessment
Constraint on variable consideration
Proposed model

Variable consideration included in the estimated transaction price should be limited to the amounts that are not subject to subsequent significant reversal.

Factors to indicate variable consideration may be subject to reversal include:

- Consideration highly susceptible to factors outside of the entity’s control
- Uncertainty not expected to be resolved for a long period of time
- Limited historical experience or experience not predictive
- History of offering broad range of price concessions or changing payment terms and conditions
- Contract has large number and broad range of possible consideration amounts
Collectibility

► Significant concerns about the customer’s ability to pay may suggest the arrangement is not within the scope of the standard, as the customer is not committed to perform its obligation

► Alternatively, if the entity believes the customer will pay but has concerns about how much the customer will pay, this may suggest an implied concession (variable consideration) within the transaction

► An implied concession should be treated like all other variable consideration and treated as a reduction of revenue (including subsequent changes to the estimates around this amount)

► Only amounts not known to have collectibility concerns at the onset of the arrangement would be considered bad debt

► In a change from the 2011 ED, the Boards decided that effects of customer credit risk (i.e. bad debt) would be presented prominently as a separate line item in operating expense
Collectibility (continued)

► It’s not clear how entities should distinguish between when significant doubt of a customer fulfilling its obligations results in the agreement not meeting the definition of a contract versus the entity accepting a price concession.
  ► What level of uncertainty must exist in order for an entity to determine that the customer isn’t going to fulfill its obligation?

► In addition, it is not clear why concerns about collectibility would be treated differently if structured as a price concession.
  ► If an entity grants a price concession because the customer is unable to pay the full transaction price, it could be seen as the same as an incurred impairment loss.
Leases project
In May 2013, FASB released a second exposure draft of its leases proposal:

- Lessees would recognize most leases on balance sheet.
Effective date and transition

Effective date

- Effective date not specified
  - Boards intend to consider feedback before determining
- Apply transition provisions at beginning of earliest comparative period presented in year of adoption
  - For example, assume a calendar year company with an effective date of 1 January 2017 and three-year comparative financial statements
    - 1 January 2015 would be beginning of earliest comparative period presented
- Evaluate all existing arrangements
- No arrangements would be grandfathered
Definition of a lease

 Lease

A contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration

- A lease must include both:
  - Use of an identified asset
  - A right to control the use of the identified asset
    - Ability to direct its use
    - Derive benefits from its use
Definition of a lease
Customer’s ability to direct the use

ability to make decisions about the asset’s use that most significantly affect economic benefits derived from use of the asset throughout the contract term, for example:

► How the asset is operated
► Purpose for which the asset is employed
► Who operates the asset
Definition of a lease
Customer’s ability to derive benefits from use

► Customer obtains substantially all of the potential economic benefits from use throughout the lease term
  ► Primary outputs (i.e., goods or services)
  ► Secondary outputs (e.g., renewable energy credits)
    ► Tax benefits related to asset ownership excluded

► Broader than “physical output” considered today
  ► Some arrangements that meet today’s definition of control based on physical output (840-10-15-6) might not be leases

Supplier arrangements will have to be evaluated carefully to determine if the customer has the ability to direct the use or obtain substantially all of the potential economic benefits from use
Definition of a lease
Customer’s ability to derive benefits from use

A customer would not have the ability to derive benefits from the use of an asset if both of the following conditions exist:

► Benefits can only be obtained in conjunction with additional goods or services from supplier
  ► Additional goods or services not sold separately by the supplier or others

► Asset is incidental to delivery of a service
  ► Asset is designed to function only with additional goods or services provided by the supplier
Definition of a lease
Customer’s ability to derive benefits from use – example

Assume:

- Customer contracts for use of specialized medical equipment
- Customer’s personnel will operate equipment at its location
- Equipment can only be operated in conjunction with a disposable consumable product
- Customer is contractually required to purchase the consumable from supplier
- The consumable is available from other suppliers and supplier sells the consumable to customers that do not lease equipment from supplier (i.e., customers that purchase equipment)

Analysis: Customer can derive benefits from the equipment on its own without the consumable
Definition of a lease
Separating components of a contract

- Contracts that meet the definition of a lease and contain a right to use multiple underlying assets
  - Determine if the right to use an asset is a separate lease component of the contract

- A right to use an asset is a separate lease component if both of the following are met:
  - Lessee can benefit from use of the asset either on its own or together with other readily available resources
  - Underlying asset is neither dependent on nor highly interrelated with other assets in the contract
Definition of a lease
Accounting for lease and non-lease components

Allocate contract consideration between each lease and non-lease component (next slide)

- Lease components: each lease component would be subject to the Leases ED
- Non-lease components (e.g., maintenance, training):
  - Lessees would follow executory contract accounting
Definition of a lease
Allocation of contract consideration

Lessee allocation

- Relative standalone price basis if an observable price for each component exists
- Residual method when observable standalone prices are available for one or more, but not all, components
- As a single lease component if there are no observable standalone prices for any component

Identifying standalone prices would be critical to lessees’ accounting for contracts with multiple components and would likely involve judgment
Key concepts
Lease term

- Short-term leases – leases with a maximum possible term of 12 months or less
  - Accounting policy election, by class of underlying asset
  - No lease assets or lease liabilities recognized
  - Recognize lease payments in profit or loss on a straight-line basis over the lease term (lessors could use another systematic basis if more representative of income earned)

<table>
<thead>
<tr>
<th>Non-cancelable lease term</th>
<th>Optional renewal period(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>9 Months</td>
<td>4 Months</td>
</tr>
<tr>
<td>9 Months</td>
<td>1 Month</td>
</tr>
</tbody>
</table>

9 Months 9 Months 1 Month
The non-cancelable period for which a lessee has the right to use an underlying asset together with both of the following:

a) Periods covered by an option to extend the lease if the lessee has a significant economic incentive to exercise that option

b) Periods covered by an option to terminate the lease if the lessee has a significant economic incentive not to exercise that option
Classification
Principle

Lease commencement

Lease

Lessee is **expected to consume** more than insignificant portion of underlying asset → Type A lease

Lessee is **not expected to consume** more than insignificant portion of underlying asset → Type B lease
Lessee accounting
Comparing lease types

<table>
<thead>
<tr>
<th>Current</th>
<th>Proposed *</th>
<th>Effect on income statement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property (i.e., land, building, part of a building)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating lease</td>
<td>Type B lease</td>
<td>Generally similar</td>
</tr>
<tr>
<td>Capital lease</td>
<td>Type A lease</td>
<td>Generally similar</td>
</tr>
<tr>
<td>All other leases (e.g., equipment, vehicles)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating lease</td>
<td>Type A lease</td>
<td>Front-loaded expense; separate presentation of amortization and interest</td>
</tr>
<tr>
<td>Capital lease</td>
<td>Type A lease</td>
<td>Generally similar</td>
</tr>
</tbody>
</table>

* Indicates the expected classification of most arrangements given the nature of the underlying asset and the classification of the lease under current accounting; however, not all leases would be classified as shown.
Lessee accounting
Initial and subsequent measurement

<table>
<thead>
<tr>
<th>Type A leases</th>
<th>Type B leases</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initially measure the right-of-use asset(^1) and lease liability at the present value of the lease payments</td>
<td>Calculate periodic straight-line expense amount</td>
</tr>
<tr>
<td>Accrete the lease liability based on the interest method and reduce the lease liability by the payments made</td>
<td>Reduce right-of-use asset by the difference between periodic straight-line expense and liability accretion</td>
</tr>
<tr>
<td>Amortize the right-of-use asset, generally on a straight-line basis</td>
<td></td>
</tr>
</tbody>
</table>

\(^1\) Initial measurement of the right-of-use asset would also include the lessee’s initial direct costs and prepayments made to the lessor (less, lease incentives received from the lessor), if any.
Lessee accounting
Impact of leases on financial statements

► What motivates management to enter into a capital versus operating lease?
  ► Operating leases
    ► Considered off-balance-sheet financing
    ► Treated as an operating expense
    ► Does not impact most financial metrics
  ► Capital leases
    ► Balance sheet gross-up
    ► Treated as debt with depreciation and interest expense
    ► Impacts financial metrics such as return on assets; impairment; debt to equity ratios; liquidity; debt covenants
Lessee accounting  
Impact of leases on financial statements

► Why do health care entities generally prefer operating leases?
► NFP health care entities generally have very strict capital budgets
  ► Subsidiaries or operating units are often allocated little to no capital budget. All purchases of property and equipment are made from the operating budget.
► Many are conduit obligors of municipal debt
  ► Debt has financial covenants that could be impacted by capital leases, including a debt-to-equity ratio
  ► It is very difficult to amend these master trust agreements to change covenants once established
► Certain health care entities receive reimbursement from Medicare or Medicaid on a cost-basis
  ► Depending on the type of arrangement, changes in lease accounting could increase or decrease reimbursement
Polling question

Have you begun your assessment of how the FASB’s lease project will impact your organization?
A. Yes
B. No
C. Not applicable
Financial instrument project
In June 2012, the FASB proposed requiring all entities – public, private and not-for-profit – to provide quantitative and qualitative liquidity risk disclosures in their audited financial statements.

The proposal would require significant effort by preparers to provide the disclosures, which would be required to be audited.

Public entities would provide these disclosures both annually and quarterly. Nonpublic entities would be required to provide the disclosures annually.
In February 2013, the FASB issued its classification and measurement exposure draft.

The proposal would apply to all entities across all industries, including health care and not-for-profit sectors.

The FASB is currently reviewing comments that they received regarding the draft.
Financial instruments project
Classification and measurement

**Is the business model hold to collect cash flows?**

<table>
<thead>
<tr>
<th>Amortized cost</th>
<th>FV-OCI</th>
<th>FV-NI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

**Is the business model both hold to collect cash flows and sell financial assets?**
Key changes from current US GAAP would include:

- Debt instruments (including loans) classified and measured in one of three categories based on the instrument’s cash flow characteristics and an entity’s business model for managing the instrument.
- Reclassifications required only when an entity’s business model for managing its financial assets changes (no “tainting” notion).
- Equity investments measured at fair value through net income (FV-NI), unless they qualify for certain exceptions.
- Alternative investments held for sale would no longer qualify for equity-method accounting.
- Elimination of today’s embedded derivative bifurcation requirements for hybrid financial assets.
- Limitation on the use of the fair value option.
- Expanded presentation and disclosure requirements.
If they qualify, alternative investments could still be accounted for using the equity-method of accounting.

Equity-method investments that are held for sale, must be classified and measured at FV-NI.

An investor would consider its equity method investment to be held for sale if both of the following conditions are met:

- The investor has identified potential exit strategies, even though it may not yet have determined the specific method of exit.
- The investor has defined the time that it expects to exit the investment, which may be either an expected date or range of dates or a time defined by specific facts or circumstances, such as achieving certain milestones or the stated investment objectives of the investor.
Financial instruments project
Classification and measurement

Does the equity investment need to be accounted for under the equity method or result in consolidation?

No

Does specialized industry guidance apply (e.g. broker-dealers, investment companies)?

No

Does the equity investment have a readily determinable fair value?

Yes

Measure at FV-NI

No

Does the equity investment qualify for the net asset value practical expedient in ASC 820?

Yes

Is the practicability exception elected?

Yes

Measure at cost less impairment, adjusted for observable price changes for an identical or similar investment of the same issuer

No

Apply other US GAAP

Yes

No
Not-for-profit financial reporting project
The FASB has two not-for-profit financial reporting projects:

- Financial statements standard-setting project aims to improve:
  - Net asset classification requirements
  - Information provided in financial statements and notes about liquidity, financial performance and cash flows

- Other financial communications research project – to study communications other than financial statements used by not-for-profit entities to tell their financial story

- An ED and a Discussion Paper are planned for the first half of 2014
Tentative decisions made include:

- Defining an intermediate operating measure based on two criteria: mission and availability
- The presentation of the operating measure in the statement of activities
- The classification of net assets as either those with donor-imposed restrictions or those without donor-imposed restrictions
Definition of a public business entity
Definition of a public entity

The FASB has issued a proposed ASU regarding the definition of a public business entity

- Not-for-profit entities, including conduit bond obligors, will no longer be considered either public or nonpublic entities
- Not-for-profit entities will receive separate consideration during the standard-setting process
- Transition and effective date have not yet been deliberated
Insurance project
Insurance project
Background

► FASB issued exposure draft on insurance contracts on 27 July 2013
► IASB issued revised ED on 20 June 2013
► 120-day comment period ending on 25 October 2013
► Principles-based model for accounting for insurance contracts
► No longer issuer-based guidance (i.e. not just insurance companies)
Insurance project
Overview

 ► Standard includes two measurement models
   ► Building Block Approach (BBA) and
   ► Premium Allocation Approach (PAA)
 ► Many insurance contract liabilities will be based on current assumptions adjusted for the time value of money
 ► Changes in insurance liabilities due to changes in the discount rate are recognized in OCI
Insurance project
Impact to non-insurance entities

- Captives and self-insurance

- Potentially scoped in:
  - Residual value guarantees
  - Minimum revenue guarantees
  - Reverse mortgages

- Contracts specifically scoped out include:
  - Fixed-fee service contracts
  - Employer’s assets and liabilities under benefit plans
  - Product warranties issued by manufacturer, retailer, or dealer
  - Certain financial guarantees
ASC 958-805 Business combinations

- Applies to combinations of not-for-profit entities, either by merger or by acquisition
- Does not apply to:
  - Formation of a JV
  - Acquisition of an asset or group of assets that does not constitute either a business or nonprofit activity
  - A combination between NFP entities, businesses, or nonprofit activities under common control
  - A transaction or other event in which control is obtained of another entity, but that entity is not consolidated under SOP 94-3 or the Health Care Guide
Distinguish between a Merger and an Acquisition

Merger of not-for-profit entities:
- A combination in which the governing boards of two or more NFP entities cede control of those entities to create a new NFP entity. If the merging entities retain shared control of the new entity, they have not ceded control. To qualify as a new entity, the combined entity must have a newly formed governing body; a new entity often is, but need not be, a new legal entity.

Acquisition by a not-for-profit entity:
- A combination in which a NFP acquirer obtains control of one or more businesses or nonprofit activities.
The NFP entity resulting from a merger (the new entity) accounts for the merger by applying the carryover method.

**Recognition**—the new entity recognizes in its financial statements the assets and liabilities reported in the separate financial statements of the merging entities as of the measurement date in accordance with GAAP.

At merger date, the new entity carries forward the merging entities’ classifications and designations of the assets and liabilities as necessary to subsequently apply other GAAP.

**Measurement**—the new entity measures the assets and liabilities in its financial statements as of the merger date at their recorded amounts in the financial statements of the merging entities as of that date in accordance with GAAP.
ASC 958-805 Business combinations

- **Presentation**—the entity resulting from the merger is a new reporting entity, with no activities before the reporting date. The merger itself is not an activity of the new entity’s initial reporting period

  - Statement of activities
  - Statement of cash flows

- **Disclosures**—the new entity shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of the merger that resulted in its formation
A NFP entity should account for each acquisition by applying the acquisition method, which requires:

- Identifying the acquirer
- Determining the acquisition date
  - Generally, the date on which acquirer legally transfers the consideration, acquires the assets, and assumes the liabilities of the acquiree (the closing date)
- Recognizing and measuring the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree
- Recognizing and measuring goodwill or a contribution received
Recognizing and measuring the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree

**Recognition**
- As of the acquisition date, the acquirer recognizes, separately from goodwill, the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree.
- To qualify for recognition, the identifiable assets acquired and liabilities assumed must meet the definition of assets and liabilities as defined in the codification.
- As of the acquisition date, the acquirer classifies or designates the identifiable assets acquired and liabilities assumed as necessary to subsequently apply other GAAP.

**Measurement**
- The acquirer measures the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values.
Recognizing and measuring goodwill or a contribution received

Goodwill acquired

If operations of the acquiree are NOT expected to be predominately supported by contributions and returns on investments, the acquirer recognizes goodwill as of the acquisition date, measured as the excess of (a) over (b):

(a) Fair value of consideration transferred plus the fair value of any noncontrolling interest in the acquiree

(b) The net of the acquisition-date amounts (at fair value) of the identifiable assets acquired and liabilities assumed

If operations of the acquiree ARE expected to be predominately supported by contributions and returns on investments, the acquirer recognizes the excess of (a) over (b) as a separate charge in its statement of activities (i.e., goodwill is NOT recognized)
Recognizing and measuring goodwill or a contribution received

Contribution received

Components of calculation

(a) Fair value of consideration transferred plus the fair value of any noncontrolling interest in the acquiree

(b) The net of the acquisition-date amounts (at fair value) of the identifiable assets acquired and liabilities assumed

The acquirer recognizes an excess of (b) over (a) as a separate credit in its statement of activities as of the acquisition date

Describe the credit appropriately, such as “excess of fair value of net assets acquired over consideration paid in acquisition of XYZ Entity”

For entities within the scope of the Health Care Guide

Unrestricted contribution is presented within the performance indicator unless the acquired business meets the criteria in ASC 360 to be classified as held for sale

A contribution that is either temporarily or permanently restricted is presented separately from the performance indicator
Disclosures for an acquisition

The acquirer shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of an acquisition that occurs either:

- During the current reporting period
- After the reporting date but before the financial statements are issued

The Statement requires significantly expanded disclosures, including the following:

- Name and description of the acquiree
- Acquisition date
- Percentage of voting equity interest acquired
- Primary reasons for the business combination and how the acquirer obtained control

The disclosure of separately recognized transactions required shall include the amount of acquisition-related costs, the amount recognized as an expense, and the line item or items in the income statement in which those expenses are recognized. The amount of any issuance costs not recognized as an expense and how they were recognized also shall be disclosed.
A NFP acquirer that is a public entity shall disclose all of the following information for each acquisition that occurs during the reporting period:

- Revenues attributable to the acquiree since the acquisition date that are included in the statement of activities for the reporting period
- Changes in unrestricted net assets, changes in temporarily restricted net assets, and changes in permanently restricted net assets attributable to the acquiree since the acquisition date that are included in the statement of activities for the reporting period
- The revenues of the combined entity as though the acquisition date for all acquisitions that occurred during the current year had been at the beginning of the annual reporting period (supplemental pro forma information)
- Changes in unrestricted net assets, changes in temporarily restricted net assets, and changes in permanently restricted net assets as though the acquisition date for all acquisitions that occurred during the current year had been at the beginning of the annual reporting period (supplemental pro forma information)
- The nature and amount of any material, nonrecurring pro forma adjustments directly attributable to the acquisition(s) included in the reported pro forma revenues and changes in unrestricted net assets, changes in temporarily restricted net assets, and changes in permanently restricted net assets (supplemental pro forma information).
Additional Pension Guidance
US generally accepted accounting principles (GAAP)

- Basic terminology
- Consolidated financial statements:
  - Balance sheet
    - Includes funded status and net assets
  - Income statement
    - Includes pension expense
US GAAP

Balance sheet

► Funded status
  ► Market value of assets – projected benefit obligation (PBO)

► Net assets
  ► Includes unrecognized gains/losses and prior service cost
  ► Element of shareholder equity
  ► Will be reclassified as pension expense over time
US GAAP

Balance sheet items

▶ PBO
  ▶ Present value of future benefit payments based on pay projected to decrement (retirement, termination, etc.) and service accrued to the measurement date

▶ Market value of assets
  ▶ Just like it sounds
  ▶ Also referred to as fair market value
  ▶ Does not include accrued contributions as in funding

▶ Prior service cost (PSC)
  ▶ PSC base established in connection with a plan amendment equal to the change in PBO resulting from the amendment
    ▶ May include the change in PBO due to assumption changes, if those assumption changes are inherent in the plan change
  ▶ Accelerated recognition following a curtailment
  ▶ Zeroed out in purchase accounting
Balance sheet items (continued)

- Gains and losses
  - The accumulation of changes in the PBO due to experience different than expected (assets and obligation) and changes in assumptions
  - Accelerated recognition following a settlement
  - Zeroed out in purchase accounting
US GAAP

- Income statement
- Pension expense
  - Components:
    - Service cost
    - Interest cost
    - Expected return on assets
    - Amortization of gain/loss
    - Amortization of prior service cost
    - Settlement/curtailment/special termination benefits
  - Determined at the beginning of the year based on the same assumptions used at the end of the prior year for disclosures
Pension expense items

► Service cost
  ► Present value of benefits accrued during the year (on a PBO basis, with projected pay and current service)
  ► For a frozen plan, zero, unless administrative expenses included
  ► Includes interest to the end of the year

► Interest cost
  ► Interest for one year on the PBO, less interest (generally for half a year) on expected benefit payments

► Expected return on assets
  ► Expected return (interest, dividends, realized and unrealized gains) for one year on the market-related value of assets, plus expected return on expected contributions, less expected return on expected benefit payments
Pension expense items (continued)

► Amortization of gain or loss

► Gain/loss outside the “corridor” amortized over the average remaining service of the active participants or over the life expectancy of the inactive participants if “all or almost all” of the participants are inactive

► Corridor is 10% of max (PBO, MVA).

► May be amortized over any consistent and systematic method that is faster than the minimum “corridor” method

► Some companies use “mark to market,” recognizing gains and losses immediately.

► Some do not use corridor.
Pension expense items (continued)

► Amortization of prior service cost

► Each PSC base is amortized over the future service of the active participants or over the life expectancy of the inactive participants if “all or almost all” of the participants are inactive and the amendment affects the benefits of inactive participants.

► PSC base is not amortized over the future service of only those participants affected, but rather all active participants.

► Commonly, benefit increases contained in collective bargaining agreements are amortized over the terms of the agreements.
Settlements

Definition under US GAAP

- An event that eliminates the risk involved with an employer’s obligation and assets
- An irrevocable action
- An action that relieves the employer (or the plan) of primary responsibility for a pension or postretirement benefit obligation
- Must meet all of the above
Settlements

What events trigger a settlement?

- Lump sum payments in excess of service cost plus interest cost
- Lump sum payments to participants in exchange for their rights to receive specified postretirement benefits
- Purchase of non-participating annuity contracts to cover vested benefits (e.g., if a plan were to be terminated)

The settlement should be recognized at the time of the event.
Settlements

What is the impact?

- Immediate recognition within (income) expense of all or a portion of the unrecognized net (gain) loss
- Immediate recognition within (income) expense of all or a portion of the unrecognized transition asset
- Change in obligation and assets shown within the reconciliation of benefit obligation under Accounting Standards Codification (ASC) 715, Compensation – Retirement Benefits, disclosures
- Change to assets and obligation may or may not be the same
- For IFRS, immediate recognition within (income) expense of gains or losses resulting from the settlement (i.e., change in funded status)
Settlements

How do you calculate the impact of a settlement?

- Determine the settlement ratio that is equal to the percentage reduction in obligation.
- For other post-employment benefits, offset any existing unrecognized transition obligation.
- Multiply the unrecognized net (gain) loss and unrecognized transition asset by the settlement ratio.
  - Unrecognized net (gain) loss should include effects related to the settlement (e.g., lump sum rates, accelerated retirements).
- Do not multiply the unrecognized prior service cost or unrecognized transition obligation by the settlement ratio.
Settlements

For re-measurements, the (income) expense for the remainder of the fiscal year

Generally, a full year of expense will be determined as of the re-measurement date, and this will be prorated based on the remainder of the year (e.g., if the re-measurement date is 30 September 2012, each component of expense will be multiplied by 3/12 to get the expense for the period 1 October 2012 to 31 December 2012).
Curtailments

Definition of curtailment under US GAAP

- An event that significantly reduces the expected future years of service for active plan participants

Or

- An event that eliminates accrual of benefits for a significant number of participants
Curtailments

► What is “significant”?  
  - Less than a 10% reduction in expected future years of service may not be considered significant.  
  - Greater than a 10% but less than a 20% reduction in expected future years of service is a grey area.  
  - Greater than a 20% reduction in expected future years of service is considered to be significant in nearly all cases.  
  - Team must understand what the client has done in prior situations because curtailments should be consistent.
Curtailments

► Curtailment triggers:
  ► Termination of participants earlier than expected
    ► Review changes in active participants since the prior year
    ► Have seen this more over the past few years due to the economy and company layoffs
  ► Termination or suspension of a plan so that participants no longer accrue additional benefits (e.g., hard plan freeze)
Curtailments

What is the impact?

- Immediate recognition of all or a portion of the unrecognized transition obligation and prior service (credit) cost amounts in (income) expense.
- Immediate recognition of all or a portion of any remaining amount of (gain) loss arising due to the curtailment (including re-measurement effects) in excess of the unrecognized (gain) loss.
- For IFRS, immediate recognition within (income) expense of gains or losses resulting from the curtailment (i.e., change in funded status).
- Change in obligation within the reconciliation of benefit obligation under ASC 715 disclosures.
Curtailments

How do you calculate the impact of a curtailment?

- Determine the curtailment ratio that is equal to the percentage reduction in remaining service of all active participants.
- Multiply the unrecognized prior service cost and unrecognized transition obligation by the curtailment ratio.
- Do not multiply the unrecognized net (gain) loss or unrecognized transition asset by the curtailment ratio.
Curtailments

Timing of curtailment recognition

Under US GAAP, this depends on whether or not the event causes a net loss or net gain:

- Net loss – recognize in earnings when it is probable that a curtailment will occur and the effects are reasonably estimable
- Net gain – recognize in earnings when the related employees terminate or the plan amendment is adopted

Under IFRS, a curtailment should be recognized when it occurs.
Curtailments

Net loss or net gain?

This is **not** determined based on the change in obligation.

Three pieces:

1. Recognition of any unrecognized transition obligation is a loss.
2. Recognition of any unrecognized prior service cost is a loss.
3. Recognition of any unrecognized net (gain) loss may be a gain or loss.

- To the degree a gain in obligation exceeds any unrecognized loss or unrecognized gain, then this is a curtailment gain.
- To the degree a loss in obligation exceeds any unrecognized gain or unrecognized loss, then this is a curtailment loss.

Net loss – sum of (1)–(3) is a net loss (charge to expense)

Net gain – sum of (1)–(3) is a net gain (credit to expense)
For re-measurements, the (income) expense for the remainder of the fiscal year

Generally, a full year of expense will be determined as of the re-measurement date, and this will be prorated based on the remainder of the year (e.g., if the re-measurement date is 30 September 2012, each component of expense will be multiplied by 3/12 to get the expense for the period 1 October 2012 to 31 December 2012).
Understanding significant classes of transactions: Process narratives

Common issues
► Documentation of the process is not sufficiently detailed or up to date
► Important sources of information not identified and evaluated
► Implications of third party service (and sub-service) organizations not evaluated
► Unique classes of transactions/variations in processing not identified and evaluated
► WCGWs and identified controls not reconsidered
  ► Starting with walkthroughs rather than starting with flow of transactions and WCGWs
  ► Not updating WCGWs annually and considering whether identified controls effectively mitigate the risks
► Overreliance on review controls as a result of rationalization of controls
Understanding significant classes of transactions: Process narratives

Document the entire flow of transactions from initiation through reporting (i.e., initiation, authorization, processing, recording and reporting)

► Major input and output sources
► Relevant data files, documentation and records
► Risks — WCGWs
► Controls relevant to WCGWs and their description
► Additional considerations for estimation SCOTs
  ► Controls over method or model used
  ► Controls over key assumptions, data used
  ► Involvement of specialists
Identifying relevant controls and their attributes

Common issues

► Distinguishing a control from the transaction process
► Documenting relevant attributes of the controls to support their effective design
  ► Who, when, what and how of the controls
  ► Evaluating the “precision” of the controls (i.e., is the control designed such that it will prevent or detect errors or fraud that could be material to the financial statements)
► Controls are not identified for all non-routine and estimation processes, particularly those that happen infrequently (e.g., business combinations)
Identifying relevant controls and their attributes

As part of evaluating design effectiveness of each control, consider and document:

► How the control actually operates
► How the control appropriately addresses the WCGW
  - Control will effectively prevent or detect and correct errors that could result in material misstatements
► Whether the control operates effectively throughout the entire period of reliance
► Controls that assure that the data or reports used in the performance of the control are complete and reliable
► Whether the control is applied on a timely basis
► Whether the person performing the control possesses the necessary authority and competence
# Identifying relevant controls and their attributes

## Controls vs. transaction process:

<table>
<thead>
<tr>
<th>Transaction process</th>
<th>Control</th>
</tr>
</thead>
<tbody>
<tr>
<td>The AR sub-ledger is uploaded to the general ledger on a nightly basis.</td>
<td>Interface validation checks, including batch totals and date validation, ensure that AR sub-ledger data is uploaded to the general ledger in a complete and timely manner. Interface failures are resolved by the production support team.</td>
</tr>
<tr>
<td>Employees enter their time in the Kronos application.</td>
<td>Department managers are responsible for reviewing and approving time submitted by their employees on a weekly basis. Variances greater than 10% of the expected hours (based on a 40 hour work week) are assessed for appropriateness.</td>
</tr>
</tbody>
</table>

## What do properly worded controls look like?

<table>
<thead>
<tr>
<th>Poor</th>
<th>Better</th>
</tr>
</thead>
<tbody>
<tr>
<td>An account reconciliation is performed.</td>
<td>On a monthly basis, the Accounting Manager performs an account reconciliation using an Account Detail report from the Lawson application. Reconciling items greater than $1,000 are resolved within three business days.</td>
</tr>
<tr>
<td>The application is configured to perform a 3-way match.</td>
<td>All direct purchases are processed via a 3-way match in the JD Edwards application. All variances with an average less than $25 are posted to the Cost of Goods Sold account. All variances with an average equal to $25 or greater result in a vendor invoice requesting a credit from the vendor. Access to modify the 3-way match tolerances is limited to the system support group.</td>
</tr>
</tbody>
</table>
Evaluating controls that use system-generated data or reports

- Identify system-generated data or reports utilized in the performance of key controls and consider the following:
  - Source of data/report
  - What controls has management implemented to address the risks over integrity of the data?

- Computation/system processing — what control has management implemented to ensure computation or system processing is accurate?

- Excel spreadsheets
  - Reports may be exported to spreadsheets (e.g., Excel) or other tools where data is manipulated or additional calculations are performed. In addition, reports may be created in spreadsheets or other tools via manual inputs.
    - Identify what controls management has implemented to support the completeness and accuracy and continued integrity of the data in the spreadsheet.
    - Identify what controls management has implemented to support the accuracy and continued integrity of formulas used in the spreadsheet.
Review controls – what are they?

- Controls designed to review financial statements, account balances, account analyses, estimates, reconciliations or other data for:
  - Completeness and accuracy
  - Appropriate accounting recognition
  - Potential errors or misstatements
  - Timely, effective performance of other controls

- Examples:
  - Controls designed to determine that important estimates are complete and accurate and potential errors are detected and corrected:
    - Goodwill impairment, business combinations, income taxes
    - Other estimates — revenue allowances, warranties
    - Assumptions and data used, and conclusions reached, by third party specialists in valuing assets/liabilities in a business combination
  - Detect controls designed to determine that other controls continue to function as designed
    - Review of account reconciliations
  - Direct entity level controls designed to identify unusual trends or inaccuracies in financial reporting
    - Quarterly balance sheet fluctuation analyses
    - Quarterly budget to actual/actual to actual reviews
Review controls — issues

Common issues

► Insufficient testing of management review and reconciliation controls, including:
  ► Not testing all relevant attributes of the control
  ► Precision, sensitivity not addressed
  ► Completeness and accuracy of underlying data — controls not identified/tested
  ► Non-recurring transactions — not identifying or testing controls and inferring the effectiveness of controls through the results of substantive testing or relying on “back-end” review controls without considering the full complement of controls
Key consideration = Precision

► Precision:
  ► The sensitivity at which a control functions
  ► Whether controls (individually or in combination) can effectively prevent or detect errors or fraud that could result in material misstatement

What questions can we ask?

► Does control ever identify errors? Their nature? Examples?
► Does the control trigger appropriate follow-up? In what circumstances? Examples?
► What is nature of questions, follow-up and outcome?
► Can the review process be observed?
► Is there contradictory evidence indicating control is not sufficiently precise or sensitive to detect errors? (e.g., audit adjustments indicating that the review control did not identify misstatements)
### Review controls — precision example

<table>
<thead>
<tr>
<th>Section</th>
<th>Poor example</th>
<th>Better example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Describe the nature of questions resulting from the review, the subsequent follow-up and adjustments or changes.</td>
<td>The AR manager inquires about the completeness of the analysis and the existence of any other balances that should be specifically reserved.</td>
<td>The AR manager evaluates the completeness of the analysis by comparing key totals directly to the system and performs a recalculation of the general reserve percentages applied based on policy. The AR manager discusses all specific reserve balances greater than $10,000 with the credit manager to understand the current status of collection efforts and determine that the amounts are appropriately reserved within policy. In addition, the AR manager performs an overall review of the aging and discusses other specific customer balances with the credit manager for an update, as she deems necessary based on her experience.</td>
</tr>
<tr>
<td>How does the control trigger follow-up actions? Document our conclusions on the appropriateness of the quantitative thresholds or qualitative considerations of the follow-up trigger. We obtain and review an example of such follow-up (if applicable in the current year).</td>
<td>The AR manager follows up on unusual items and unreconciled differences resulting from the inquiries.</td>
<td>The monthly meeting between the AR manager and the credit manager does not result in formally prepared minutes or a summary of actions. We discussed the actions taken subsequent to meetings with both the AR manager and the credit manager and confirmed that there are instances specific reserves have been increased or removed based on other qualitative factors of collection efforts. We were provided an example e-mail from the April review whereby a customer filed for bankruptcy but their balance was not reserved in the initial analysis prepared by the credit manager. We also reviewed the updated analysis and journal entry demonstrating the account was subsequently adjusted. Based on the evidence obtained and the inquiries of both the preparer and reviewer of the analysis, it appears the quantitative thresholds and qualitative design and functioning of the control are appropriate to detect a material misstatement.</td>
</tr>
</tbody>
</table>
OMB Circular A-133 Single Audit Developments
Common A-133 Quality Issues

► Schedule of Expenditures of Federal Awards (SEFA)
► Testing
  ► Internal control over compliance
  ► Compliance
► Reporting findings
Common A-133 Quality Issues – Schedule of Expenditures of Federal Awards

► Missing information
  ► CFDA number or other identifying number if CFDA information is not available
  ► Official CFDA program titles
  ► Name of federal agency or name of pass-through entity and identifying number
  ► Total expenditures for each federal program
  ► Cluster identification and related totals
  ► Failure to combine programs with the same CFDA
Common A-133 Quality Issues – Schedule of Expenditures of Federal Awards

- Reconciliation of SEFA amounts to financial records
- Basis of Accounting
- Process and controls with respect to the accuracy and completeness of the SEFA
Common A-133 Quality Issues – internal control over compliance

► Applied to major program transactions, not other transactions recorded in the financial statements

► Understanding internal control over compliance
  ► Each major program
  ► Each direct and material compliance requirement

► Plan testing of internal control to support low level of control risk

► Distinguish internal controls from compliance attributes

► Assess impact on tests of compliance
Common A-133 Quality Issues – compliance

► Compliance testing provides evidence that each of the individual steps in Part 3 (and Part 4 or Part 5, as applicable) are addressed

► Sample sizes for compliance should be per major program (unlike internal control over compliance where sample size may be spread across major programs)
Common A-133 Quality Issues – reporting findings

► Report all internal control and compliance findings as required by Circular A-133 in the Schedule of Findings and Questioned Costs
► Threshold for reporting findings is relatively low
► Evaluating internal control findings
► Evaluate impact of noncompliance on major program opinion
Proposed changes to A-133 – overview

► Goals
  ► Reform grant policies to increase the efficiency and effectiveness of federal programs
  ► Eliminate unnecessary and duplicative requirements
  ► Focus grant policies on areas that emphasize the achievement of better grant outcomes at a lower cost

► Key changes
  ► Audit requirements
  ► Cost principles
  ► Administrative requirements

► Proposed changes to the SF-SAC
Proposed changes to A-133 – Audit requirements

► Audit threshold would increase to $750,000
► Changes to major program determination process
  ► Type A/B program threshold- $300,000→$500,000
  ► Treatment of loan and loan guarantee programs
  ► High-risk Type A programs
  ► Type B programs
► Percentage of coverage changes
► Criteria for low-risk auditee
► Audit findings
  ► Reported in more detail
  ► Questioned costs threshold- $10,000→$25,000
Proposed changes to A-133 – Audit requirements

- Reduction in types of compliance requirements to be tested (14→7 types)
  - Activities allowed or unallowed
  - Allowable costs/cost principles (would also include matching and period of availability of federal funds)
  - Cash management
  - Eligibility
  - Reporting
  - Sub recipient monitoring
  - Special tests and provisions
Proposed changes to A-133 – other changes

- Public accessibility of A-133 reporting package
- Submission of separate A-133 Corrective Action Plan
- Summary Schedule of Prior Audit Findings
- Expansion of pass-through entity responsibilities
- Reporting of amounts passed through to subrecipients on the SEFA
Polling question

Do you anticipate the proposed increases in limits impacting your organization?

A. Yes
B. No
C. Not applicable
Proposed changes to A-133 – cost principles

► Consolidating three cost circulars into a single document
► Indirect costs
► Time and effort reporting
Proposed changes to A-133 – administrative requirements

► Generally Circular A-110 forms the basis of the consolidated proposed guidance
► Contractors would replace vendors
Proposed changes to the SF-SAC

► Would replace current form for audit periods ending in 2013, 2014 and 2015
► Comments due by 8 July 2013
► Final form expected to be issued in late summer/early fall
Proposed changes to the SF-SAC

- Auditor EIN on the form
- Report Federal loans and loan guarantees
- Standard audit finding reference numbers
- Federal programs
  - Removal of certain form items
  - Added new column—number of findings
- Federal awards finding summary
  - Identifies CFDA #, Federal program name, finding reference number, type of compliance requirement(s), type of audit finding and questioned costs
- Personally identifiable information certification
- Changes to PDF uploads
Proposed changes to the SF-SAC
Federal award findings section

<table>
<thead>
<tr>
<th>Page 3 Row Number</th>
<th>Federal Agency Prefix</th>
<th>CFDA Extension</th>
<th>Name of Federal program</th>
<th>Audit Finding Reference Number (YYYY-###)</th>
<th>Type(s) of Compliance Requirement(s)</th>
<th>Modified Opinion</th>
<th>Other Noncompliance</th>
<th>Material Weakness</th>
<th>Significant Deficiency</th>
<th>Other</th>
<th>Questioned Costs</th>
</tr>
</thead>
</table>

These columns are populated automatically from Part III, Item 6, columns a, b, and c on rows with findings.

For each award with findings, one row is created for each finding reported on Part III, Item 6k.

This page is not required if no findings are reported on Part III, Item 6k.
Changes to the 2013 compliance supplement

- Part 2 - Matrix of Compliance Requirements
  - Modified to eliminate the applicability of certain compliance requirements (requirements F, I and J)

- Part 3 - Compliance Requirements
  - Clarifications to procurement threshold
  - Suggested audit procedures for FFATA revised

- Part 4 - Agency Program Requirements
  - Various changes to programs

- Part 5 - Clusters of Programs
  - Removal of ARRA programs

- Use Appendix V for the list of changes to the Supplement
Conclusion
Objectives - Recap

► Our objectives were to:
  ► Gain an understanding the key Accounting Standards Updates (ASUs), FASB projects and other accounting and auditing matters that are currently impacting or will impact health care organizations in the near future
  ► Cover practical matters relative to adoption of the new ASUs and other industry initiatives
  ► Understand the resources available to assist in further understanding the specifics related to the matters discussed within this presentation
Were the objectives of today’s session met?

A. Yes

B. No
Additional questions?
Contact information

► Brian Pavona, brian.pavona@ey.com, 312-879-3344

► Christine Erdmann, Christine.Erdmann@ey.com, 1 312-879-2173

► Gregg Ferlin, gregg.ferlin@comhs.org, 219-934-8249
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