On the Potential Accounting Problems Associated with DM Vendor "Extended Payment Plans"

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Introduction

A disease management ("DM") services contract between a health plan and a DM vendor requires that the vendor perform certain services on behalf of the health plan, in exchange for compensation. It is expected that these DM services will produce cost savings for the health plan. In many cases, the level of compensation paid to the DM vendor is tied to the savings actually achieved, such that a refund of previously paid fees is made if the savings fall short of an agreed threshold.

Under a contract feature referred to as "Extended Payment Plan" or "Work-off Provision", the refund of fees is not due immediately following the reconciliation of the measuring period (usually twelve months after the end of the service period), but instead is made over time, in the form of a reduction in the DM vendor's fees for the next period's services. Stated differently, the DM vendor is required (or may be required) to continue or to renew the services contract at a reduced fee, where the total amount of reduction equals the refund that would have been due the health plan if a more usual "fee-at-risk" approach had been used.

As an example, consider a DM vendor charging $100 per month for services. Suppose the vendor has guaranteed savings of $20 for the first year. Suppose further that actual savings over the year amount to only $8. Under an Extended Payment Plan, the health plan would have the right to force the DM vendor to provide the same services during the next year at a cost of only $99 per month. The $1 fee reduction each month ($12 over the year) is the differential between the guaranteed savings and the actual savings in the prior year.

In considering the proper accounting for an Extended Payment Plan, the DM vendor may wish to consider the effects of Statement of Financial Accounting Standards No. 5, Accounting for Contingencies ("FAS 5").

Potential Accounting Implications of the Extended Payment Plan

Under FAS 5, a "contingency" means "… a set of circumstances involving uncertainty as to possible gain … or loss … that will ultimately be resolved when one or more future events occur or fail to occur." Once the uncertainty is resolved, FAS 5 anticipates a possible outcome being the incurrence of a liability.

FAS 5 gives some examples of loss contingencies. These may be closely aligned with the provisions of an Extended Payment Plan. For example, FAS 5 references "obligations related to product warranties" and "actual or possible claims and

assessments." A warranty is further defined as "… an obligation incurred in connection with the sale of goods or services that may require further performance by the seller after the sale has taken place" [emphasis added].

Under the Extended Payment Plan, the health plan has the right to force the DM vendor to perform in the next measuring period essentially the same services as performed in the previous measuring period, but at a reduced cost. Since the DM vendor has guaranteed (either explicitly or implicitly) a certain level of savings, it has, in effect, issued a warranty of its performance. Alternatively, the future fee reduction can be viewed as an assessment against the DM vendor for failure to deliver the guaranteed savings.

An arrangement under which the health plan simply negotiates a lower rate for future DM services would not seem to fall under FAS 5 if the DM vendor is not obligated to accept the lower fee to perform the services. The key component of an Extended Payment Plan is the right of the health plan to receive substantially similar services at a lower cost.

FAS 5 requires a charge to income (by accrual of a liability) if (1) "[i]nformation available prior to issuance of the financial statements indicates that it is probable that … a liability had been incurred at the date of the financial statements" and (2) "[t]he amount of loss can be reasonably estimated." Under an Extended Payment Plan, the amount of future fee reduction is known with certainty (or can be reasonably estimated). Therefore, if it seems probable that the health plan will renew the DM services contract at the lower fee (by, in the terms of FAS 5, making a warranty claim), the DM vendor should establish a liability for this loss contingency, in an amount equal to the best estimate of the future fee reduction.

The merits of a health plan continuing to employ the services of a vendor that has not met its objectives are debatable. In addition, a requirement to establish a liability may reduce the attractiveness of Extended Payment Plans for DM vendors, since the desired income statement impact (i.e., deferral of the recognition of the amount due the health plan) is not achieved. Nevertheless, vendors are advised to seek guidance from their auditors whenever an Extended Payment Plan is contemplated.