CASE 2-1

Revenue and Expense Recognition—Orthodontic Centers of America

CASE OBJECTIVES

The objective of this case is to evaluate the revenue and expense recognition methods used by the company.

INTRODUCTION

The following information was extracted from the 1999 and 2000 annual reports of Orthodontic Centers of America [OCA].

The company provides practice management services to orthodontic practices in the United States. OCA acquires and develops orthodontic centers and manages the business operations and marketing aspects of affiliated orthodontic practices. At December 31, 2000, there were 592 orthodontic centers, of which the company developed 306 and acquired 361 (75 were consolidated into another center).

The affiliated orthodontists control the orthodontic practices, determine which personnel, including orthodontic assistants, to hire or terminate, and set their own standards of practice in order to promote quality orthodontic care.

A typical patient receives an initial consultation and preliminary procedures (teeth impressions, x-rays, and the placing of spacers between the teeth for braces) in advance of the next appointment. The patient signs a contract for treatment in the event the orthodontist recommends orthodontic treatment. Generally, braces are applied two weeks later and subsequent adjustments to the braces are made every four to eight weeks.

The contract specifies the terms and the length of the treatment as well as the total fees. The average contract length is 26 months. No initial down payment is required; the patient makes equal monthly payments followed by a final payment on completion of the treatment.

OCA provides the following services to its affiliates:

1. Staffing
2. Supplies and inventory
3. Computer and management information services
4. Scheduling, billing, and accounting services

An unrelated financial institution finances operating losses and capital improvements for newly developed orthodontic centers; OCA guarantees the related debt.

1999 REVENUE RECOGNITION

The Company earns its revenue from long-term service or consulting agreements with affiliated orthodontists. Through December 31, 1999 OCA recognized monthly fees equal to approximately:

- 24% of the aggregate amount of all new patient contracts entered into during that particular month, plus
- The balance of contract amounts allocated equally over the remaining term of the contract.

Gross amounts are reduced by the portion of contract amounts expected to be retained by the orthodontist.

OCA recognizes operating expenses as incurred.

Required:

1. OCA believes that at least 24% of its services relate to the first month of the patient contracts. Given the services provide by OCA and the terms of the service and consulting agreements:
   - Evaluate the revenue recognition method used by OCA.
   - Propose and justify a more appropriate revenue recognition method.
2. Estimate OCA’s average contract balance for new patients in 1999, using the operating data in Exhibit 2C-1.

3. Estimate the first year revenue that OCA recognizes from a new patient contract, assuming that OCA’s share of the contract amount is $3,000, the contract length is 26 months, and the contract is signed on
   (i) January 1 of the first year
   (ii) July 1 of the first year
   (iii) December 1 of the first year

4. Estimate the second year revenue that OCA recognizes from a new patient contract, under the same assumptions as Question 3, for each of the three signing dates.

5. Explain why, using your answers to Questions 3 and 4, OCA must expand its operations rapidly to maintain revenue growth.

2000 Revenue Recognition

Effective January 1, 2000, OCA changed its revenue recognition method citing SEC Staff Accounting Bulletin No. 101 (see page 45 of text). OCA now recognizes net revenue using a straight-line allocation of patient contract revenue over the duration of the patient contract (typically 26 months). The company reported that

The cumulative effect of this accounting change, calculated as of January 1, 2000, was $50.6 million, net of income tax benefit of $30.6 million. The effect of this accounting change in 2000 was to reduce revenue by $26.3 million. In 2000, the Company recognized revenue of $57.3 million that was included in the cumulative effect adjustment.¹

The company also reported the pro forma effect of the accounting change on net income, assuming it had been in effect in prior years. Results for those years were not, however, restated.

Exhibit 2C-1 contains operating and income statement data for OCA for the years 1997 through 2000. The exhibit also shows reported balance sheet data for 1998 through 2000, and restated data for 1999 (see Question 15). Use the exhibit to answer the questions that follow.

Required:


7. Compare the first and second year revenue recognized under the 2000 and 1999 methods. Note: use an average of the three signing assumptions.

8. The accounting change had two effects on year 2000 revenue:
   • Revenue recognized from new patients was reduced.
   • Revenue from patients signed in prior years, included in the cumulative effect adjustment, was recognized in 2000.

   (i) From the company’s disclosure of the effect of the accounting change, compute each of these effects.

   (ii) Use your answer to Question 7 to estimate the second of these effects.

9. Compute OCA’s 2000 revenue and net income assuming that it had not changed its revenue recognition policy.

10. Explain why OCA’s revenue recognition policy has a disproportionate effect on net income.

11. Discuss the effect of the accounting change on your answer to Question 5.

12. Compute the annual percent changes in each of the following statistics for 1997 to 2000, and discuss their trend and their implications for future revenue growth:
   • Number of orthodontic centers
   • Total case starts
   • Number of patients under treatment

13. Describe the effect of the accounting change on OCA’s receivables.

¹Source: footnote 2 to 2000 financial statements.
14. Compute each of the following statistics for 1997 to 2000. Discuss their trend, their impact on reported income, and their implications for future revenue and income growth. Discuss the effect of the accounting change on the 2000 statistics.

   (i) Revenue, expense, and operating profit per patient under contract
   (ii) Revenue, expense, and operating profit per center

15. In 2000, OCA restated its 1999 balance sheet to aggregate billed and unbilled patient receivables (as service fee receivables). It also reduced that amount by patient prepayments,
previously shown as a current liability. Compute the ratio of the allowance for uncollectible amounts to gross receivables for:

- Billed and unbilled patient receivables for 1998 and 1999
- Service fees receivable for 1999 (restated) and 2000.

(i) Discuss whether the differences between the ratios for billed and unbilled receivables accord with the nature of the receivables.

(ii) Discuss the trend in the allowance ratios over the 1998 to 2000 period.

(iii) Explain why the aggregation is a loss of information useful for financial analysis.

16. Compare the trend of earnings per share for 1997 to 2000 using the pro forma data with the trend as originally reported. Explain which time series better represents the operating results over that time period.

17. Discuss two reasons why the time series that is your answer to question 16 may not be a reliable basis for forecasting future results.