FASB Ruling -Entrance Fees Understanding the Impact on CCRC's

CliftonLarsonAllen Webinar
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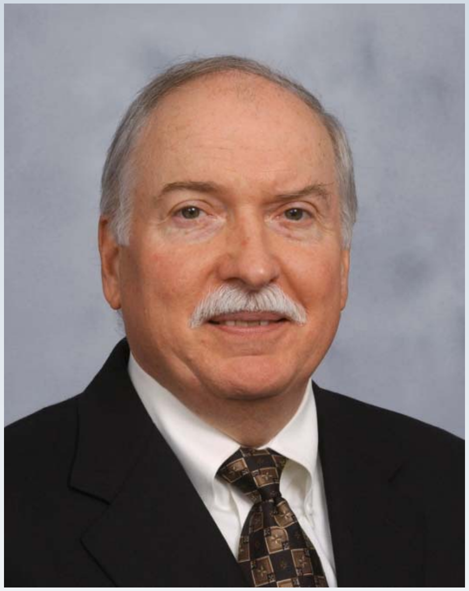
Agenda and Discussion Topics

- Technical Guidance
  - History
  - Changes and reporting
- Examples and Reporting
- Proactive Steps for CCRC Organizations
- For Those Effected – Impact on Reporting
  - Internally
  - Externally
  - Investors
- Strategic issues – looking ahead
- Questions

Speaker Bio – Cline Comer, CPA

- Cline Comer is a partner with CliftonLarsonAllen LLP, located in Charlotte, NC, and a member of the Firm's Accounting and Auditing Quality Group. He serves as the primary Accounting and Auditing Quality Technical Partner for the firm's national health care practice.
- Cline has over 35 years of experience concentrated in serving health care providers and is a member of the AICPA Healthcare Industry Expert Panel and the Audit Guide Revision Task Force. Cline also is currently serving as a member of the Governmental Accounting Standards Advisory Council and has served on the AICPA Technical Issues and Governmental Accounting and Auditing Committees and a number of AICPA Task Forces.



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Speaker Bio – Mario Mckenzie, CPA

- Mario Mckenzie is a partner with CliftonLarsonAllen LLP specializing in assurance and advisory services, including feasibility studies (financial and market) as well as in all aspects of strategic planning for senior living and health care providers.
- Mario has over 20 years of experience in the health care field. He has assisted senior living organizations with:
  - Audit and Assurance Services
  - Feasibility Studies for tax-exempt and other financings
  - Strategic Capital Planning
  - Market Studies
  - Pricing Studies
  - Facility Master Planning via the interactive financial planning process
  - Operations Assessments
  - Acquisition Due Diligence

Technical Guidance

CCRC Technical Corrections ASU

- CCRC Contract language issue originally included in working draft of revised Audit and Accounting Guide for Health Care Entities in early 2011
- AICPA HC EP had identified diversity in practice
- Accounting Standards Codification and prior guidance had not been specific as to contract language issue
- After discussion and review of comment letters AICPA removed the additional language (2 new paragraphs) from the working draft and left unchanged
- FASB learned of diversity in practice

CCRC Technical Corrections ASU

- FASB Issued Technical Corrections ED October 2011
- Intended to be minor corrections and clarifications
- CCRC Issue contained in the ED
  - Refundable entrance fees; revenue recognition for refunds limited to proceeds of re-occupancy
  - ED included requirement for **specific** contract language **limiting refunds to proceeds of reoccupancy**
  - ED included transition; cumulative effect adjustment
  - FASB staff discussed with Board May 30, approved issuance of separate ASU for CCRC issue
- ASU 2012-01 published on FASB Website July 24, 2012

CCRC Technical Corrections ASU (continued)

Background (revisionist history)

- SOP 90-8 was the original guidance for refundable fees
- Amortization of fees refundable through reoccupancy was intended to be a **narrow exception**
- "In effect, the CCRC acts as if it were an agent for present and future residents" ("risk" is with the resident)
- Diversity in practice developed due to misunderstanding of the intent of the original SOP
- Contract terms changed as a result of changing economic conditions and marketing approaches
- "Dangling Debit" Issue

CCRC Technical Corrections ASU (continued)

Inconsistency in Original SOP Language

- Summary section: "The portion of the advance fee that is refundable to the resident on death or withdrawal only on the condition that a new entrance fee is received for the same unit should be reported as deferred revenue, provided that law and management policy and practice support the withholding of refunds under this condition. The amount reported as deferred revenue should be amortized over the useful life of the facility."
- Conclusion section: "That portion of the fees that will be paid to current residents or their designees only to the extent of the proceeds of reoccupancy of a contract holder's unit should be accounted for as deferred revenue, provided that…"

ASU 2012-01
CCRC's – Refundable Advance Fees

- Published on FASB website July 24, 2012
- Requires specific language in contract limiting refunds to proceeds of reoccupancy
- Reported as cumulative effect adjustment to beginning net assets or retained earnings of the earliest year presented
- Early adoption permitted
  - If not early adopted, disclosure consideration if material
  - For many, will likely need to do the work to calculate whether material or not for disclosure purposes…

ASU 2012-01
CCRC's – Refundable Advance Fees – FSO Calculation

- Current guidance requires deferred revenue from entrance fees to be off-set against the Future Service Obligation (FSO)
- No new specific guidance has been issued
- Adoption of ASU 2012-01 may result in recording FSO
  - Should record as component of cumulative effect adjustment
- Communities with Type A contracts and/or high refund plans more likely to have FSO
  - Impact needs to be considered
  - Consult with Actuaries and Auditors

ASU 2012-01
CCRC's – Refundable Advance Fees

- Effective Dates
  - For public entities, fiscal periods beginning after December 15, 2012
    - ◊ If your organization has publicly traded debt or conduit debt, you would be considered a public entity for reporting purposes
    - ◊ (For example, tax exempt bonds issued through an issuing authority would be conduit debt)
  - For non-public entities, fiscal periods beginning after December 15, 2013
- **HOWEVER**: FASB Revenue Recognition Exposure Draft
  - Expected to allow NO amortization of refundable fees
  - Anticipated be issued in 2013, likely not effective prior to 2015

ASU 2012-01
CCRC's – Refundable Advance Fees

Implementation considerations:

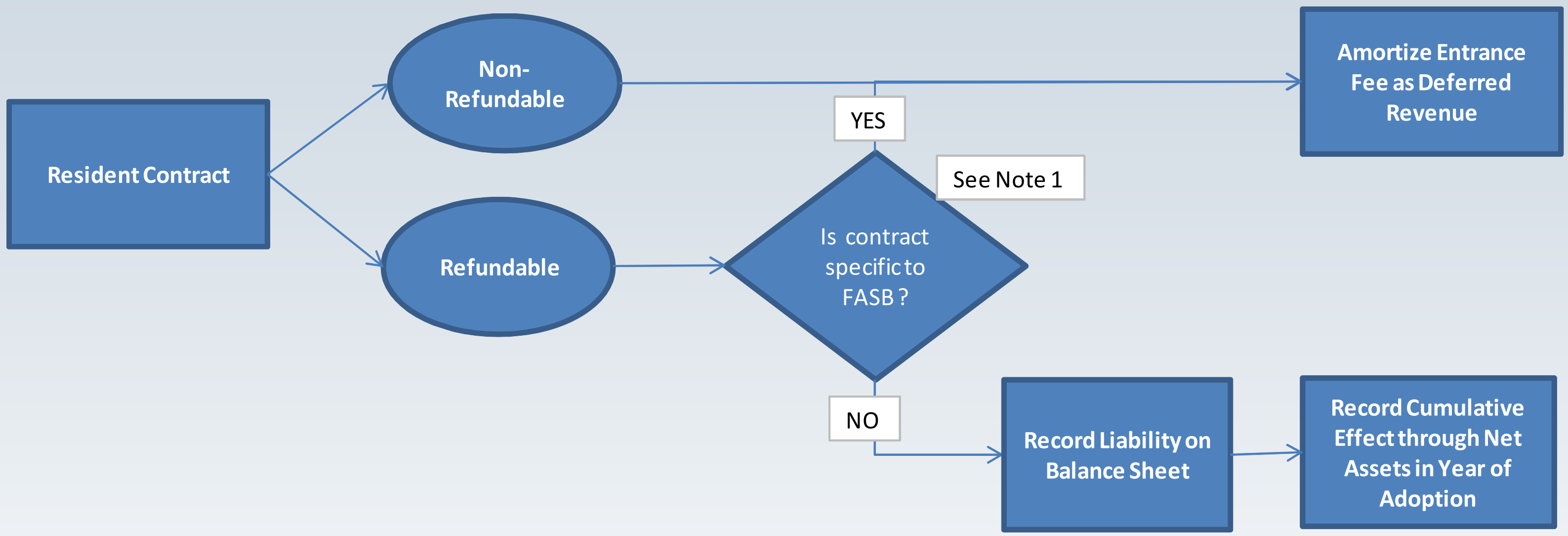
- Amounts of resident contracts **not** containing appropriate language would be restored to the full amount of contractual refunds
- Amounts of previous amortization on applicable contracts will be recorded as cumulative effect adjustment
- Future Service Obligation determination
- Bond covenants or other agreements – *identify impact*
- Marketing and perception of residents - *education*
- Early adoption?

Examples and Reporting

Emerging Accounting Standards - Refundable Entrance Fees
How do we evaluate?

- Review original and current resident contracts
- Does the contract have the **specific** language that would meet the definition FASB outlines?
- What is current Management Practice and does it match the contract?
  - Refunding prior to contract language requirements?
  - Specific unit vs. "Similar" unit
- "Dangling Debit" issue?
  - Entrance fee to Rental contracts (or vice versa)
  - Refundable to Non-Refundable (or vice versa)
  - Within the new standard, if an entity resold a unit under a 0 % plan ($100,000) but was refunding a 90% plan ($200,000) policy would need to be that the resident only receives $100,000 since this is the proceeds received from the sale of their unit

Emerging Accounting Standards - Refundable Entrance Fees Decision Tree



Note 1:

*Refundable advance fees should be accounted for as deferred revenue and amortized **only** when the contract between a resident and a CCRC stipulates that the refundable portion of the entrance fee will be refunded to current residents (or their designees), **and limited** to the proceeds of the re-occupancy of the **contract holder's unit**.*

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Emerging Accounting Standards - Refundable Entrance Fees Journal Entries

Journal Entry #1

Adjust the amortized deferred revenue for the re-characterization of current year revenue to a liability

IS-xxx-xxx		Deferred Revenue	5,000,000	
	BS-xxx-xxx	Refundable entrance fees		5,000,000

Journal Entry #2

Adjust future deferred revenue that can no longer be amortized to a liability

BS-xxx-xxx		Deferred Revenue from Entrance Fees	20,000,000	
	BS-xxx-xxx	Refundable entrance fees		20,000,000

Journal Entry #3

Adjust previously recognized deferred revenue included in net assets to a liability

IS-xxx-xxx		Cumulative Effect of Chg in Accting Principle	10,000,000	
	BS-xxx-xxx	Refundable entrance fees		10,000,000
			35,000,000	35,000,000

Note: The cumulative effect of the change in accounting principle will be reflected as an accounting change in the statement of operations (income statement) for the earliest year presented to reflect consistency of all periods presented

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Emerging Accounting Standards - Refundable Entrance Fees Financial Statement Presentation

	Pre- Adoption	Post- Adoption
REVENUES, GAINS, AND OTHER SUPPORT		
Monthly Fees	$ 30,000,000	$ 30,000,000
Amortization of Deferred Revenue from Entrance Fees	15,000,000	10,000,000
Health Care Services	6,000,000	6,000,000
Contributions	700,000	700,000
Investment Income	1,000,000	1,000,000
Resident and Other Services	500,000	500,000
Net Assets Released from Restrictions	300,000	300,000
Other	50,000	50,000
Total Revenues, Gains, and Other Support	53,550,000	48,550,000
EXPENSES		
Administrative and General	2,000,000	2,000,000
Marketing	500,000	500,000
Resident and Social Services	1,000,000	1,000,000
Environmental Services and Plant Operations	6,000,000	6,000,000
Dietary	6,000,000	6,000,000
Health and Wellness	12,000,000	12,000,000
Fellowship Assistance - Monthly Fees, Net	400,000	400,000
Fellowship Assistance - Entrance Fees	20,000	20,000
Other Program Services	200,000	200,000
Depreciation	8,000,000	8,000,000
Amortization	75,000	75,000
Interest	6,000,000	6,000,000
Total Expenses	42,195,000	42,195,000
OPERATING INCOME (LOSS)	11,355,000	6,355,000

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Emerging Accounting Standards - Refundable Entrance Fees Financial Statement Presentation (Continued)

LIABILITIES AND NET ASSETS (DEFICIT)	Pre- Adoption	Post- Adoption
CURRENT LIABILITIES		
Current Portion of Long-Term Debt	$ 700,000	$ 700,000
Accounts Payable	4,000,000	4,000,000
Health Care Center Deposits	75,000	75,000
Accrued Interest	1,500,000	1,500,000
Other Accrued Expenses	1,000,000	1,000,000
Total Current Liabilities	7,275,000	7,275,000
LONG-TERM DEBT, Net of Current Portion	120,000,000	120,000,000
ENTRANCE FEES AND DEPOSITS		
Entrance Fee Deposits	400,000	400,000
Refundable Entrance Fees	10,000,000	45,000,000
Deferred Revenue from Entrance Fees	100,000,000	80,000,000
Total Entrance Fees and Deposits	110,400,000	125,400,000
FAIR VALUE OF INTEREST RATE SWAP	1,000,000	1,000,000
Total Liabilities	238,675,000	253,675,000
NET ASSETS (DEFICIT)		
Unrestricted	(1,000,000)	(11,000,000)
Temporarily Restricted	500,000	500,000
Permanently Restricted	1,000,000	1,000,000
Total Net Assets (Deficit)	500,000	(9,500,000)
Total Liabilities and Net Assets (Deficit)	$ 239,175,000	$ 244,175,000

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Proactive Steps & Impact on Users/Investors

Emerging Accounting Standards - Refundable Entrance Fees Other Considerations

- Debt Covenants
  - Covenants that require equity or net assets to be part of the calculation would be impacted by this accounting standard.
- Industry Capitalization Ratios
  - In the past, “Deferred Revenue” , sometimes viewed as quasi-equity, was often added to equity as a means to evaluate debt to equity
- Positive “net assets” or “new worth” ratios
  - Many providers have been renewing existing LOC with more traditional bank loans, and those loan covenants have conformed more closely with other commercial lending criteria

Emerging Accounting Standards - Refundable Entrance Fees Other Considerations (Continued)

- Statement of Operations
  - Recognizing less amortization of deferred revenue will decrease certain margin calculations across the industry, and for some entities that only offer high refund plans, may eliminate a sizeable component of "earnings".
    - ◊ Need to consider the changes when utilizing historical benchmarking.
  - This standard is intended to create consistency in reporting across the industry by eliminating diversity in practice.

Emerging Accounting Standards - Refundable Entrance Fees Recommendations for Next Steps

Step 1
- Review contract language for current residents and past residents (or estates) that are owed an entrance fee refund to determine compliance with standard in the contract language (i.e., specific language and practices supporting such language in place)

Step 2
- If not in compliance, begin to quantify the contracts that are not eligible for future amortization (consider actuary for assistance)

Step 3
- Evaluate impact on Future Service Obligation Calculation

Step 4
- Determine whether organization will early adopt or not
- Evaluate required disclosures for current audit

Step 5
- Prepare an internal and external communication plan

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An External View of the Change

- Many organizations offering high refund plans will need to consider how their balance sheets and income statements will appear to consumers
  - Potential for operating losses when refundable entrance fees are no longer amortized
  - Potentially large unrestricted net deficits that don't reverse
  - Potentially large liabilities (refundable entrance fees)
  - Potential Future Service Obligation liabilities

Initial Reactions

- Providers have options to consider:
  - Modify new contracts so that new contracts have the requisite language
    - ◊ May need to consult contract attorney because new contract language establishes a very specific refund obligation tied to a unit which might be incompatible with previous contracts (that called for resale of a comparable unit, for example)
    - ◊ Many providers have indicated that this may create a competitive disadvantage in the market place and that they were unlikely to modify the contracts
  - Modify/amend existing contracts
    - ◊ May be able to do this, but recommend consultation with attorney and state laws
    - ◊ Likely need to offer some consideration in exchange for contract modifications

Back to Basics

- What are the economics of a CCRC?
  - Regardless of type of contracts, or contract language, the reality is that many organizations need to formulate plans to ensure a lasting viable organization
    - ◊ Entrance fee refunds must be managed and properties physically maintained (no functional obsolescence) so that future residents will move into the community (and associated entrance fees by which to pay refunds)
    - ◊ Yields must be safeguarded if part of the pricing embedded in the entrance fee assumes a rate of return
      - What is the PV of the net entrance fee transaction?
    - ◊ Focus on balance sheet strength in light of the refund liability
  - Contracts must appeal to the consumer
    - ◊ What is better for the community vs. the resident…difficult question to tackle
  - Cash flow analysis and actuarial analyses will become important tools to explain the business model to third parties
    - ◊ At the end of the day, it is about managing our long-term liabilities and ensuring that our business model can account for that

Questions?

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