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ASC 606: Implementation guidance for CCRCs

ASC 606: Implementation guidance for CCRCs (Life Plan Communities)

Mark Ross, CPA

Partner and National Healthcare

Practice Leader

Baker Tilly

Brian Gabriel, CPA

Partner, Healthcare

Baker Tilly

AV Powell, ASA, MAAA

Founder and Chief Strategy Officer

A.V. Powell & Associates, LLC

A.V. POWELL & ASSOCIATES LLC
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Learning objectives

> Obtain an understanding of FASB ASC 606 as it pertains to CCRCs

> Review the AICPAs implementation guidance for FASB ASC 606 specific to CCRCs, including:
  - Accounting for monthly/periodic fees, nonrefundable entrance fees and refundable entrance fees
  - Obligation to provide future services and facilities
  - Significant financing component considerations for CCRC contracts

> Consider the potential impact on a CCRC's financial results of ASC 606 using pilot sites

Agenda

1. **ASC 606 background**
2. ASC 606 and its applicability to CCRCs
3. Actuarial considerations
4. Pilot site results
5. Life after ASC 606
6. Questions and answers

Polling question #1

On a scale of 1-5 (1 being the least and 5 being the most), how prepared is your organization for ASC 606?

A) 1 – Not prepared at all

B) 2 – Somewhat unprepared

C) 3 – Neutral

D) 4 – Somewhat prepared

E) 5 – We feel comfortable and are very prepared

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The core principle and the five-step model

Core principle

An entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

1. Identify the contract(s) with a customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations in the contract
5. Recognize revenue when (or as) the entity satisfies a performance obligation

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Effective dates

One year deferral

ASU 2015-14, *Deferral of the Effective Date, defers the original effective date by one year*.

> Early application would be permitted (but not before original effective date, i.e., in annual periods beginning after Dec. 15, 2016)

Public business entities and certain not-for-profit entities

Fiscal years, and interim periods within those years, beginning after Dec. 15, 2017

All other entities

Fiscal years beginning after Dec. 15, 2018, interim periods in fiscal years beginning after Dec. 15, 2019

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Agenda

2. **ASC 606 and its applicability to CCRCs**
3. Actuarial considerations
4. Pilot site results
5. Life after ASC 606
6. Questions and answers

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AICPA guidance – issue #8-3

> The AICPA Health Care Revenue Recognition Task Force issued Working Draft: Health Care Entities Revenue Recognition Implementation Issue #8-3, *Applicability of FASB ASC 606 to CCRC Contracts*, on February 1, 2018. Issue #8-3 addresses the following:
>
> - Accounting for monthly/periodic fees and nonrefundable entrance fees under the different contract types (focus primarily on type A contracts)
> - Significant financing component considerations for refundable and nonrefundable entrance fees
> - Obligation to provide future services and use of facilities

> Comment period for Issue #8-3 ends April 2, 2018

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AICPA.org/frc

February 1, 2018

Financial Reporting Center –
Revenue Recognition

Working Draft:

Health Care Entities Revenue Recognition Implementation Issue

Issue #8-3– Application of FASB ASC 606, *Revenue from Contracts with Customers*, to Continuing Care Retirement Community Contracts

Expected Overall Level of Impact to Industry Accounting: Significant

Wording to be Included in the Revenue Recognition Guide:

Background

1. Continuing care retirement communities (CCRCs) provide residents with a diversity of residential, social, and health care services, in accordance with a resident service agreement (resident agreement or contract) specifying the obligations of the CCRC to the resident. Generally, a resident entering a CCRC initially lives in an independent living unit designed for seniors such as a cottage, duplex, townhome, or apartment. If and when the health of a resident declines, he or she may be permanently transferred to an assisted living facility or a nursing facility, both of which are generally located on the same campus as the independent living units. The health care services provided by CCRCs generally include nursing care and assisted living, and may also include home health care, physician services, and other health care related services. These health care services are provided in addition to the residential services and amenities, including social, recreational, dining, and laundry services. In addition to providing these services to CCRC residents, certain services, predominantly assisted living and nursing services, may be provided to nonresidents. Most CCRCs require some type of entrance (or advance) fee, which may or may not be refundable, and a monthly fee. The entrance fee and monthly fee may vary depending on the type of contract selected by the resident.

2. This paper is focused on Type A life care contracts that are all-inclusive continuing-care contracts that include residential facilities, other amenities, and access to health care services, primarily assisted living and nursing care, for little or no increase in periodic (or monthly) fees, other than increases as stipulated in the resident agreement, generally based on increases in operating costs or inflationary increases. CCRCs should separately assess other types of life care contracts to determine the appropriate accounting under FASB ASC 606, *Revenue from Contracts with Customers*.

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ASC 606

- Supersedes substantially all existing CCRC-specific guidance in the ASC; FSO guidance (and methodology) remains the same

Contract

- A resident agreement between the resident and the CCRC would generally meet the criteria in FASB ASC 606-10-25-1 to be considered a contract with a customer to be accounted for under FASB ASC 606 (para. 4 of Issue #8-3)
- Because a CCRC resident has the ability to move-out and discontinue paying the monthly fee at any time, the resident agreement for a type A life care CCRC resident may be viewed as a monthly contract with the option to renew (para. 7 of Issue #8-3)
- CCRCs should consider whether the type A life care contract contains a lease in the scope of FASB ASC 840 (or FASB ASC 842 after adoption of that topic) (para. 8 of Issue #8-3)

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Performance obligation(s)

- Need to determine whether promised goods and services in the resident agreement represent performance obligations
- FinREC believes the promised good or service (that is, the performance obligation) in the resident agreement for a Type A life care resident is that the CCRC is standing ready each month to provide a service such that the resident can continue to live in the CCRC and access the appropriate level of care based on his or her needs (para. 13 of Issue #8-3)

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Performance obligation(s)

- If an entity grants a customer the option to acquire additional goods or services, that option gives rise to a performance obligation in the contract only if the option provides a **material right** to the customer that it would not receive without entering into that contract …..If the option provides a material right to the customer, the customer in effect pays the entity in advance for future goods or services (para. 14 of Issue #8-3)
- FinREC believes that the nonrefundable entrance fee paid by a resident under a Type A life care contract contains a material right (para. 17 of Issue #8-3)

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Performance obligation(s)

- CCRCs should also evaluate whether the monthly renewal options included in the resident agreement for a Type A life care resident provide a material right to the resident. This evaluation will require judgment
  - FinREC believes that, generally, the monthly renewal options included in the resident agreement for a Type A life care resident would not provide a material right to the resident (para. 18 of Issue #8-3)

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Determining the transaction price

> Monthly fees and refundable and nonrefundable entrance fees generally entitle CCRC residents to the use of residential facilities and access to health care services
  - Monthly fees are included in the transaction price as the monthly options to extend the contract are exercised (para. 19 of Issue #8-3)
  - Nonrefundable entrance fees are a component of the transaction price (para. 20 of Issue #8-3)

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Determining the transaction price

- In accordance with ASC 606-10-32-10, consideration received from a customer should be recognized as a liability if the entity expects to refund some or all of that consideration to the customer. FinREC believes that the refundable entrance fees received from residents should be recorded as a liability at the inception of the resident agreement and not included in the transaction price (para. 22 of Issue #8-3)

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Recognizing revenue

- Generally, FinREC believes a CCRC should recognize **monthly fees** as revenue when the services for the month are performed (that is, the CCRC satisfies the performance obligation) (para. 40 of Issue #8-3)
- Judgment is required to determine how to account for **nonrefundable entrance fees**. FinREC believes that a nonrefundable entrance fee that contains a material right associated with access to future services should be allocated to optional future periods covering a resident’s life expectancy (para. 41 of Issue #8-3)

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Recognizing revenue

- FinREC believes the acceptable methods to allocate the nonrefundable entrance fees to the material rights are as follows:
  - **Time-based** (i.e., straight-line) measurement that results in an equal amount allocated to each month (para. 42 of Issue #8-3)
  - Based on when the future estimated costs or services are transferred to a CCRC resident (similar to a **cost-to-cost method**) (para. 43 of Issue #8-3)
  - Allocating the transaction price to the optional periods by reference to the goods or services expected to be provided and the consideration for those goods or services (for example, monthly fees) (para. 44 of Issue #8-3)

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Nonrefundable entrance fee revenue recognition model – Cost to cost

Note the following illustrations are for discussion purposes only and are not intended to represent authoritative guidance

Revenue recognition model – Type A or "Life Care" contract – Assumptions

Assumptions:

Non-refundable entrance fee	$	200,000
Inflation factor		3.00%
Expected years in IL		10
Expected years in Assisted Living (AL)		2
Expected years in Skilled Nursing (SN)		2

Estimated annual costs by level of care at contract inception:

IL	$	20,000
AL	$	40,000
SN	$	100,000

Type A or "Life Care" contract - Projected costs by level of care for sample resident

	IL	AL	SN	Total
Year 1	$ 20,000	$ -	$ -	$ 20,000
Year 2	20,600	-	-	20,600
Year 3	21,218	-	-	21,218
Year 4	21,855	-	-	21,855
Year 5	22,511	-	-	22,511
Year 6	23,186	-	-	23,186
Year 7	23,882	-	-	23,882
Year 8	24,598	-	-	24,598
Year 9	25,336	-	-	25,336
Year 10	26,096	-	-	26,096
Year 11	-	53,757	-	53,757
Year 12	-	55,370	-	55,370
Year 13	-	-	142,577	142,577
Year 14	-	-	146,854	146,854
Totals	$ 229,282	$ 109,127	$ 289,431	$ 627,840
Relative values	**36.52%**	**17.38%**	**46.10%**	**100.00%**

Note: Inflation factor of 3% applied to costs in all levels of care

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Type A or "Life Care" contract - Allocation of nonrefundable entrance fee to level of care

	IL		AL		SN		Total	
Nonrefundable entrance fee	$	200,000	$	200,000	$	200,000	$	200,000
Relative value		36.52%		17.38%		46.10%		100.00%
Allocation	$	73,040	$	34,760	$	92,200	$	200,000

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Type A or "Life Care" contract - Revenue recognition over pattern of transfer

	Revenue Recognized (a)	Contract Liability (b)
Inception		$ 200,000
IL:		
Year 1	$ 6,370	193,630
Year 2	6,560	187,070
Year 3	6,760	180,310
Year 4	6,960	173,350
Year 5	7,170	166,180
Year 6	7,390	158,790
Year 7	7,610	151,180
Year 8	7,840	143,340
Year 9	8,070	135,270
Year 10	8,310	126,960
	73,040	

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Type A or “Life Care” contract - Revenue recognition over pattern of transfer

	Revenue Recognized (a)	Contract Liability (b)
AL:		
Year 11	17,120	109,840
Year 12	17,640	92,200
	34,760	
SN:		
Year 13	45,420	46,780
Year 14	46,780	-
	92,200	
Total	$ 200,000	

(a) Nonrefundable entrance fee allocated to deliverables using cost to cost method.

(b) Contract liability is equal to the nonrefundable entrance fee less revenue recognized.

Polling question #2

Which method does your organization plan to use to recognize nonrefundable entrance fees after adoption of ASC 606?

A) Time-based

B) Cost-to-cost

C) Other

CCRC revenue recognition

What about…

> Couples

> Type B and C contracts

> CCaH contracts

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Future service obligation

- ASC 606 does not change the guidance related to the calculation of the obligation to provide future services and use of facilities; however, the determination of deferred revenue and deferred marketing costs components of calculation may change (para. 53 of Issue #8-3)

Significant financing component

- ASC 606 requires CCRCs to evaluate whether each of their contractual arrangements with residents provide a **significant** benefit of financing to either party of the contract. The financing component may be explicitly identified in the contract or, may be implied (para. 23 of Issue #8-3)

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Significant financing component

- FinREC believes that the **refundable entrance fees** received by a CCRC from residents are not part of the transaction price. As a result, refundable entrance fees do not need to be considered in a CCRC's significant financing component analysis (para. 30 of Issue #8-3)
- A CCRC should consider all facts and circumstances in assessing whether the **nonrefundable entrance fee** payment from a resident results in a contract that is deemed to have a significant financing component (para. 31 of Issue #8-3)

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Significant financing component

- FASB ASC 606-10-32-17 states that, “Notwithstanding the assessment in paragraph 606-10-32-16, a contract with a customer would not have a significant financing component if the customer paid for the goods or services in advance, and the timing of the transfer of those goods or services is at the discretion of the customer…” (para. 33 of Issue #8-3)
- BC233c states, in part, that “The primary purpose of those payment terms may be to provide the customer with assurance that the entity will complete its obligations satisfactorily under the contract, rather than to provide financing…” (para. 34 of Issue #8-3)

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Other CCRC considerations

Costs of acquiring CCRC contracts

- Under existing guidance, certain costs of acquiring continuing care contracts when a facility is being initially occupied can be capitalized; subsequent contract acquisition costs are expensed
- In accordance with FASB ASC 340-40-25-1, “an entity shall recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs”

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Costs of acquiring CCRC contracts

- FASB ASC 340-40-25-2 indicates that the incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract that the entity would not have incurred had the contract not been obtained
- Costs capitalized are amortized over a period based on the terms of the contract (in a CCRCs case, most likely over the resident's life expectancy)

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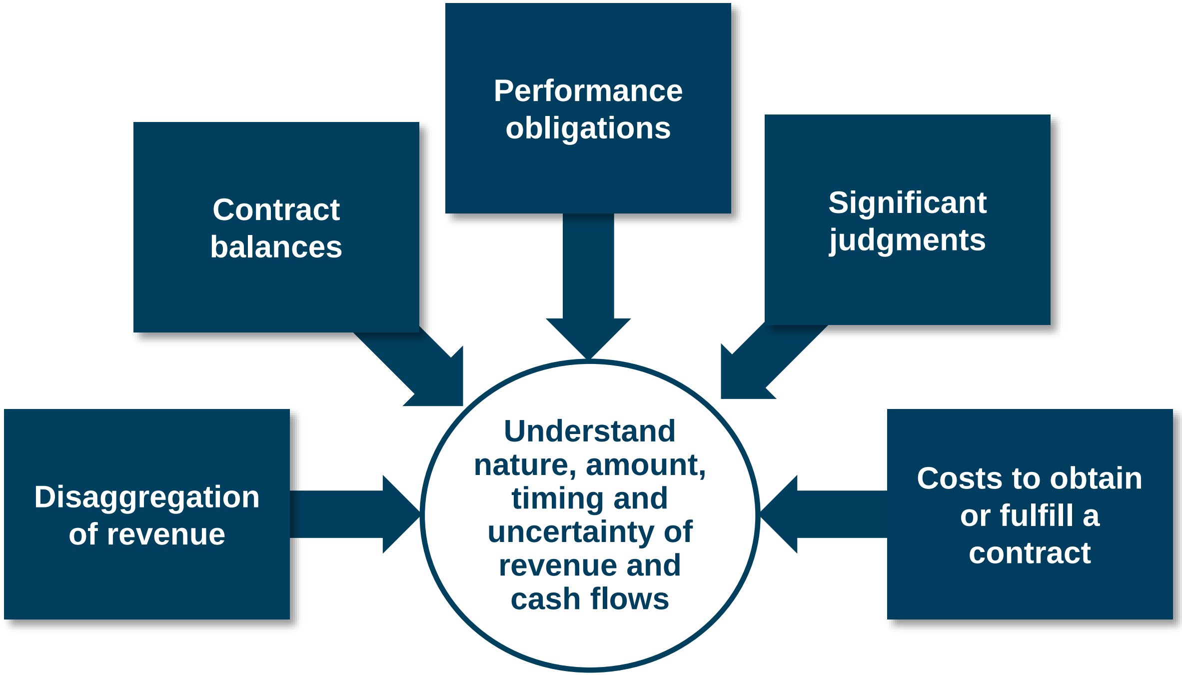
Disclosure requirements



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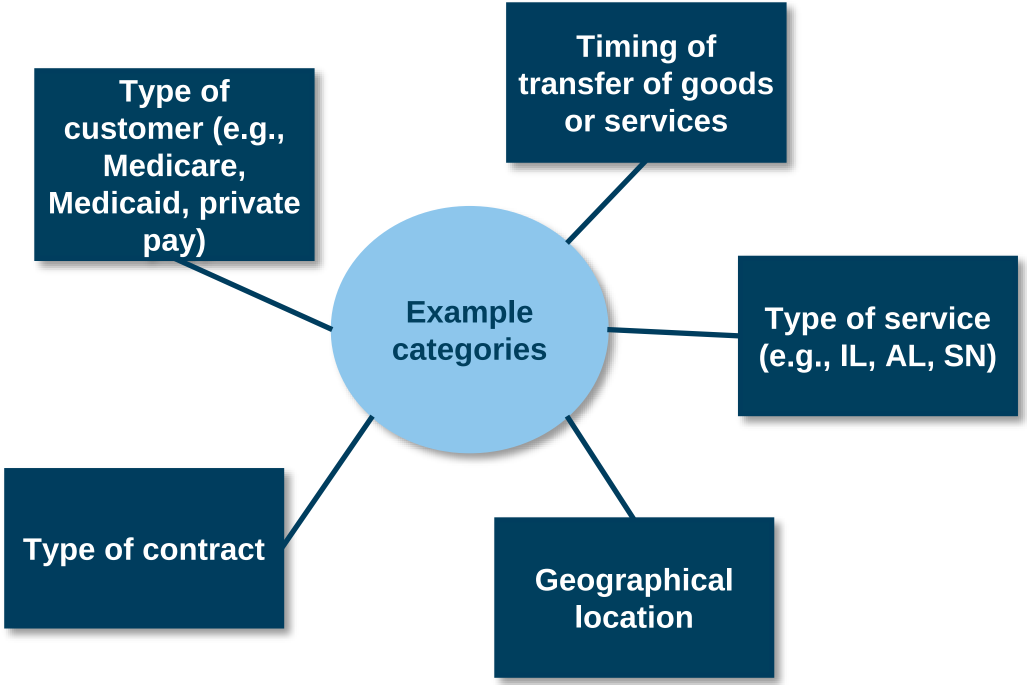
Disaggregation of revenue



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Polling question #3

On a scale of 1-5 (1 being the least and 5 being the most) how difficult do you believe it will be to disaggregate and disclose your net resident service revenues in accordance with ASC 606?

A) 1 – Very easy

B) 2 – Somewhat easy

C) 3 – Neutral

D) 4 – Somewhat difficult

E) 5 – Very difficult

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Agenda

3. **Actuarial considerations**
4. Pilot site results
5. Life after ASC 606
6. Questions and answers

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Applying actuarial techniques to explore the real world impact of ASC 606

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Consideration for adopting ASC 606

- Option 1 (time-based measure)—easy to implement since no changes
- Option 2 (cost-to-cost method)—relatively complex to implement
- Actuarial and other required assumptions
  - Life expectancies
  - Costs by level of care matching performance obligations
  - Conventions for resident and contract nuances
- New formula that uses:
  - Life expectancies by level of care, i.e., performance obligation
  - <100% of deferred balance used in calculation
  - Reflects anticipated inflation

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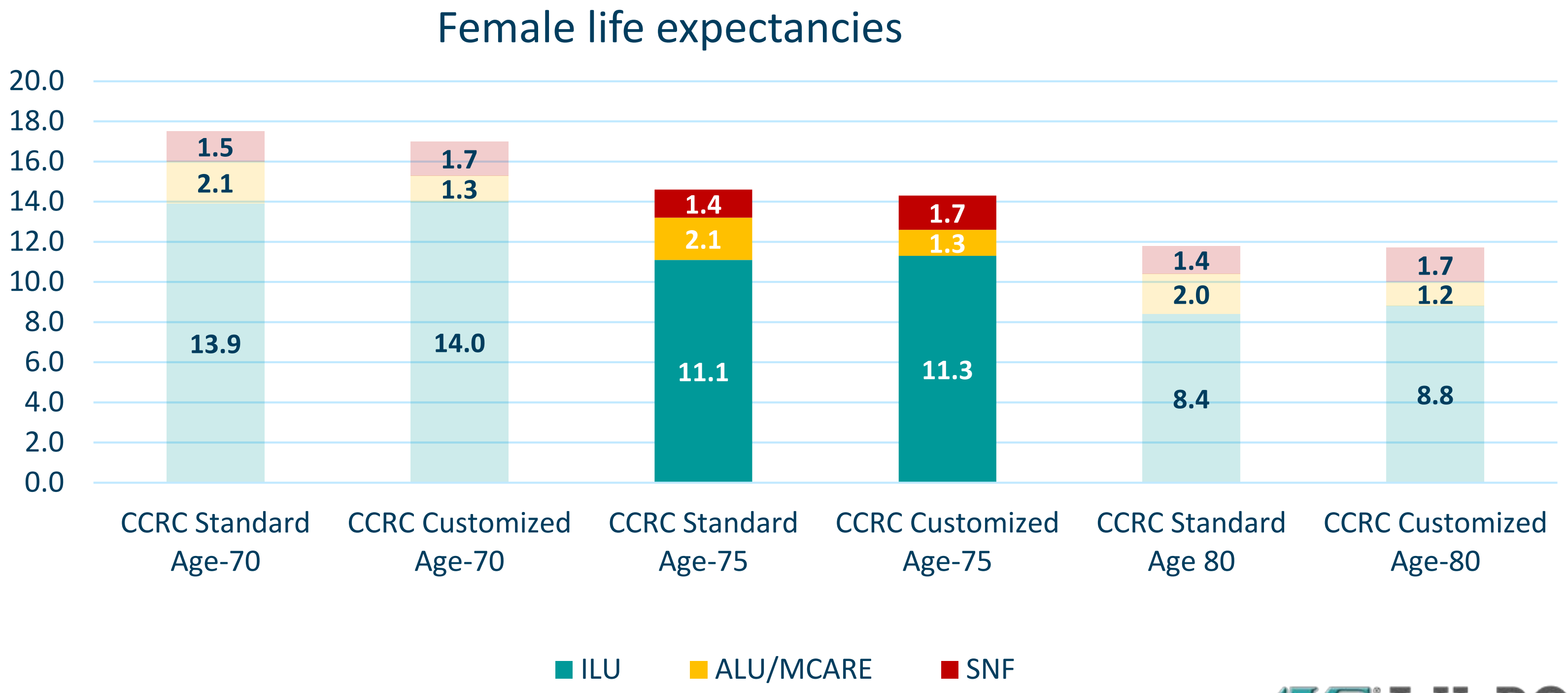
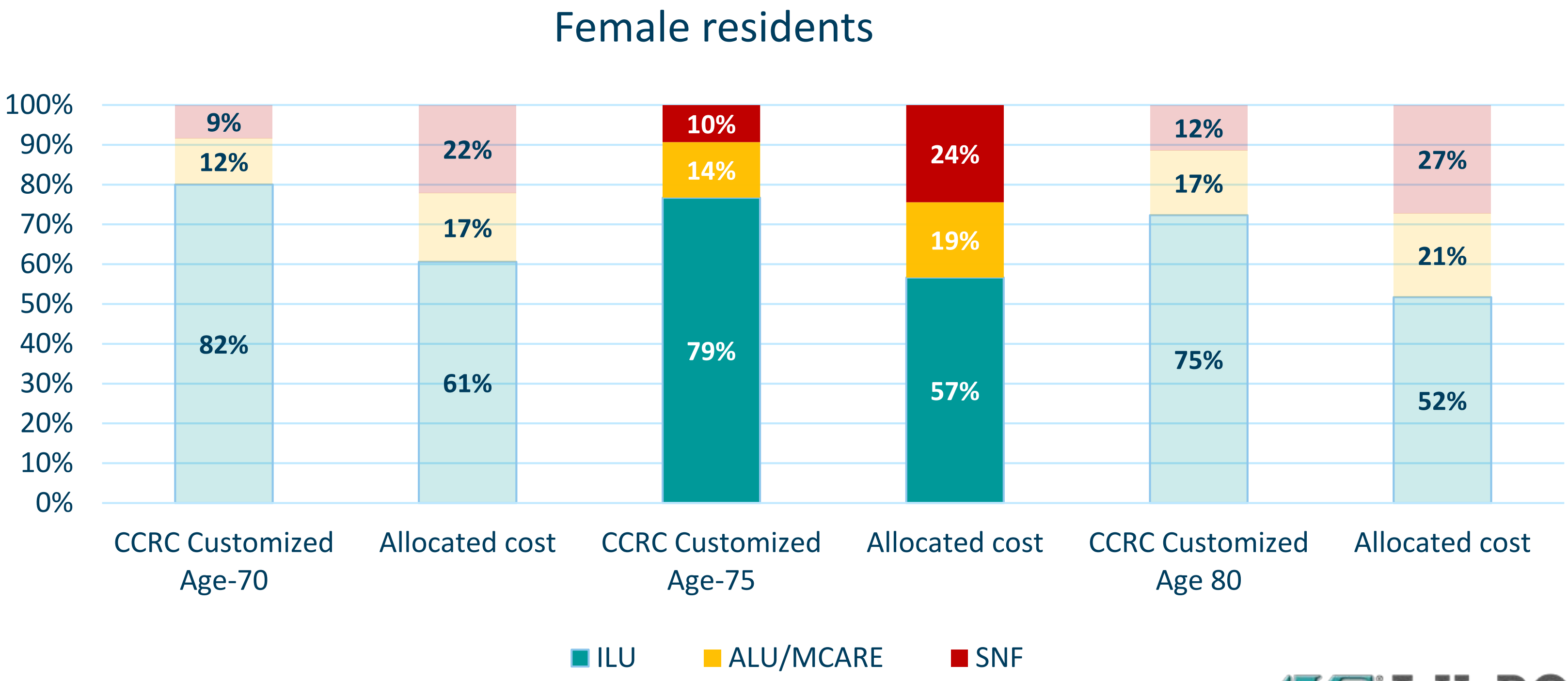
Time-based measure straight lines e_x



Cost-to-cost method reallocates income



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Simplified comparison of ASC 606 options

Current (time-based) guidance	Assumption	Result
1. Advance fee paid	$200,000	
2. Total life expectancy (11.3 + 1.3 + 1.7)	14.3	
3. Income recognized in year 1	(1 ÷ 2) =	$13,986
Alternative (cost-to-cost) guidance	**Assumption**	**Result**
1. Advance fee paid	$200,000	
2. Percentage of costs in performance level 1	57%	
3. Portion of advance fee that may be recognized	$114,000	
4. Life expectancy in performance level 1	11.3	
5. Adjustment for revenue inflation of 3%	17.5	
6. Income recognized in year 1	(4 ÷ 5) =	$6,514

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Which method is consistent with real world?

n = 97	Net Operating Expenses	GAAP Depreciation	Operating + Depreciation	Average 1st Person MFs	MF minus Expenses
25th Percentile*	$ 1,883	$ 626	$2,523	$2,740	$257
50th Percentile*	2,269	817	3,096	3,747	499
Average	2,311	817	3,128	3,620	492
75th Percentile*	2,682	986	3,678	4,206	822
*Values do not sum across categories					

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Steps to comply with new ASC 606 option

> Define historical and future costs by level of care
> Generate/obtain life expectancies by level of care
> Create new software programs to handle complex formulas
> Compare income recognition and deferred balances using
  - Legacy allocation, i.e., time-based method
  - New alternative allocation, i.e., cost-to-cost method

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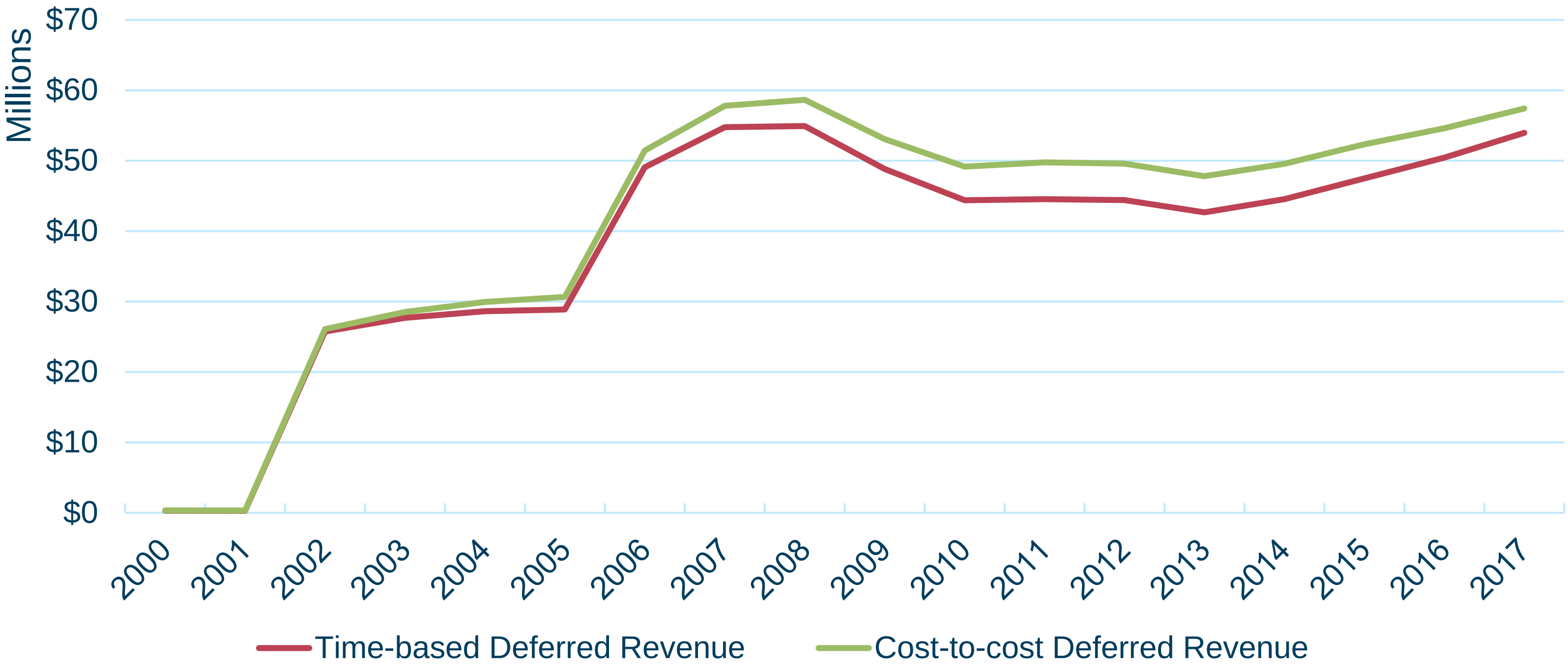
Pilot site deferred rev. variance: <10%



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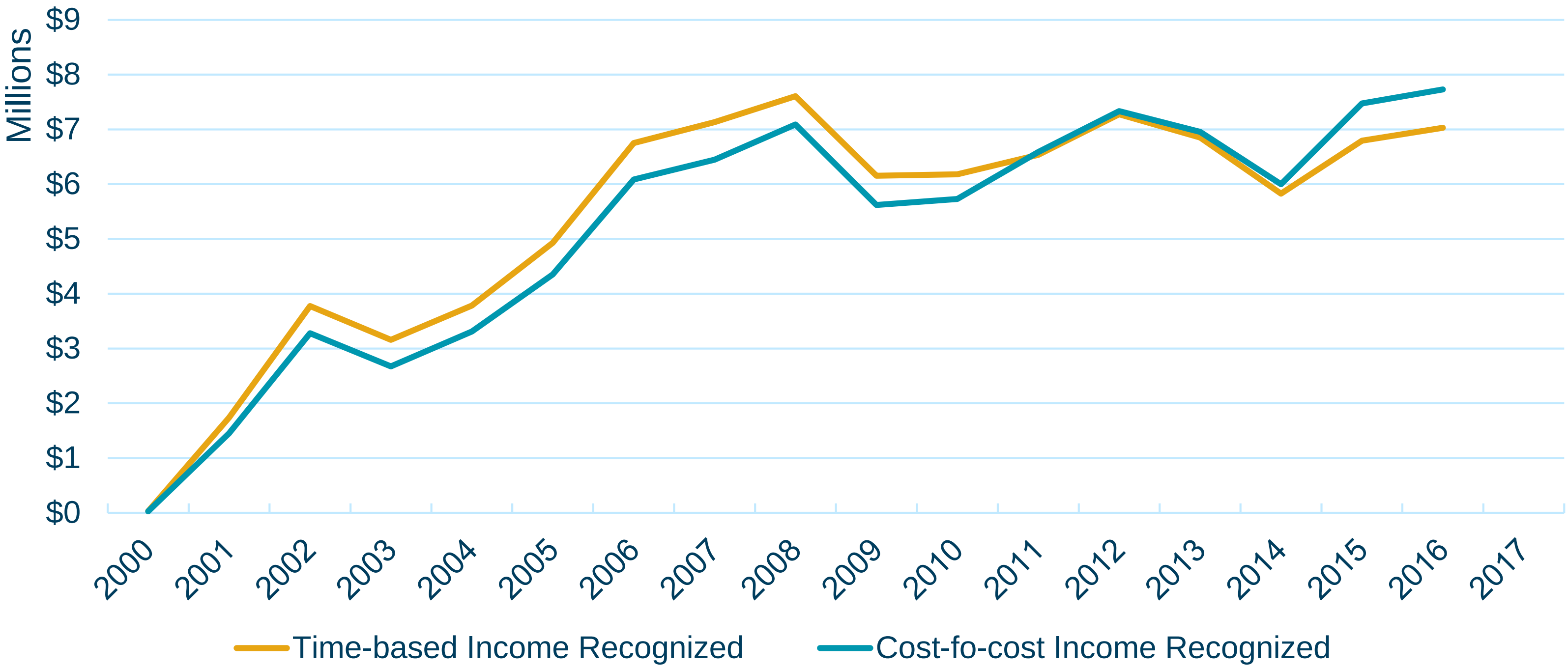
Income recognition variance: -17% to + 10%



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ASC 606 may materially impact financials

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Many moving parts in ASC 606 formula

Cum. results as of 12.31.16 (dollars in thousands)	Deferred revenue	Percent variance	Income recog.	Percent variance
Time-based (legacy guidance):	$53,950	(6.0%)	$91,809	3.9%
Benchmark ASC 606 cost-to-cost: IL:AL:NC cost ratio 1:1.46:2.50 All inflation assumptions match	**$57,414**	**0.0%**	**$88,345**	**0.0%**
Health care inflation: +3%	$60,020	4.5%	$85,739	(2.9%)
Revenue inflation: -1%	$56,700	(1.2%)	$89,059	0.8%
Change to AVP standard life expectancies:	$57,207	(0.4%)	$88,551	0.2%

Many moving parts in ASC 606 formula

Cum. Results as of 12.31.16 (dollars in thousands)	Deferred Revenue	Percent Variance	Income Recog.	Percent Variance
Time-based (legacy guidance):	$53,950	(6.0%)	$91,809	3.9%
Benchmark ASC 606 cost-to-cost: IL:AL:NC cost ratio 1:1.46:2.50 All inflation assumptions match	**$57,414**	**0.0%**	**$88,345**	**0.0%**
IL:AL:NC cost ratio: 1:2:5 Based on ASC 606 illus. costs	$62,273	8.5%	$83,486	(5.5%)
IL:AL:NC cost ratio: 1:1:1 Illustrative constant cost	$52,885	(7.9%)	$92,874	5.1%
IL:AL:NC cost ratio: 1:1.56:2.88 Based on client expenses	$57,284	(0.2%)	$88,474	0.1%
IL:AL:NC cost ratio: 1:2.10:3.58 Based on AVP median exps.	$60,182	4.8%	$85,577	(3.1%)

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Agenda

4. **Pilot site results**
5. Life after ASC 606
6. Questions and answers

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Pilot site #1 with 100% non-refundable

Entrance fee income recognition

> Deferred revenue of $600m

> Annual income recognition of $92.5m

- Entrance fee income: $74.3m
- Termination income: $18.2m
- Represents 19% of total revenue

	(in millions)
Cash revenue	$382.4
Non-cash revenue	**92.5**
Total revenue	**$474.9**

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Pilot site #2 with 100% refundable

Entrance fee income recognition

> Deferred revenue of $12,567k
> Refundable entrance fees of $77,678k
> Annual income recognition of $1,853k
  - Entrance Fee Income: $1,377k
  - Termination Income: $476k
  - Represents 9% of total revenue

	(in thousands)
Cash revenue	$18,870
Non-cash revenue	**1,853**
Total revenue	**$20,722**

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Will ASU 606 change CCRC practices to set fees and determine solvency?

> Annual actuarial valuations
  - New entrant pricing
  - Funded status

> Healthcare utilization projections

> Financial qualifications of residents

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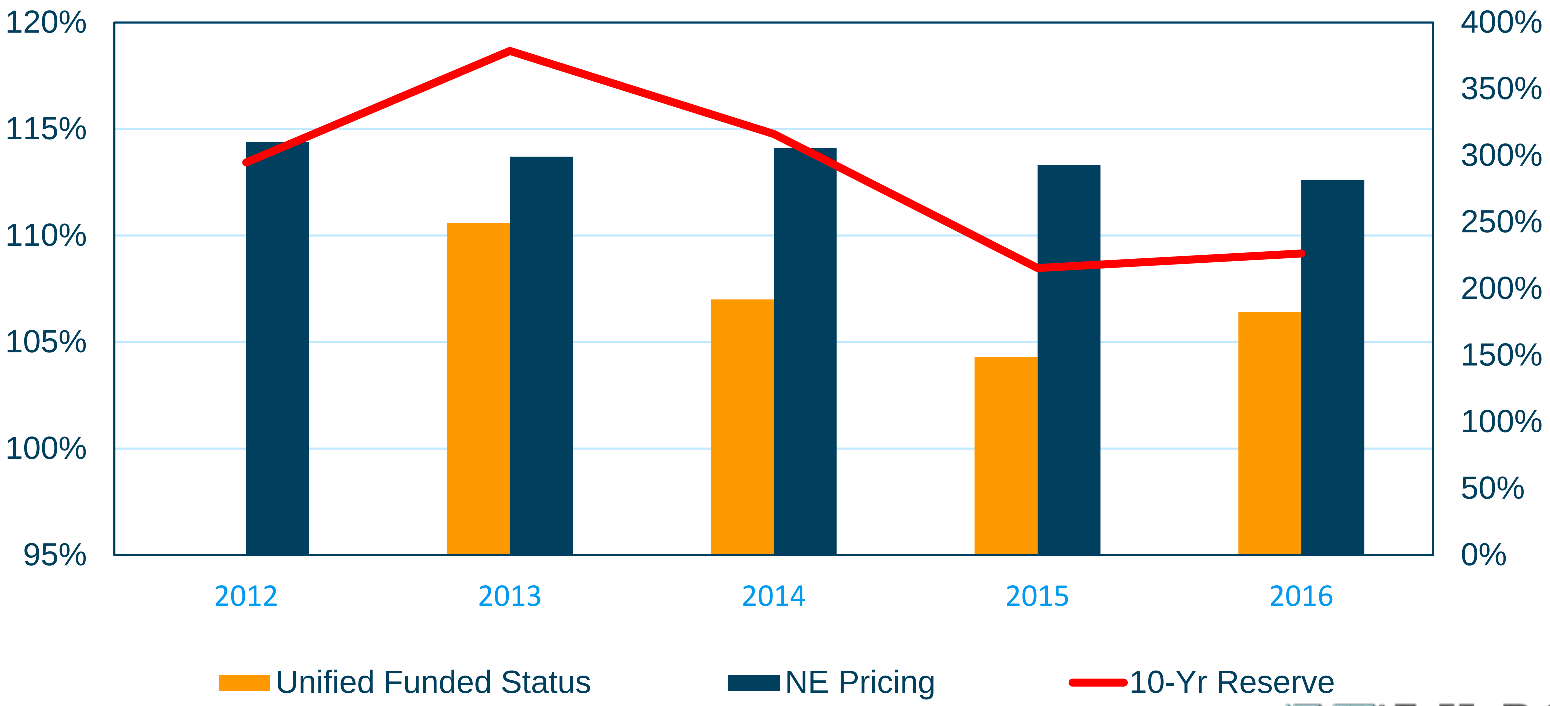
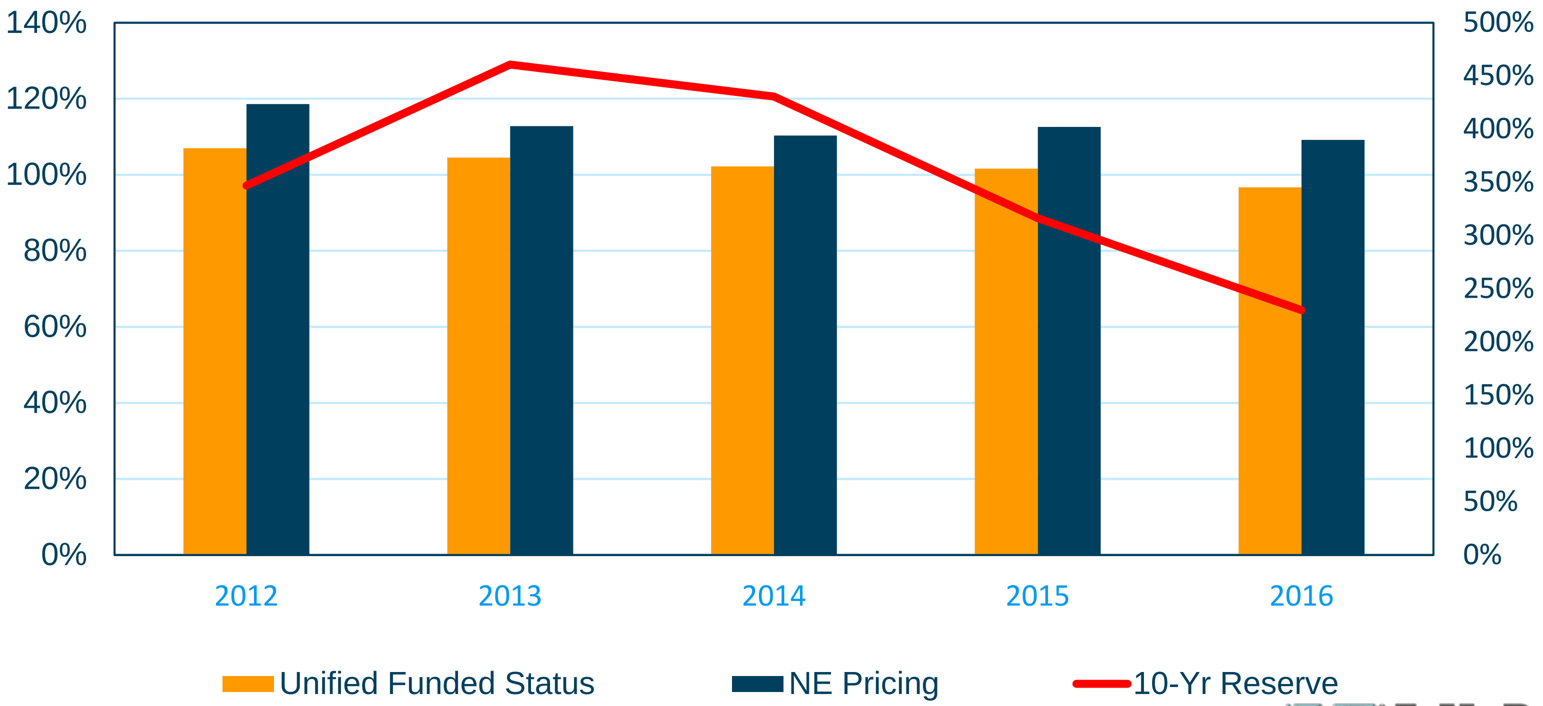
ASOP#3 annual updates for Pilot site #1



ASOP#3 annual updates for Pilot site #2



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Agenda

5. **Life after ASC 606**
6. Questions and answers

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Conversation with attendees

- What questions are boards likely to ask about options?
  - Are there standard decision criteria to adopt change or not
  - Is the more conservative option “correct”
- How does ASC 606 affect creditworthiness evaluations?
- Do ASC 606 options affect budgeting policies?
- Should practices to set fees be changed?
- Do ASC 606 financial statements or FSO measure solvency?
- Will future GAAP converge to one ASC 606 option?

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Polling question #4

On a scale of 1 to 5 (1 being the least and 5 being the most), how relieved are you that the AICPA guidance provides you with options to recognize the monthly and nonrefundable entrance fees?

1 – Unrelieved

2 – Somewhat unrelieved

3 – Neutral

4 – Somewhat relieved

5 – Very relieved

Polling question #5

Do you believe your financial statements accurately represent the economic reality of your financial condition?

A) Very conservative

B) Slightly conservative

C) Generally accurate

D) Slightly optimistic

E) Very optimistic

Questions

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Connect with us

Mark Ross, CPA

Partner and National Healthcare Practice Leader

Baker Tilly

mark.ross@bakertilly.com

Brian Gabriel, CPA

Partner, Healthcare

Baker Tilly

brian.gabriel@bakertilly.com

AV Powell, ASA, MAAA

Founder and Chief Strategy Officer

A.V. Powell & Associates, LLC

av@avpowell.com

A.V. POWELL & ASSOCIATES LLC

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