

National Continuing Care Residents Association

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Technical Director
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Financial Accounting Standards Board
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The National Continuing Care Residents Association is the sole national resident organization representing the estimated 700,000 residents of Continuing Care Retirement Communities (CCRCs) in the United States. In CCRCs as commonly configured, residents pay large entrance fees, and recurring fees thereafter, in return for a contract typically promising lifetime residence and the availability of care services when, and if, needed.

Revenue Recognition.

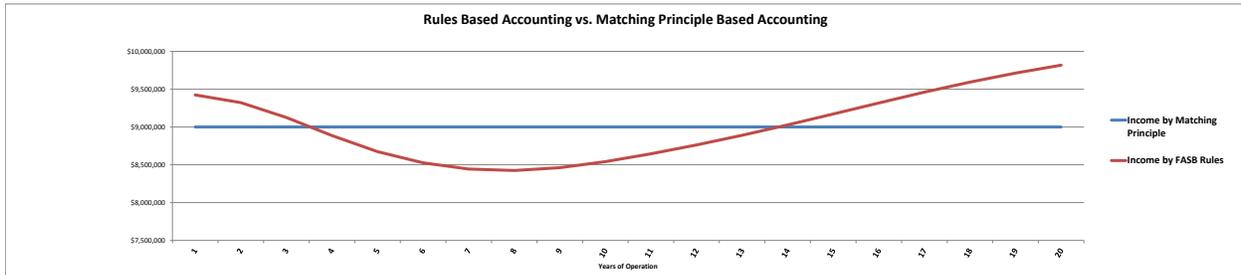
CCRCs have been singled out for special treatment in the accounting rules that apply in the United States (Accounting Standards Codification 954-430). The effect of the current revenue recognition rules is to increase revenue recognition in the early contract years leaving deficits in the later years that must be made up by ad hoc fee increases. We understand that American GAAP is rules based but we urge changes to conform CCRC accounting to the consistency and matching principles that long applied to the accounting profession. Special legislated (codified) treatment for a single industry conflicts with the consistency principle since consistency would have like transactions recorded in like fashion regardless of the context in which they occur.

CCRC liabilities are analogous to life insurance and annuity obligations which call for actuarial modeling. CCRC accounting has long relied on the use of life expectancies, as though a life expectancy were like an amortization factor. Among other shortcomings this methodology ignores the time value of money in the calculation of CCRC liabilities allowing interest effects to artificially inflate earnings in the early years of CCRC contracts.

A simple example can make this clear. Consider a monthly rental community that decides to introduce an entrance fee with the understanding that the entrance fee will fund a level monthly life annuity toward the monthly rental that would otherwise be required. It's clear that the matching principle, in such a simple case, would require that the entrance fee be recognized in revenue on a level basis over the lifetime of the subject resident.

To compare the revenue patterns of today's accounting rules with the accounting that would result from a principled matching of revenue recognition to the "performance obligations," we projected for fifty years a hypothetical cohort of 85 year old female CCRC residents. We assumed for the purposes of this illustration that those who die were immediately replaced by new female residents who were exact age 85 at entrance. The projections were prepared using mortality from the 1980-93 California CCRC Mortality Study and interest at 3%.

The following compares over the first twenty years the effect of revenue recognition according to 954-430 compared with the level recognition that would result from treating the recognition of the entrance fee as the annuity that it is.



The red line shows: (1) the early fronting of revenue recognition according to today’s FASB rules; (2) the subsequent deficit in revenue recognition; and (3) the permanent overstatement of revenue once the CCRC reaches a permanent stable population status. The blue line represents actuarial recognition of income according to the matching principle and the level recognition is a result of the calculation rather than a preconceived concept. We can make the projection available to FASB on request.

Proposal.

The integrity of accounting statements can only be as valid as is the adherence of such statements to the underlying principles that govern accounting. Those principles are grounded in logic and are universal and immutable. Hence, we favor restoring CCRC revenue recognition and accounting to consistency with general accounting principles.

Even CCRCs that operate on a fee for service basis undertake long term contractual commitments to make those services available. Typically the commitments are for the lifetime of the resident and, frequently, for the joint lifetimes of the resident and a spouse. Projecting mortality and care needs for life – whether they are prefunded or pay-as-you-go – involve human life contingencies and, hence, are actuarial in nature.

Accordingly, we suggest that the contingent liabilities of a CCRC be actuarially determined just as such liabilities are determined for an annuity or life insurance company. Actuarial calculation of contingent liabilities will intrinsically bring revenue recognition into conformance with the matching and consistency principles.

To this end we suggest that CCRC accounting include an actuarial certification (or at least an actuarial opinion) to confirm the adequacy of the contingent liabilities to make full and sufficient allowance for the deferred future “performance obligations.” We believe that the actuarial elements in the financial statements of CCRCs should be determined by qualified actuaries and that accountants should rely on recognized experts rather than substituting their own judgments for the more refined understandings of actuarial professionals.

We recognize that conforming CCRC accounting to general principles may work a hardship for some CCRCs that have relied on the liberal early years accounting of the past, so we suggest a phase in period. During the transition we would suggest allowing CCRCs to report earnings on both the old and proposed standards until they are financially able to fully adopt the new standards. Year to year comparability will require parallel reporting for several years.

There is financial hazard in today’s CCRC accounting practice. An example will make this clear. Recently (early February 2012) one of our Board members – the signatory, who is an actuary –

was talking with the Chief Financial Officer (CFO) for a CCRC who is a CPA. When asked who made the actuarial calculations for the CCRC, the CFO responded, "I do." The actuary then asked how the CFO took entrance fees into income. The CFO responded that the refund obligation steps down at a rate of 2% a month so he recognizes 2% of the entrance fee as revenue until the entrance fee is fully recognized, i.e. over 50 months.

When the actuary asked if there was any recognition of the lifetime commitments that the entrance fees are intended to fund, the answer was, "No." Clearly, practices like this result in a distortion of revenue recognition and are inconsistent with the stewardship obligation that financial managers have toward the residents who entrust CCRCs with entrance fees. Another CFO, also a CPA, at another provider organization was recently heard to say, "Our operating gain is down but cash is king and we've just received \$26 Million in cash entrance fees."

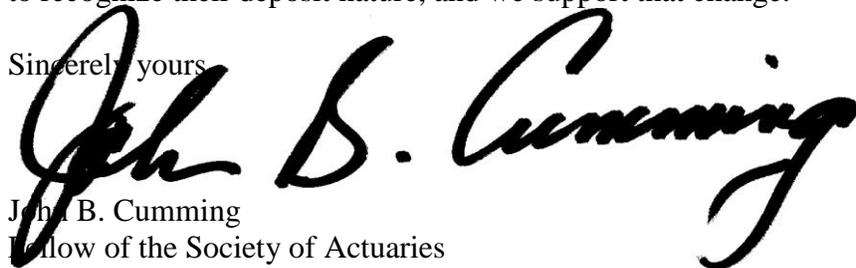
Often these entrance fees represent the residents' life savings or the proceeds from the sale of the family home. There is a clear imbalance between the importance of the entrance fees for residents and their value for CCRC managers. Hence, from the perspective of the residents we represent, the need for care is evident in determining how such funds are recognized as revenue.

Other Areas of Concern.

Among other variants, CCRC contracts vary in their advance coverage of care obligations and in the right of residents to a partial or full refund of the entrance fee upon death or withdrawal. At one extreme CCRCs can be partially supported by the forfeitures from departing residents and at the other extreme entrance fees are similar to demand bank deposits subject to call when the resident is no longer in residence.

Some CCRCs predicate the payment of such refunds on the "resale" of the residence to a successor resident. It has been argued that this alleviates the CCRC of an accounting liability for the refund commitment since the burden of the commitment falls to the hoped-for successor resident. We disagree. We believe that such refund obligations should be actuarially computed and that the CCRC should maintain sufficient liquidity to meet all its obligations without dependence on events subsequent to the event that gives rise to the obligation. We understand that FASB intends to strengthen the accounting for the refund obligations of CCRC entrance fees to recognize their deposit nature, and we support that change.

Sincerely yours,



John B. Cumming
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For the National Continuing Care Residents Association