December 23, 2005

Letter of Comment No: 10  
File Reference: FSP78U  
Date Received: 1/18/06

Susan Cosper  
Practice Fellow  
Financial Accounting Standards Board

Subject: Comments on potential FSP Entrance Fee Deposits and Deferred Revenue

Dear Ms. Cosper:

I am pleased to have the opportunity to provide comments on the AICPA Health Care Expert Panel Issue Summary, Accounting by Continuing Care Retirement Communities (CCRCs) for the refundable portion of entrance fee deposits and the potential FASB Staff Position Entrance Fee Deposits and Deferred Revenue (FSP).

FASB Statement No. 78 requires that “obligations that, by their terms, are due on demand or will be due on demand within one year (or operating cycle, if longer) from the balance sheet date, even though liquidation may not be expected within that period” be classified as current liabilities.”

**Issue 1: Should refundable entrance fees be classified as current**

FASB Statement No. 78, Paragraph 13 states in part, that “(i) if the creditor has at that date, or will have within one year (or operating cycle, if longer) from that date, the unilateral right to demand immediate repayment of the debt under any provision of the debt agreement, the Board concluded that the obligation should be classified as a current liability... (emphasis added)”

Refunds of entrance fee deposits are governed by both contract and state law. Many continuing care retirement contracts do allow a resident the option to terminate their contract; however there are reciprocal actions required of the resident that ultimately trigger the issuance of a refund. Of greatest importance is the obligation to vacate the community. Many contracts require advance notice of an intention to terminate by either party. The entrance fee is typically not refundable until such time as the resident has vacated the property. In addition, many contracts have provisions whereby a significant portion, if not all, of the entrance fee is only refundable upon resale of the unit vacated. In those cases, the amount that is refundable upon resale is not subject to a demand for immediate payment and would be appropriately classified as a non-current liability. Oftentimes, there are also provisions to recoup repair/renovation costs from the entrance fee refund, as well as the right to recoup any unpaid fees.
Debt obligations, as originally contemplated in FAS 78, do not impose such requirements upon the creditor. When the FASB was considering this Statement, it was contemplating general debt obligations, such as loans and bonds. Such debt obligations may include provisions for a creditor to call or demand repayment in full upon written notice, with no other obligation placed upon the creditor. This is material differentiation between debt obligations covered by FAS 78 and refundable entrance fees at a CCRC.

Based on these factors, a resident does not have the "unilateral right to demand immediate payment" and as such, Statement No. 78 should not be applied.

Issue 2: Comparability of Financial Statements
In its July 15, 2005 Issue Summary, Accounting by Continuing Care Retirement Communities (CCRCs) for the refundable portion of entrance fee deposits, the AICPA Healthcare Expert Panel provided the following example illustrating how deferred revenue that is potentially refundable would be classified in accordance with the guidance in SFAS 78 (for purpose of this illustration, amortization of deferred revenue is ignored):

Example 1:
"Assume pursuant to contract terms, the resident pays a $100,000 entrance fee to the CCRC. If the resident vacates the CCRC during the first year, $80,000 of the fee is refundable. If the resident vacates the CCRC during the second year, $60,000 of the fee is refundable. If the resident vacates the CCRC after the second year of residence, $50,000 is refundable. Based on prior experience, the CCRC estimates that the resident will stay at least two years and that $50,000 will be refunded.

In accordance with paragraphs 14:20-25 of the Audit and Accounting Guide, Health Care Organizations (the Guide), the entrance fee would be accounted for as $50,000 of refundable entrance fees and $50,000 in deferred revenue.

In year one, the entity would classify $80,000 within current liabilities - $50,000 as refundable entrance fees and $30,000 in deferred revenue-current. Deferred revenue-noncurrent would be $20,000.

In year two, the entity would classify $60,000 within current liabilities - $50,000 as refundable entrance fees and $10,000 in deferred revenue-current. Deferred revenue-noncurrent would be $40,000.

In year three and thereafter, the entity would classify $50,000 within current liabilities - $50,000 as refundable entrance fees and $0 in deferred revenue-current. Deferred revenue-noncurrent would be $50,000.

The example illustrates two classification matters under the guidance in SFAS 78. The first is that the classification of the refundable entrance fee liability is always current. The second is that a portion of deferred revenue would be required to be classified as current liabilities until it becomes non-refundable. This latter classification may confuse the reader of financial statements because the current portion of deferred revenue in
accordance with SFAS 78 is not the amount of deferred revenue that would be recognized as (or amortized to) revenue in the next year."

What this example does not illustrate is the effect that contractual restrictions on the timing of the refund. Let us assume that in addition to the above assumptions that state law requires that the community refund an amount equal to the entrance fee, less 2% per month of occupancy and that under the terms of the contract, any remaining refundable amount is payable upon resale of the unit vacated. The revised example would look like the following:

**Example 2:**
In year one, the entity would classify $78,000 within current liabilities - $50,000 as refundable entrance fees and $28,000 in deferred revenue-current. Deferred revenue-noncurrent would be $24,000.

In year two, the entity would classify $52,000 within current liabilities - $50,000 as refundable entrance fees and $2,000 in deferred revenue-current. Deferred revenue-noncurrent would be $48,000.

In year three, the entity would classify $28,000 within current liabilities - $28,000 as refundable entrance fees-current and $0 in deferred revenue-current. Deferred revenue-noncurrent would be $50,000 and refundable entrance fees-noncurrent would be $22,000.

In year four, the entity would classify $4,000 within current liabilities - $4,000 as refundable entrance fees-current and $0 in deferred revenue-current. Deferred revenue-noncurrent would be $50,000 and refundable entrance fees-noncurrent would be $46,000.

In year five and thereafter, the entity would classify $0 within current liabilities. Deferred revenue-noncurrent would be $50,000 and refundable entrance fees-noncurrent would be $50,000.

This treatment has the effect of creating even more volatility between current and noncurrent liabilities, thus affecting the comparability of financial statements from year-to-year as well as the reader's ability to compare different communities that have different refund policies.

**Issue 3: Consistency of financial statements**
Current practice requires CCRC's to estimate the amount of advanced fees to be recorded as a liability "based on the individual facility's own experience or, if records are not available, on the experience of comparable facilities." The deferred revenue is then amortized over the remaining life expectancy of the resident, or the length of the contract, whichever is shorter. Since in most cases, the remaining life expectancy is greater than one year, much of the deferred liability has been appropriately classified as noncurrent. This is reflected in Examples 1 and 2, shown above, to the extent that the deferred revenue could not be demanded within one year.
This treatment is inconsistent with the application of FAS 78. The rationale for treating the refundable portion of the entrance fee as current is based upon the notion that the refund could be unilaterally demanded by the resident. If that were to happen, the unamortized portion of the deferred revenue would then become recognizable. Based upon this, FAS 78 would require that the entire amount of deferred revenue be classified as current. This would make the financial statements even more confusing because the amount recorded as current deferred revenue would vary even more greatly from the amount that would be expected to be amortized in the coming year.

**Issue 4: Usefulness of financial statements**

Re-classification of refundable entrance fee deposits as current liabilities would significantly skew the financial statements of continuing care retirement communities. It would not be atypical for a retirement community to have $4 million in combined current assets and marketable securities (classified as non-current assets). It is also not atypical for such a retirement community to have in excess of $20 million in refundable entrance fees in addition to what has been historically classified as current liabilities. A reclassification of these refundable fees as current would make the community look as if it had over $15 million in current liabilities that it could not repay from current assets.

This is clearly a worst-case presentation that could significantly impact a community’s ability to access credit on both a long-term and short-term basis.

**Summary**

FASB Statement No. 78 was adopted by only a 4-3 margin, even when focusing on obligations that are due on demand by requiring simple notification. At the time, Messrs. Block, Brown and Walters dissented based on the notion that this was shifting the classification of current liabilities to a “worst-case notion instead of a reasonable-expectation notion.” The dissenters argued that this was contrary to the original intention of ARB 43. Classifying these obligations as current would be an even greater shift away from the original intent of ARB 43.

Financial statements would become less useful and more misleading by applying FAS 78. Significant amounts of liabilities would be classified as current, far in excess of the amounts reasonably expected to be refunded within one year. In addition, deferred revenues would become classified as current, despite reasonable expectations that the revenue would not be earned within one year.

I appreciate the opportunity to provide comments on the FSP. If you have any questions about these comments, please feel free to contact me at (413) 567-7800.

Sincerely,

David S. Leslie
Controller