
Q&A Section 6400

Health Care Entities

.55 Background to Sections 6400.56–.62 — Accounting for Lease Components in Type A Life Care Contracts by Continuing Care Retirement Communities

Continuing care retirement communities (CCRCs) provide residents with a diversity of residential, social, and health care services in accordance with a resident agreement 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, or 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.

Type A life care contracts are all-inclusive continuing-care contracts that include initial occupancy in an independent living unit and other services and amenities while the resident occupies the independent living unit and access to health care services for the remainder of the resident's life (that is, a stand-ready obligation). Health care services primarily consist of assisted living, skilled nursing care, or both, 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.

Refer to chapter 14, “Financial Accounting and Reporting by Continuing Care Retirement Communities,” of the AICPA Audit and Accounting Guide *Health Care Entities* for further background on CCRC contracts.

[Issue Date: August 2020.]

.56 Embedded Lease Component Within Type A Life Care Contracts

Inquiry — What are some of the considerations in determining whether Type A life care contracts offered by CCRCs contain a lease (or leases) under FASB *Accounting Standards Codification* (ASC) 842, *Leases*?

Reply — At inception of the contract, CCRCs should analyze their specific resident agreements to determine whether the contract contains a lease (or leases). As the initial occupancy in the CCRC is in independent living, the CCRC should generally begin the analysis with the independent living unit. However, the resident agreements may include a lease (or leases)



beyond the initial independent living unit, and the CCRC should evaluate whether the resident's future use of the assisted living and skilled nursing units meets the definition of *leases* at contract inception. Refer to section 6400.62 for a discussion of lease considerations related to a resident moving to the CCRC's assisted living or skilled nursing facility.

CCRCs need to consider the guidance in the FASB ASC Master Glossary, which defines a *lease* as a "contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration."

CCRCs also must consider the guidance in FASB ASC 842-10-15-9, which states "[a]n asset typically is identified by being explicitly specified in a contract. However, an asset also can be identified by being implicitly specified at the time that the asset is made available for use by the customer." Accordingly, the CCRC should consider the initial independent living unit and any additional living units that the resident uses, including those units used by the resident when the resident moves to different levels of care. CCRCs also should consider the guidance in paragraphs 10–15 of FASB ASC 842-10-15 related to substantive substitution rights, specifically, whether the CCRC would have the practical ability to substitute another independent living unit throughout the period of use and, if so, whether the CCRC would benefit economically from exercising the right to substitute another unit.

Factors that CCRCs should consider in determining whether a contract includes an identified asset generally include the following:

- Whether the resident agreement executed at time of admission to the CCRC identifies a specific independent living unit that the resident will move into. This identification could be an address, unit number, or similar specific identifying characteristic
- Whether the terms of the resident agreement do or do not provide for a substantive substitution right for the independent living unit throughout the period of use

If there is an identified asset in the arrangement, FASB ASC 842-10-15-17 states the following:

To control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use (for example, by having exclusive use of the asset throughout that period). A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding, or subleasing the asset. The economic benefits from use of an asset include its primary output and by-products (including potential cash flows derived from these items) and other economic benefits from using the asset that could be realized from a commercial transaction with a third party.

In addition to having the right to substantially all the economic benefits of an identified asset, in order to control the use of the asset, the resident also must have the right to direct the use of the asset throughout the period of use. In accordance with FASB ASC 842-10-15-20, a resident has

the right to direct the use of an identified asset throughout the period of use if the resident has the right to direct how and for what purpose the asset is used throughout the period of use.

A resident agreement generally provides the resident exclusive rights to the asset (for example, the independent living unit). Therefore, if this criterion is met and it is determined the contract contains an identified asset, then the contract would generally contain a lease because the resident would have the right

- a.* to obtain substantially all the economic benefits from use of the asset throughout the period of use, and
- b.* to direct how and for what purpose the identified asset is used throughout the period of use.

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.57 Determination of the Lease Term When an Embedded Lease Component for an Independent Living Unit Is Present Within Type A Life Care Contracts

Inquiry — If a CCRC determines that a Type A life care contract contains a lease for an independent living unit, what are the considerations that should be made in determining the lease term?

Reply — FASB ASC 842-10-55-23 indicates that “[a] lease is no longer enforceable when both the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignificant penalty.” CCRCs should refer to the FASB ASC Master Glossary for the definition of a *penalty* as it applies to lease agreements. CCRCs should consider whether the nonrefundable portion of entrance fees would constitute a more than insignificant penalty to the resident.

If the arrangement is enforceable, CCRCs will then need to consider the guidance in FASB ASC 842-10-30-1, which indicates that the lease term includes the noncancelable period of the lease, together with periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option, periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option, and periods covered by an option to extend (or not terminate) the lease in which exercise of the option is controlled by the lessor.

FASB ASC 842-10-30-2 further indicates that, “[a]t the commencement date, an entity shall include the periods described in paragraph 842-10-30-1 in the lease term having considered all relevant factors that create an economic incentive for the lessee (that is, contract-based, asset-based, entity-based, and market-based factors).” FASB ASC 842-10-55-26 provides additional guidance on the economic factors to consider at the commencement date of the lease in determining whether a lessee is reasonably certain to exercise or not exercise an option.

CCRCs should evaluate their specific facts and circumstances in determining the lease term, including determining whether it is reasonably certain that residents will exercise renewal

options or whether it is reasonably certain that residents will not exercise termination options (and will, therefore, continue to occupy the independent living unit). The CCRC should consider the economic incentives residents may have for continuing to live at the facility, along with other relevant factors that may provide information that is helpful in assessing whether the resident (lessee) is reasonably certain to exercise, or not exercise, an option. In particular, one of the economic factors the CCRC should consider is the nature of the entrance fee, and whether it is fully or partially refundable, when considering whether exercise of a termination option would result in the resident incurring an economic penalty in such an amount that it appears reasonably certain that the lease will continue. If historical experience indicates that residents continue to live in the independent living unit for their lifetime, the actuarially determined life expectancy of the resident may be a relevant data point when determining the lease term.

Refer to section 6400.61 for a discussion of reassessing the lease term after the commencement date and to sections 6400.61–.62 for the accounting ramifications if the lease is terminated or the resident moves permanently to an assisted living or skilled nursing facility.

[Issue Date: August 2020.]

.58 Classification of an Embedded Lease Component Within Type A Life Care Contracts

Inquiry — If the CCRC determines that there is an embedded lease for the independent living unit in its resident agreements, what are the considerations regarding how the lease should be classified?

Reply — CCRCs should consider the guidance in FASB ASC 842-10-25-3, which indicates lessors should classify leases as operating leases or direct financing leases if the criteria in FASB ASC 842-10-25-2 to classify the lease as a sales-type lease are not met. To be classified as a sales-type lease, a lessor considers the guidance in FASB ASC 842-10-25-2, which states that the lease would need to meet any of the following criteria at lease commencement:

- a. The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- b. The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- c. The lease term is for the major part of the remaining economic life of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion shall not be used for purposes of classifying the lease.
- d. The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments in accordance with FASB ASC 842-10-30-5(f) equals or exceeds substantially all the fair value of the underlying asset.

- e. The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

In order to determine lease payments in a Type A life care contract, the CCRC would need to allocate consideration in the contract between lease and non-lease components. Refer to section 6400.59 for discussion of non-lease components within the resident agreement of a Type A life care contract. Paragraphs 38–40 of FASB ASC 842-10-15 discuss a lessor’s allocation of contract consideration between lease and non-lease components.

If the CCRC determines that none of the sales-type lease criteria are met, the CCRC would need to evaluate the criteria to classify the lease as a direct financing lease in accordance with paragraph 3b.1–2 of FASB ASC 842-10-25. Specifically, the CCRC would need to evaluate whether

- a. the present value of the sum of the lease payments (and any residual value guaranteed by the lessee that is not already reflected in the lease payments in accordance with FASB ASC 842-10-30-5(f) or any other third party unrelated to the lessor, or both) equals or exceeds the fair value of the underlying assets, and
- b. it is probable that the lessor will collect the lease payments (plus any amount necessary to satisfy a residual value guarantee).

If one or both of these criteria are not met, the CCRC should classify the lease for the independent living unit in its resident agreements as an operating lease. Criterion *a* is only met in situations in which the lessor obtains unrelated third-party residual value support, such as residual value insurance.

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.59 Non-Lease Components Within the Resident Agreement of Type A Life Care Contracts

Inquiry — Does the resident agreement contain non-lease components and, if so, what are the factors to consider in determining if the practical expedient in FASB ASC 842-10-15-42A can be applied?

Reply — CCRCs should consider the terms of their resident agreements to determine whether or not non-lease components are included. For example, access to amenities the facility has to offer or the ability to access health care services when needed (that is, a stand-ready obligation) could be considered non-lease components. FASB ASC 842-10-15-42A indicates that the lessor may, as an accounting policy election, by class of underlying asset, choose to not separate the non-lease components from the lease components and, instead, account for each separate lease component and the non-lease components associated with that lease component as a single component if the non-lease components to be combined otherwise would be accounted for under FASB ASC 606, *Revenue from Contracts with Customers*, and if both of the following are met:

- a. The timing and pattern of transfer for the lease component and non-lease components associated with that lease component are the same.
- b. The lease component, if accounted for separately, would be classified as an operating lease in accordance with paragraphs 2–3 of FASB ASC 842-10-25.

FASB ASC 842-10-15-42B indicates that a lessor that applies the practical expedient will account for the combined component as a single performance obligation under FASB ASC 606 if the non-lease component or components are the predominant component or components. Otherwise, a lessor will account for the combined component as an operating lease in accordance with FASB ASC 842.

If a lessor that has elected to apply the practical expedient enters into a contract that includes a lease and multiple associated non-lease components, a lessor must combine all components that qualify for the practical expedient and separately account for the components that do not qualify. In doing so, the lessor is required to allocate the consideration in the arrangement between the combined component and the components that do not qualify.

CCRCs would need to consider whether the timing and pattern of transfer of the benefits of using the independent living unit (that is, the lease component) and each of the identified non-lease components (for example, amenities and the stand-ready obligation to access health care services) are the same. Generally, the lease component would be recognized with a time-based measure (that is, straight line over the lease term). Similarly, the non-lease components might be recognized using a time-based measure such that the access to the amenities and the stand-ready obligation would be satisfied over the same time period as the lease component on a time-elapsed basis; however, CCRCs would need to consider whether, under their specific facts and circumstances, the timing and pattern of transfer is the same for the lease and each non-lease component.

In addition to assessing the pattern of transfer between the lease and non-lease components, the timing of transfer is also critical to the determination of whether lease and non-lease components can be combined. Given the nature of these arrangements, it is likely that an entity will generally be able to conclude that it meets the timing of transfer requirement because the resident can only obtain the benefit of the non-lease components while they are in the facility (that is, the resident cannot elect to remain in the facility and not receive the services specified in the resident agreement); therefore, the lease term and the services term would be equivalent. However, CCRCs should carefully evaluate the facts and circumstances of their resident agreements to determine whether the timing and pattern of lease and non-lease components are the same such that combination is appropriate.

Refer to section 6400.58 for a discussion of a CCRC's classification of a lease.

If it is concluded that the timing and pattern of transfer for the lease and non-lease components are the same, CCRCs also will need to evaluate what the predominant component is in the terms of their resident agreements related to the independent living unit. FASB ASC 842-10-15-42B indicates that when determining whether a non-lease component or components are the

predominant component or components of a combined component, a lessor should consider whether the lessee would be reasonably expected to ascribe more value to the non-lease component or components than to the lease component.

Paragraph BC35 in the Basis for Conclusions of FASB ASU No. 2018-11, *Leases (Topic 842): Targeted Improvements*, also states that “[t]he Board concluded that an entity should be able to reasonably determine which Topic to apply (based on predominance) without having to perform a detailed quantitative analysis or theoretical allocation to each component.”

Accordingly, for contracts that otherwise qualify for the practical expedient as described previously, CCRCs will need to consider the specific facts and circumstances related to such contracts regarding whether their residents would be reasonably expected to ascribe more value to

- a. the non-lease components, for example, the amenities of the community and the stand-ready obligation to access to health care services, in which case, CCRCs should apply FASB ASC 606 to account for the combined component, or
- b. the occupancy of the independent living unit, in which case, CCRCs should apply FASB ASC 842 to account for the combined component.

When a contract has multiple non-lease components, there may be some non-lease components that may have the same timing and pattern of transfer as the lease components and other non-lease components that do not. When electing the practical expedient, all non-lease components that qualify for the expedient must be combined. Non-lease components that do not meet the criteria to be combined under the practical expedient will be accounted for separately under other generally accepted accounting principles (GAAP) (for example, FASB ASC 606).

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.60 Measurement of Lease Payments if a Lease for an Independent Living Unit Exists in a Type A Life Care Contract

Inquiry — If the CCRC determines that an embedded lease for the independent living unit exists in its resident agreements, how should the CCRC consider advance fees and periodic fees when determining the measurement of the lease payments?

Reply — CCRCs should consider the guidance in FASB ASC 842-10-30-5, which states that at the commencement date, the lease payments shall consist of the payments relating to the use of the underlying asset during the lease term. This amount includes allocated fixed payments, including in-substance fixed payments, less any lease incentives paid or payable to the lessee (see paragraphs 30–31 of FASB ASC 842-10-55), variable lease payments that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date, and other payments (refer to paragraph 5(c)–(f) of FASB ASC 842-10-30).

Generally, the payments specified in the CCRC resident agreement consist of entrance fees and periodic fees, which are fixed under the terms of the resident agreement. These payments may be for the use of the independent living unit, the stand-ready obligation to provide access to certain services and amenities and health care services, or other non-lease components the CCRC has identified. In the resident agreement, these fixed entrance and periodic fees typically will be included in the consideration within the contract that will be allocated to the lease and non-lease components (paragraphs 38–40 of FASB ASC 842-10-15 discuss a lessor’s allocation of contract consideration between lease and non-lease components), unless the CCRC qualifies for the practical expedient, which allows for combining lease and non-lease components, and further elects to combine the lease and non-lease components. Some resident agreements may provide for increases in periodic fees based on inflation. These payments may be variable lease payments based on an index or rate under FASB ASC 842-10-3-5(b) that also would be included as consideration in the contract.

[Issue Date: August 2020.]

.61 Reassessment of Lease Term Within the Resident Agreement of Type A Life Care Contracts

Inquiry — Under what circumstances would the CCRC reassess the lease term related to an embedded lease for an independent living unit in its resident agreements?

Reply — CCRCs should consider the guidance in FASB ASC 842-10-35-3, which indicates that a lessor shall not reassess the lease term or a lessee option to purchase the underlying asset unless the lease is modified, and that modification is not accounted for as a separate contract. The FASB ASC Master Glossary defines a *lease modification* as “[a] change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease (for example, a change to the terms and conditions of the contract that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term).” FASB ASC 842-10-35-3 also states that when a lessee exercises an option to extend the lease or purchase the underlying asset that the lessor previously determined the lessee was not reasonably certain to exercise or exercises an option to terminate the lease that the lessor previously determined the lessee was reasonably certain not to exercise, the lessor shall account for the exercise of that option in the same manner as a lease modification.

Accordingly, if the CCRC determines that a lease modification has occurred or a lessee has exercised (or not exercised) an option and the exercise (or lack of exercise) is inconsistent with the lessor’s previous assumption when it determined the lease term, the lease term should be reassessed.

[Issue Date: August 2020.]

.62 Impact on a Lease Component Within the Resident Agreement of Type A Life Care Contracts When a Resident Transitions to Assisted Living or Skilled Nursing

Inquiry — What is the accounting treatment when the lease for an independent living unit is terminated, for example, when a resident makes a permanent move to an assisted living or skilled nursing facility as specified in the terms of their resident agreement?

Reply — If the CCRC concluded at contract inception that a resident agreement included a lease for an independent living unit and the resident subsequently transitions to an assisted living unit or skilled nursing bed, the CCRC must reassess whether the arrangement still is or contains a lease.

If the CCRC concludes that the resident no longer controls the use of the identified independent living unit, which includes both the right to receive substantially all the economic benefits from use of the asset and the right to direct its use, and the contract does not contain a lease for an assisted living or skilled nursing unit, a lease would no longer exist. The CCRC accounts for the termination of the lease and recognizes revenue received under the remaining term of the resident agreement using the guidance in other GAAP (for example, FASB ASC 606). Similarly, if the resident is no longer residing at the facility, then the CCRC would consider the contract terminated.

If the arrangement contains a lease for an assisted living or skilled nursing unit, the lessor would consider whether the changes in facts and circumstances constitute a modification. If so, the modification guidance in paragraphs 8–10 of FASB ASC 842-10-25 should be applied.

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