The Financial Advisor's Roadmap for Evaluating a Continuing Care Retirement Community

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In the past 14 years of my career, directing the financials for a family of not-for-profit Continuing Care Retirement Communities (CCRC), I have learned a great deal. As an accounting professional, with a background in for-profit manufacturing, I had to learn the ins and outs of a new financial structure.

What I have learned, and have been able to share with hundreds of residents and their financial advisors, is that though accounting principles don't change all that often, it does take some time, and some inside knowledge, to understand how to assess the financial strength of a CCRC. Even experienced financial advisors can be stumped when reviewing a CCRC's balance sheet and income statement.

The purpose of this white paper is to share what I have learned with others so that it is easier to analyze different communities' financial strength effectively for your clients.

The challenge is that there are approximately 1,900 Continuing Care Retirement Communities in the United States. Each community has a slightly different definition of services, many have different contract types and all have different costs. On top of that, there are different state regulations that govern the level and type of service provided. It's worth noting that more than 80% of these communities are non-profit.

Yet, a financial advisor's role is to help put the decision in a framework for your client, so there can be an "apples to apples" comparison. Additionally, you will want to ensure that this organization, which will consume a portion of your client's assets, is financially stable, and able to weather future economic storms. This is your due diligence for your client.

Despite the fact that audited financial statements of two communities may look very different, there are key measurables you can track which should give you a solid sense of their financial strength.

What is a CCRC?

A Continuing Care Retirement Community (CCRC) is an over 62 retirement community that welcomes residents who can live independently and provides them the promise of community as well as the guarantee of providing future long-term health care needs within the community. CCRCs are insurance contracts, providing housing and nursing needs for a resident's life; not a real estate contact as is often misunderstood. Typically, CCRCs provide multiple levels of care; independent, assisted living, memory support, long term care and skilled nursing, so that a resident can be cared for during the full continuum of their life, without having to move.

What type of contract does the community offer?

There are predominantly three types of contracts in the CCRC industry:

1. **Type A (all-inclusive)** This contract provides the highest level of coverage, and consequently, typically has the highest entrance fees. In these communities, residents who at some point require a higher level of care (Assisted Living or Nursing) move into those areas without an increase in fees. Type A contract monthly services fees carry the highest insurance component. In practice, independent residents' monthly service fees can be considered a partial "pre-pay" of their possible future health care costs and are often tax deductible as a pre-paid medical expense.
2. **Type B (limited/modified)** These contracts typically provide independent residents with the ability to move to Assisted Living or Nursing at no additional cost initially, but only for a limited amount of time. If the resident requires Assisted Living or Nursing services for a longer period, the monthly service fees will increase significantly. Type B contracts have a modified insurance component in the monthly service fees.
3. **Type C (rental)** Independent residents who require access to Assisted Living and/or Nursing do not benefit from any discounts. They will pay higher monthly services fees immediately upon entering the new level of care. Typically, there is no insurance component in a Type C contract.

Does the organization charge an entrance fee, and if so, is there a provision for an entrance fee refund?

The entrance fee is defined as a one-time, up-front payment that is paid to the organization when the contract is put in force. Typically, one will see larger entrance fees with Type A contracts because the monthly service fee with a Type A contract is the same regardless of IL, AL or Nursing care.

Refundability options can range from 100% refundable to declining balance (0%), with numerous variations in between. A declining balance contract starts out at 100% refundable but reduces by a set amount (amortizes) periodically over a defined period, typically, within 48 months. At the end of the defined time, no refund is owed.

When evaluating the refund provision, you should also understand its terms and conditions. What conditions need to be met for the refund to be paid? Is there a time limit? Is the refund amount limited by the re-sale proceeds of the unit to the next resident? What is the average length of time for a unit to be resold for an entrance fee to be triggered?

Why is the entrance fee refund amount important?

The entrance fee refund is a key differentiator in many contracts. The terms of the contract are often dictated by the amount of refund, and one community will sometimes offer as many as four different contracts, based on refundability. Many seniors look at this as a component to their overall estate planning, as they see the higher refundability options as a way to preserve their assets.

Entrance fee refund provisions also impact the accounting treatment of a CCRC's audited financial statements, which adds complexity when evaluating organizations.

Understanding the audited financial statements.

CCRC financial statements can be daunting upon first blush. However, there are certain key areas to concentrate on that will help you digest the information. The two major schedules include Statement of Financial Position (also referred to as the Balance Sheet) and Statement of Operations and Changes in Net Assets (the Income Statement). **Cash Margin, Net Operating Margin** and **Cash to Debt** are three metrics to investigate further.

Revenues and Expenses are reflected on the Income Statement. Pay close attention to the "cash-driven" line items such as Resident Service Fees, Health Center Fees, Investment Income and Operating Expenses (excluding Depreciation and Amortization).

Earned Entrance Fees Revenue is a non-cash, accounting adjustment that reflects how much of the entrance fee liability the organization can recognize as income. As discussed earlier, the type of contract and the refundability amount will have an impact on how much money can be "earned". Keep in mind that even if this revenue is earned, there is no incremental cash coming in annually to the organization from an existing resident, other than the monthly service fee. That resident paid a one-time entrance fee upon move-in.

Similarly, Depreciation and Amortization are non-cash expenses that reflect the annual costs of an initial one-time cash outlay.

When evaluating a CCRC's income statement, one should calculate the **Cash Margin** from operations of the organization. Simply take the Income from Operations figure, subtract the non-cash revenue items (Earned Entrance Fees) and add back the non-cash expenses (Depreciation and Amortization). A positive cash margin reflects the organization's ability to cover its cash operating expenses with ongoing cash revenues. Taking this one step further, you can evaluate total cash margin of the organization by including the cash items listed in the Non-Operating Gains and Losses section. Items in this section may not always be as repeatable as ongoing operations items but still are important to evaluate. By focusing on cash margin, you can eliminate the differences in earned entrance fee revenue caused by different contract types/ refundability options.

An important income statement ratio that can be easily calculated is called the **Net Operating Margin (NOM)**. NOM measures the core, sustainable business of an organization and focuses on cash revenues and cash expenses related to resident services. Investment earnings, interest expense and non-cash items are excluded. It can be calculated as follows (remember to exclude non-cash items):

(Resident Serv. & HC Fees + Other Operating Rev.) – (Cash Operating Expenses - Interest Expense)
(Resident Service & HC Fees + Other Operating Revenue)

NOM results will vary by contract type. The national medians for single site, accredited CCRCs range, over the past five years has been 4.7% - 6.9%.

On the Balance Sheet, important measures to focus on include the unrestricted cash and investments that a CCRC holds and how they relate to the amount of debt outstanding. The ratio between the two, **Cash to Debt Ratio**, is a common measure of an organization's capital structure. Higher is better on this ratio as it reflects the ability to withstand annual fluctuations in cash. Lenders usually require at least a 50% cash to debt ratio.

At the end of the balance sheet you will find **Net Assets (Deficiency)**, which is simply the difference between the organization's assets and liabilities. You should note that since a non-profit CCRC has no shareholders, there is no Owners Equity.

In accordance with Generally Accepted Accounting Principles (GAAP) standards, CCRCs with high refundable contracts (e.g., 90%) that don't limit the refund to the proceeds of the next entrance fee received, must account for the refundable portion as a liability on the

balance sheet. It cannot be considered deferred income "earned" to income statement over time. Therefore, an organization with primarily 90% refundability contracts, will have higher refund liabilities, less earned entrance fee revenue and less net assets, when compared to an organization with primarily declining balance refundability (0%) contracts, all else being equal. However, for the resident there will be a higher refund at the end of the contract.

Since the refunds of entrance fees are typically contingent upon reoccupancy, they are in a sense a permanent source of capital for the organization.

The Cash Flow statement is the third schedule you will find in the audited financials package. It details the "ins" and "outs" of the cash accounts. One area to pay attention to on this schedule is Purchases of Property and Equipment, found in the Investing Activities section. You will want to make sure that the organization is re-investing in its infrastructure, not only for the benefit of its current residents but also for future residents. Occupancy is the "life blood" of a CCRC and having an up to date campus is an important driver to staying full.

After the main financial schedules you will find the footnotes section. There is usually a wealth of knowledge here and it is highly recommended that you spend time reviewing these notes.

Other ways to evaluate the financial position of a CCRC

As noted above, occupancy is critical to a CCRC. The majority of the costs are relatively fixed once a CCRC is operational, so higher occupancy means less cost per resident, all else being equal. Ask the CCRC for its **historical and current occupancy** figures as well as future projections. The industry considers 95% independent living occupancy as full since there are usually some units that are being refurbished for new residents.

In addition to the NOM and Cash to Debt measures, there are other financial ratios that can assist you in comparing different CCRCs. Debt Service Coverage Ratio and Days Cash on Hand are two common ones. Financial ratios allow you to compare different CCRCs on an "apples to apples basis". A well-run CCRC should be more than willing to provide you with a summary of their financial ratios and describe the key drivers to the results.

CCRCs normally engage actuaries to conduct studies on a periodic basis. One calculation, the Obligation to Provide Future Services (FSO), is accounting-based and has limitations. For organizations without specific refund-limiting language in their contracts, accounting standards limit the use of the refundable portion of entrance fees as a deferred revenue offset to the FSO. A Comprehensive Actuarial Study is a more robust analysis that utilizes actuarial principles. This study projects all future cash revenues and expenses needed to

deliver promised services to all of the community's residents and it reflects the long-term viability of the business from an actuary's point of view. The study provides a wealth of detailed information but if you have limited time, focus on three key items:

- **Funded Status**: indicates that the combination of net actuarial assets and the present value of projected monthly fees for the residents over their lifetimes at the community will exceed the present value of the contractual liabilities of these residents. A funded status greater than 100% reflects the CCRC's ability to meet all of its future obligations. It is desirable to be in the range of 108-110% so as to have a buffer to deal with challenging conditions that may arise in the future.
- **Actuarial Ratio**: determines the percent of future expenses that are expected to be covered by future revenues for current residents and measures the ability to deal with adverse experience. Industry averages cover a broad range, usually dependent on contract type. For Type A or Type B communities look for a ratio of 65%-85% or 80%-100%, respectively.
- **Pricing Margin**: evaluates whether or not an organization's contracts are adequately priced. Look for a 10%-15% pricing margin.

I congratulate you for taking the time to understand this innovative non-profit model, as with the baby boomers aging, this will likely be a more popular option in the next couple of decades. Taking the time to compare financial results and comprehensive actuarial studies results of various communities will be a significant help to your client in their evaluation process.