

Financial Regulation of Entrance Fee Continuing Care Retirement Communities

Abstract: In the absence of a Statutory Accounting standard regulators rely on GAAP accounting for CCRC oversight. Yet, GAAP accounting fails to recognize adequately the nature of Entrance Fee investments or common refund provisions. This paper makes the case for Statutory Accounting as a needed standard to strengthen an industry that has the promise to help resolve America's looming long term care funding crisis.

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Unlike life and annuity insurance companies, Entrance Fee Continuing Care Retirement Communities (CCRCs) do not now have a Statutory Accounting standard despite the many similarities between the long term commitments undertaken by both industries. More particularly there are clear parallels between single premium annuity obligations and Entrance Fee contractual commitments. This paper advocates the extension of insurance Statutory Accounting to continuing care contracts since those contracts have many of the same characteristics that have made Statutory Accounting desirable for life insurance. In the absence of a Statutory standard many regulators have had little choice but to rely on Generally Accepted Accounting Principles (GAAP), specifically U.S. GAAP, the set of accounting rules and requirements mandated in the United States. This paper examines the

effects of this absence of a Statutory standard and how it impacts the public interest in the financial welfare of CCRC residents.

Before we start that examination, though, we should emphasize that the Entrance Fee model of continuing care is well-suited to the needs of older people facing the contingencies of age. It allows that segment of the population to apportion their retirement savings to fund a responsible payment toward the anticipated contingent future cost of their care and sustenance. At its finest it enables people to provide for their own aging and to avoid dependency on others, either on family or on state programs for the indigent. By prepaying a large part of that cost of aging, the elderly are able to maintain their dignity and to look forward to remaining vital members of society for as long as their health permits. The stewardship of provider organizations for the consequent Entrance Fees is a high responsibility involving trust relationships comparable to the long term commitments of life insurance.

Kevin McCarty, while President of the National Association of Insurance Commissioners (NAIC), described “the fundamental tenet” of insurance regulation as “to protect policyholders by ensuring the solvency of the insurer and its ability to pay insurance claims.”¹ The corresponding standard for CCRCs would be to protect residents by ensuring the solvency of the CCRC and its ability to fulfill its contractual commitments. In recent years the NAIC has been preoccupied with the implementation of the Patient Protection and Affordable Care Act of 2010 so it’s understandable that financial and contractual regulation of CCRCs has been neglect-

¹ <http://financialservices.house.gov/uploadedfiles/hhrg-112-ba15-ba04-wstate-kmccarty-20121129.pdf>, p. 2, accessed August 20, 2013.

ed. Regulators also have a companion responsibility to foster industry growth. That requires balanced, principled regulation sufficient to generate public trust while allowing economic success.

This paper argues that the regulatory standard for CCRCs should be no less than that for annuities. The clientele at risk in CCRCs is just as vulnerable to a lack of cogent regulation as are annuity contract holders. Many are more vulnerable. Moreover, popular concerns with the possibility of financial exploitation through the Entrance Fee mechanism, which many CCRCs use as a source of free cash, may be retarding the growth of the CCRC industry. Prospective resident resistance to CCRCs has grown despite the CCRC model's clear benefits for an aging population. More effective contract and financial regulation can counter this concern and may open the benefits of CCRC living to wider popular acceptance.

CCRC regulation in many states is under the jurisdiction of the insurance departments, so it is appropriate for the NAIC to work on CCRC regulatory issues. In the hope that the NAIC will eventually turn to CCRC regulation, the National Continuing Care Residents Association (NaCCRA) has developed proposed Statutory standards most of which are derived from the corresponding NAIC model laws relating to life and annuity insurance.² Extending the NAIC's role in Statutory Accounting to the CCRC industry fits within the NAIC's traditional role.

Why is this necessary? A series of little publicized CCRC bankruptcies have left residents floundering and have highlighted the low priority given to resident interests by the CCRC industry's predominant financial structures. Residents, who

² <http://tinyurl.com/ModelLaws> accessed February 15, 2014.

often invest the bulk of their lifetime savings in Entrance Fees, are typically relegated to the category of general creditors in the event of a bankruptcy.

The lack of a Statutory standard has led many regulators to rely on GAAP accounting, but as Kevin McCarty noted in his testimony before Congress, just cited, GAAP “is primarily designed to provide key information to investors of public companies and looks at ongoing-concerns.” Statutory Accounting Principles are “specifically designed to assist regulators in monitoring [] solvency [...] by using more of a winding up approach.” In GAAP circles “a winding up approach” is called “liquidation accounting” and it is invoked only when an enterprise is in imminent danger of liquidation.

For regulators, though, modified liquidation accounting allows the early identification of troubled enterprises so that rehabilitative actions can be initiated to protect the customers, or in the case of a CCRC, the residents. The consequences for elderly CCRC residents of a financial failure can be dire. GAAP’s focus on current, going concern results differs crucially from the alternative Statutory focus on the avoidance of financial collapse. The difference is such that CCRC residents are left unnecessarily at risk.

The Actuarial Nature of CCRC Undertakings.

CCRCs, in general, and Entrance Fee CCRCs, in particular, are intrinsically actuarial. CCRCs involve lifetime commitments; they are structured to serve their residents continuously from independence through age-related dependence into a dignified end-of-life experience. Central to the CCRC concept is a commitment to meet the contingencies of aging when and as they arise. That commitment cannot be met

unless it is anticipated by the provider, and such anticipation requires actuarial modeling of the human life contingencies involved.

Logically, one would conclude that the human life contingencies inherent in continuing care contractual commitments would lead to a conclusion that CCRC financial statements require actuarial determinations to achieve matching of revenues with the commitments that the revenues fund and to ensure consistency with accounting for similar transactions in other contexts. Unfortunately, such matching and consistency is not required by CCRC GAAP accounting as set forth in Financial Accounting Standards Board Codification 954-430, which is the rule which binds American Certified Public Accountants in their practice. Presumably in the interests of simplification, the accounting rules allow the use of a life expectancy rule.³ This does not achieve the requisite matching since it assigns to the enterprise all earnings from the investment of Entrance Fees and does not reserve an appropriate share to meet the contractual performance obligations in return for which the Entrance Fees are paid. Moreover, the use of a simple life expectancy fails to recognize the variations in contractual commitments among Continuing Care Contracts,⁴ and those variations are material. Beyond these ac-

³ FASB Codification 954-430-35. Although the codification recognizes the actuarial nature of the requisite determinations to be made, there is no requirement that a qualified actuary be involved. Paragraph 35-2 reads: "With respect to nonrefundable advance fees, if a continuing care retirement community has sufficient historical experience and relevant statistical data about life expectancies, it shall consider that information when determining the remaining life of residents. A continuing care retirement community with insufficient historical experience or reliable actuarial data may use relevant data of similar communities within that area, relevant national industry statistics, or other appropriate data. Nonrefundable advance fees shall be amortized in the manner discussed in the preceding paragraph." Judgments about what is sufficient and how best to project the future "performance obligations" undertaken is within the particular expertise of qualified actuaries for which they are trained and with which they typically have substantial experience.

⁴ Contracts vary from full care inclusive contracts to contracts which include no prepaid care and are fully fee for service with all variations in between. These are material variations affecting future performance obligations and

counting oversights relating to Entrance Fees, there are also difficulties with the GAAP accounting for refund obligations which have become increasingly prevalent of late in the industry.

From the preceding it may be evident that GAAP CCRC financials, as now constituted, do not in and of themselves provide a reliable source for Entrance Fee CCRC residents, or for CCRC industry regulators, but additionally they can also be materially misleading as a guide for management. Let's detail why that is so.

Regulatory Significance of CCRCs.

There are some authorities who consider CCRC regulation to be of low importance to insurance regulators. Many states regulate CCRCs outside the jurisdiction of their insurance departments. The NAIC has so far taken little note of this industry despite the heavy involvement in the regulation of the industry by member insurance departments in a number of the more advanced states. Still, any industry that has the potential to help ease America's looming long term care challenge ought not to be dismissed as insignificant. This paper takes the position that continuing care, of which CCRCs are a subset, is of major and growing importance and that it is important that regulators take note of this industry to ensure that it can both flourish to meet the need and that it can also operate soundly to protect those who seek the industry's shelter.

Long term care is a major national challenge. This is particularly so as the demographic bulge known as the baby boomers moves through old age. The continu-

the expectancy rule makes no attempt to match revenue recognition from Entrance Fees to these deferred obligations.

ing care industry has the potential to ameliorate this challenge. CCRCs are the most fully developed manifestation of a financial and contractual undertaking which allows those approaching advanced age to make provision for their care contingencies. CCRCs combine continuing care concepts with a coordinated residential setting. The Life Extension Foundation notes that “All aging humans will develop some degree of decline in cognitive capacity as time progresses.”⁵ Making advance provision for such exigencies is a responsible act and something to be encouraged.

Continuing care contracts are contracts of adhesion issued by sophisticated parties, i.e. CCRC providers who are advised by law firms specializing in the industry, to less sophisticated individuals, who have to accept the contracts unaltered, and who may do so against the well-considered advice of their personal attorneys and financial advisors. Those who are enticed to accept such contracts may already be exhibiting signs of the inevitable cognitive decline cited above though they retain legal competency and can be bound by contracts they are induced to accept.

Thus, both the extent and potential of the continuing care industry and the need for regulatory protection among those to whom the industry caters indicates a clear and compelling imperative for regulation. Those regulations should be at least as extensive and effective as is the regulation to which the life and annuity insurance industry is subject. Life insurance regulation has developed, been tested, and proven effective over many decades harking back to the mid-19th century.

⁵ http://www.lef.org/protocols/neurological/age_related_cognitive_decline_01.htm accessed September 14, 2013.

It can provide valid precedents and insights for conscientious legislators and regulators seeking to ensure a soundly operated continuing care industry.

Desirability of Regulatory Uniformity.

The freedom of American society allows enterprises to operate readily in multiple states and many CCRC enterprises do. That positive aspect of our culture allows the rapid upward scaling of businesses that bring positive benefits to the public. Such constructive growth can be facilitated by uniformity of regulation to avoid confusion about what is required and to reduce the costs of compliance. Uniform regulation could help the continuing care industry to respond to the growing challenge presented by a rapidly expanding aging population in America. It is a conclusion of this paper that uniformity can be more wisely achieved at the state level than by Federal legislation. That conclusion may seem paradoxical so some elaboration is appropriate.

The Case for State Regulation.

Uniformity can, of course, be achieved by Federal oversight but there are risks and limitations associated with dependence on Federal legislation. The risk is that an unintended consequence of a Federal law may drive enterprises out of business. That is not an outcome that can be easily reversed, once those businesses are defunct, if the fallacy in the law is later recognized leading to its repeal. This is not the case at the state level where an enterprise driven out of one state can

continue to thrive elsewhere and can simply reenter the inhospitable state later when the local leaders recognize the adverse consequences of the law.

A second limitation of Federal legislation arises from the doctrine of sovereign immunity which holds the Federal government to a lower level of accountability than that which pertains at the state, county or municipal levels of government. State governments can be subject to Federal oversight so they are not free to operate without accountability. Of course, the officers of the Federal government are subject to the Constitution and to replacement in periodic elections or, in the case of the Supreme Court Justices, to the strictures of the Constitution. That level of accountability, though, does not ensure the same level of oversight as that which a senior governmental entity can require of one more local, e.g. Federal over state, state over county, etc. The result is that Federal enactments are not always uniformly enforced.

These considerations lead to the conclusion that state regulation following the life and annuity insurance model, with the unifying agency of the NAIC or a similar entity, is the more desirable approach to effective, uniform continuing care regulation. State initiatives can likewise be a catalyst for addressing the nation's long term care challenge in a deliberative and thoughtful way but that is beyond the scope of this paper though it is a related subject of interest.

For the life and annuity insurance industry, the NAIC has produced a fair degree of uniformity of regulation among the several states and jurisdictions of the United States. For the continuing care industry there is no such uniformity in the regulations. One of the more valuable contributions of the NAIC is the opportunity it provides for states to pool resources, especially concerning technically complex

matters, so that the quality of regulation is elevated everywhere. This cooperative effort among the states is not now available for continuing care.

To summarize, regulatory uniformity among states can help foster the growth of continuing care as a publically beneficial industry; can reassure prospective customers that promises made will be promises kept; can allow the technical analysis needed to ensure that inappropriate preconceptions don't lead to misconceived requirements; and can fund cooperative efforts to reduce the cost burdens of regulation for individual states. In addition, people who move to a new state in retirement are likely to expect the same rigor of regulation in their new state as that they were familiar with in their home state. With uniform regulation they will find what they expect.

A Simple Model to Understand Entrance Fee Accounting.

The requirement of Entrance Fees is one of the more distinctive elements of the CCRC industry. Although there are rental communities, the most common form of CCRC involves a not-for-profit provider requiring an Entrance Fee. There are ramifications concerning the details of such Entrance Fees and the nuances of when an Entrance Fee investment can be recovered, but let's start simply so that an understanding of the nature of the transaction can be more readily understood.

The simplest form of Entrance Fee contract is an annuity transaction, so that is a good place to start. This simple analogy to annuities will show how CCRC GAAP accounting is inconsistent with the GAAP principles applied to other industries. A simple life annuity is an agreement in which an advance lump sum investment entitles an investor to receive a flat (or uniformly increasing) periodic amount for

life. For instance, based solely on interest at 3% per year compounded and the 1980-93 California CCRC Mortality study, an investment of \$200,000 can fund an annuity, rounded, of \$2,500 per month for the remaining lifetime of an 85 year old female.

A CCRC, which would otherwise charge a monthly rental, could instead offer an Entrance Fee contract with an Entrance Fee of \$200,000 and a reduction in the rental otherwise required of \$2,500. This is the simplest form of Entrance Fee agreement. Perhaps a full example can make this clear. Consider a CCRC that offers pure rental contracts, requiring residents to pay a monthly rent for recurring costs with variable costs, including care expenses, paid on a fee-for-service basis. The CCRC management might decide to offer an Entrance Fee alternative as a way to raise cash, say, to invest in the property, or to compete with other Entrance Fee CCRCs.

Let's say that the rental CCRC charges \$7,000 per month for a particular living unit with the understanding that the \$7,000 rental fee will increase over time as costs increase. Now the CCRC operator might instead decide to charge an Entrance Fee, for instance, of \$200,000 for a flat, non-inflating reduction of \$2,500 in the monthly rent. Thus, there would an Entrance Fee of \$200,000 and an initial monthly fee of \$4,500 with the monthly fee subject to increases as needed. This conceptualizes how Entrance Fees work. They are an advance payment on future contractual commitments. The reasonable accounting is to recognize the income from the Entrance Fees as the deferred commitments are performed.⁶ With this

⁶ The mathematics for this simple example (in extended form for a cadre of 300 85 year old women entering a CCRC and remaining for life with those who die replaced by new 85 year old women) can be examined in an Excel

simple model, in which the Entrance Fee merely provides a fixed offset to the rental that would otherwise be needed, it's clear that the recognition of the Entrance Fee in income as earned revenue should be level over the duration of the contract, i.e. over the lifetime of the resident.

Explication of Entrance Fee Mathematics.

The above simple example may seem obvious to many readers but others may want more elaboration on the underlying mathematics. What seems intuitive to many may seem unnecessarily complex to others, while still others may dismiss it as an oversimplification having little to do with the realities of CCRC management. It's easy to dismiss as irrelevant what we don't understand.

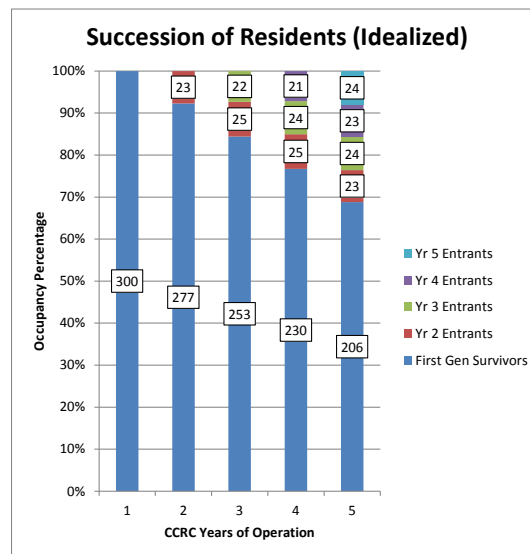
At the risk of continuing to focus on simplicity, consider a CCRC that accepts only 85 year old female residents whose health condition at entrance is such that they will follow the mortality expectations discovered in the 1980-93 California CCRC Mortality study. We'll retain our assumption that their Entrance Fees should provide an investment return toward their deferred benefits at a rate of 3% per year compounded. We'll also assume that there are 300 residents; that residents only leave at death; and that occupancy is always 100%, meaning that residents are immediately replaced when they die.

Of course, these are unrealistic and impractical assumptions, but they can make CCRC mathematics clear. While these are gross simplifications, it's evident that, if the accounting doesn't work under these idealized circumstances, it won't work

spreadsheet which can be downloaded from <http://www.naccrau.com/Library/FASB%20Submission%203-1-2012/FASB03012012.html> or from <http://tinyurl.com/FASBonCCRC>.

under the more complex realities encountered in practice. We can later add in the complicating factors of early withdrawal; sales lags; vacancy impacts; varying age, gender, health condition, and marital status; macroeconomic scenarios; etc. Actuaries are well versed in the accomplishment of these calculations.

Here’s a chart to show how this simplified model would look on a pure mortality basis before we introduce the complexities of other real world contingencies.



In this idealized model there are new entrants always available to replace those who die so that occupancy is maintained at the full hypothetical of 300 residents.

Inappropriateness of GAAP for Entrance Fee CCRCs.

GAAP is premised on the concept of an enterprise as a going concern and, only incidentally, makes provision for the prospect that some enterprises fail financially. GAAP for CCRCs is defined separately from the principles that determine accounting for other industries. Presumably in a quest for simplification, GAAP amortizes Entrance Fees into income by a standard somewhat analogous to how a capital outlay for a building is amortized into expenses arithmetically over an arbitrary period.

trary period. We refer to this standard as the “expectation approach” since it is grounded in life expectancy albeit a false understanding of the appropriate use of such expectancies. The CCRC industry is curiously singled out for special treatment.

That special treatment departs, however, from the principles which govern accounting at its finest. CCRCs serve a vulnerable clientele and so, from a resident and public interest perspective, the long-term sustainability of the trusted enterprise is of greater importance than is the mere period measurement of earnings. Hence, even if universal accounting principles were applied to CCRC GAAP, Statutory Accounting would still be desirable to give precedence to fulfillment of the long-term trust relationship involved. But the expectation approach belies CCRC GAAP even as a valid measure of period earnings. Let’s consider first what those universal accounting principles are.

The principled GAAP approach consists of the following steps: “(a) identify the contract(s) with a customer; (b) identify the separate performance obligations in the contract; (c) determine the transaction price; (d) allocate the transaction price to the separate performance obligations; and (e) recognize revenue when the entity satisfies each performance obligation.”⁷ Ironically, or perhaps not, this is the same methodology that an actuary is trained to provide, even while it is evident that CCRC GAAP departs from this principled approach, perhaps, in an effort to minimize the cost associated with the role of actuaries or equivalently qualified professionals. It should now be clear that many CCRC “performance obligations”

⁷ <http://www.fasri.net/index.php/2011/06/performance-obligations-a-new-era/> accessed April 27, 2013.

are deferred, and so contingent actuarial mathematics is essential to implementation of steps (a) through (d) as detailed above. Most accountants do not have the depth of training in making these evaluations with integrity that well-qualified actuaries do.

The expectancy approach ignores even the most basic of these steps since it doesn't "identify the separate performance obligations in the contract" and, as noted above, those "performance obligations" vary widely from one continuing care contract to the next.⁸ They may even vary over time within the term of a single contract since the provider typically retains the right to unilaterally modify the Resident Handbook, which contains many of the "performance obligations" to be modeled.

Not only does the expectancy approach ignore contract performance particulars but it also overlooks the time value of money which is an intrinsic part both of an Entrance Fee contract and of the financing of a continuing care enterprise. The result is that, in the absence of actuarial reserves, audited CCRC financials are neither meaningful for regulators nor for management nor for those residents who seek to know if their Entrance Fee investment is sound.

Consequences of Misleading Accounting.

Not only is CCRC accounting inappropriate in light of the high minded principles that have historically governed the accounting profession but the discrepancy is

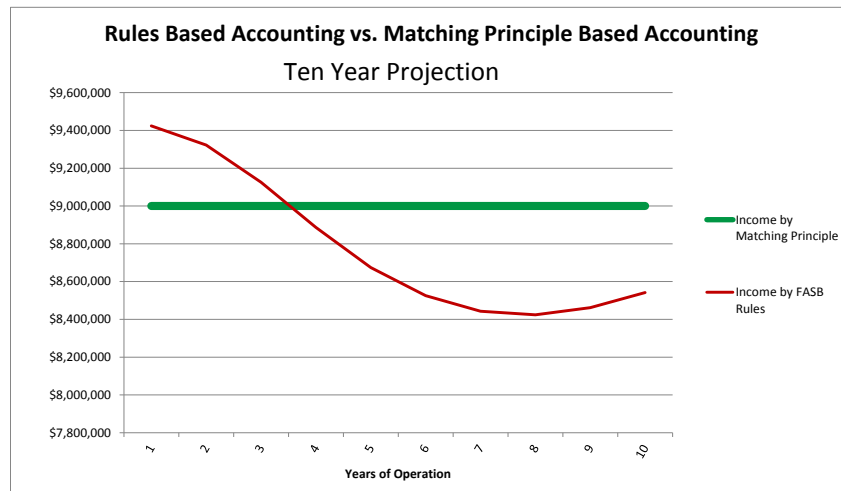
⁸ Identifying and evaluating such "performance obligations" is of the essence of actuarial modeling. Although the CCRC industry through its LeadingAge organization has identified a categorization typology for CCRC contracts, demonstrating the wide variability in the performance obligations under such contracts, the expectancy approach pays no heed to those variations and seeks a one size fits all simplified approach to revenue recognition.

misleading in a particularly odious manner. The expectancy approach overstates revenue recognition in the early years of a CCRC or in the early years of any individual continuing care contract (individual contracts are inherently in their early years during the early years of a CCRC or major addition to a CCRC). This results in a new or expanded CCRC appearing to be more profitable initially than it is in reality. This can mislead management into making financial decisions that lead to financial challenges later on. The most common result is underpricing which then leads to deficits as the costs emerge without the anticipated offsetting revenues.

The usual management response, as accounting driven deficits begin to emerge, is logically enough to drive the monthly fees upward. This creates obvious inequities between the startup generation of residents and subsequent residents, since the startup generation not only has the benefit of a newer facility but also benefits from the subsidy provided by misleading GAAP accounting. Later, after the initial rosy accounting picture, followed by a deficit period, i.e. once the artificial accounting instigated deficit is made up, the increased fees can prove redundant. This, in turn, can mislead management into believing its expertise is the cause of the resulting profits and that the managers and executives deserve bonuses and other rewards from the emerging margins. These untoward effects are highly detrimental to the welfare of the CCRC and to the residents whom the CCRC exists to serve.

An Illustration of the Financial Impacts.

Following is a comparison of a principled accounting result and the effect of the FASB rule.⁹ The principle in play here is that like transactions arising from identical economic circumstances should result in the same accounting recognition. Hence, a flat rate annuity that pays a level offset to a contracted rental should be booked as a level amount. That it is not so booked in the case of a CCRC annuity undertaking makes manifest the distortion in FASB's codification for CCRC GAAP.¹⁰



For the sake of illustrating the theoretical challenge, the graph above is without the offsetting above-need fee increases that the ostensible revenue shortfall is likely to trigger. Some industry experts have dismissed the distortion evident in

⁹ Projection of a cohort of 300 85 year old female residents with a \$2,500 a month flat Entrance Fee annuity. Deaths are replaced immediately by replacement female residents entering at age 85. Mortality: 1980-93 California CCRC, Age Last, Female; interest at 3% per annum compounded.

¹⁰ The calculation of the values in the graph can be download in the Excel spreadsheet located at <http://www.naccrau.com/Library/FASB%20Submission%203-1-2012/FASB03012012.html> as accessed on May 7, 2013. The explanation for the accounting fallacy, i.e. GAAP's advancing of revenue recognition to earlier years instead of the evident flat revenue recognition required by matching, lies in the treatment of investment earnings (or debt costs foregone) resulting from the use of the Entrance Fees. CCRC GAAP credits investment earnings to the enterprise as recognized revenue instead of retaining a proportionate share for the benefit of the residents who have prepaid deferred costs. Proper actuarial analysis holds a commensurate share of those investment earnings in reserve (and thus out of income) to help meet the cost of the deferred obligations. Today's GAAP errs in going too far to simplify what is in truth an actuarial calculation comparable to the actuarial reserves that insurance companies hold.

the graph above as immaterial relative to the overall revenues of an enterprise. The argument is that the distortion is only 4% to 6% of a truer measure so they reason that the expectancy simplification of a more complex actuarial calculation is justified as within the bounds of reasonable materiality. Materiality is an accounting principle. "...the concept of materiality allows you to violate another accounting principle if the amount is so small that the reader of the financial statements will not be misled."¹¹

Fee increases are of major importance for CCRC managers and residents. Increases are adjustments, generally annual, to the recurring and other fees that residents or participants pay for continuing care benefits. Such increases are intended to offset changes in otherwise unpredictable economic effects that result in changed performance costs. Increases are typically in the range of 2% to 6%, so clearly a distortion of 4% to 6% is material for any accounting data which are used as a guide to management in the determination of needed fee increases.

The Need for Actuarial Recognition of Performance Obligations.

The departure of CCRC GAAP accounting from the matching and consistency principles reveals the need for actuarial determinations of all Entrance Fee arrangements regardless of whether contracts are full-care-inclusive, fee-for-service, or anything in between.¹² The life annuity example illustrated here, i.e. an Entrance Fee that just results in a flat amount deduction from the monthly fee that would be needed in the absence of an Entrance Fee, is about as simple as an Entrance

¹¹ <http://www.accountingcoach.com/blog/what-is-materiality> accessed February 15, 2014.

¹² There is no standard CCRC contract, only a taxonomy (See <http://www.leadingage.org/Article.aspx?id=205> accessed May 11, 2013).

Fee concept can be and, yet, even this simple example shows the inherently actuarial nature of a lump sum payment in exchange for a contract with lifetime commitments. The answer is for the CCRC to hold actuarial reserves and to recognize revenue as the reserves for deferred performance obligations are released as fulfilled.¹³

Although the actuarial nature of Entrance Fee contracts is obvious, the actuarial imperative has not resonated either with the accounting profession or with many in the industry. The implications go beyond mere financial issues to staffing and fulfillment questions. Not only do costs escalate with inflation and other forces, but the probabilities that residents will need assistance services also increase exponentially with age. Managerial anticipation of these needs calls for actuarial modeling and evaluation. In such a context the misleading simplicity of the life expectancy approach is a distraction.

The Challenge of CCRC Refund Accounting.

Although questions related to refund obligations are also inherently actuarial in nature, and while today's accounting for such obligations brings into question common law prohibitions on perpetuities,¹⁴ we are not dealing with that in this paper. Suffice it to say that the recent accounting pronouncements relating to such refund contracts are particularly disturbing in demonstrating that the Financial Accounting Standards Board has recognized the difficulty with a partial re-

¹³ See for instance, United States Government Accountability Office, *"Continuing Care Retirement Communities Can Provide Benefits, but Not Without Some Risk,"* June 2010 (<http://www.gao.gov/new.items/d10611.pdf> accessed February 16, 2014, p. 13.

¹⁴ There is a good discussion of perpetuity law in the United States at http://www.actec.org/public/documents/studies/zaritsky_rap_survey_03_2012.pdf accessed February 16, 2014.

sponse¹⁵ but has not fully addressed it. This partial response may reflect political considerations more than principle and more than the merits of the matter. Although the refund obligations are built into the contracts, the accountants have adjudged that they are not “performance obligations”, in the sense in which that term is used in accounting parlance.¹⁶

“...instead, the CCRC is effectively facilitating the transfer of cash between the successor resident and the prior resident. If a restriction on the amount of the refund is explicitly stated in the contract and it is the entity's policy or practice to enforce the restriction, ... [accounting practices and principles] permit the refundable entrance fee paid by the unit's initial resident to be deferred and amortized into income over the life of the facility (reflecting that it is in essence capital financing).”¹⁷

This means that moneys subject to refund may have been amortized into income and, thus, not available to meet the refund obligation when it comes due (absent

¹⁵ http://www.naic.org/documents/committees_e_app_sapwg_2012_fall_nm_agenda.pdf?1 accessed February 16, 2014.

¹⁶ The term “performance obligations” is not generally defined though it is widely used in accounting pronouncements (see for instance <http://www.fasri.net/index.php/2011/06/performance-obligations-a-new-era/> accessed December 28, 2013) though an article in the Journal of Accountancy includes the following:

“According to the [FASB and the International Accounting Standards Board (IASB) revenue recognition] proposal, a performance obligation is a promise in a contract with a customer to transfer a good or service to the customer. The proposal specifies that, if an entity promises to transfer more than one good or service, the entity would account for each promised good or service as a separate performance obligation “only if it is distinct.” Indistinct goods or services could be combined with other promised goods or services until the entity identifies a distinct bundle of goods or services, which could result in an entity’s accounting for all the goods or services promised in a contract as a single performance obligation.”

(<http://www.journalofaccountancy.com/issues/2012/jan/20114806.htm> accessed December 28, 2013).

¹⁷ FASB 2011-230, Comment Letter No. 68, p. 5.

the successor resident constraint), so honoring such an obligation promptly, as a contracting resident might expect, can place the CCRC under financial strain. This is a clearly a problem. Life insurance companies are required to pay cash values promptly after the contract is terminated. Banks are required to honor withdrawals in a timely manner, often immediately upon demand. But no such requirement is now applied to CCRCs. Life insurance companies and banks are able to anticipate their liquidity needs and CCRC enterprises can also.

The Insolvency Caper.

Many CCRCs have what CCRC GAAP accounting euphemistically labels as a Negative Net Asset position.¹⁸ Although this means that GAAP liabilities are greater than GAAP assets, it is not immediately taken as a sign of insolvency. This suggests that the logical conclusions that a user of CCRC GAAP financials might draw from the document are not meaningful, which calls into question the value of the GAAP financials as a management or evaluative tool.

As one expert preparer of GAAP audits puts it, “The reader of the financial statements” is encouraged to look optimistically at the possibility that the entity may have sufficient cash flow to meet its obligations since the test of solvency is “over the life of the facility.”¹⁹ Since the refund obligation is indefinitely deferred due to the premise of a perpetual organization, we can conclude that CCRC GAAP contends that the facility’s life has no end.

¹⁸ See for instance <http://www.guidestar.org/FinDocuments/2012/521/281/2012-521281156-08faefe6-9.pdf> or <http://www.guidestar.org/FinDocuments/2012/860/335/2012-860335417-099e8eab-9.pdf> accessed February 15, 2014.

¹⁹ <http://info.blumshapiro.com/acton/attachment/2392/f-015d/1/-/-/-/file.pdf> accessed February 15, 2014.

Our expert commentator continues to justify this departure from the standard of integrity that residents might expect to find in the financials since, “this [assets insufficient to fund liabilities] results when there is a minimal amount of equity invested in the entity but, instead, the capitalization is ‘financed’ mainly through either debt or entrance fees received.”²⁰ In other words the management which exercises the ownership interest has no skin in the game. There is no essential at-risk equity capital other than the Entrance Fees received. Entrance Fees are often the primary source of invested equity capital even while the residents are denied ownership.

Moreover, the residents have but scant standing to petition to put the CCRC into bankruptcy reorganization. That standing falls to the CCRC managers, or to the debt holders, and their interests are senior to the residents’ Entrance Fee investments so they are unlikely to act until the cash to meet the debt obligations dries up or unless some element of the bond covenants such as vacancy levels is triggered. Consideration of the residents’ interests – funded by the huge cash inflows from substantial Entrance Fee requirements – is purely secondary. Primary are the interests of the debt holders in receiving interest and principal payments on time and the interests of the executives in remaining in management control of the organization that employs them. There is a regulatory interest to ensure that these controlling elements are carefully balanced with the consumer’s reasonable expectation that contractual obligations undertaken will be equitably fulfilled. As Commissioner Mr. McCarty of Florida noted in his statement cited above regulators have a primary responsibility to ensure the solvency of a critical,

²⁰ Ibid., p. 4.

trusted enterprise on which consumers are expected to rely over a long period of years.²¹

The History of Today's CCRC Financial Preconceptions.

At this point the reader may be wondering, how did this flawed and misleading accounting come to be so widely accepted? The answer is an historical one and it requires a bit of historical sleuthing. It's easy to lose sight of how young the CCRC industry is. Before 1972 the nonprofit senior housing industry was strictly charitable with the term "charitable" used in section 501(c)(3) of the Code in its generally accepted legal sense. "Such term includes the relief of the poor and distressed or of the underprivileged."²² Exemption from income tax depended "upon whether an organization relieves the financial distress of aged persons by providing care and housing for them on a gratuitous, or below cost, basis."

In 1972 Revenue Ruling 72-124, cited in the preceding footnote, extended the meaning of "charitable" with the following major change: "Thus, an organization, otherwise qualified for charitable status under section 501(c)(3) of the Code, which devotes its resources to the operation of a home for the aged will qualify for charitable status for purposes of Federal tax law if it operates in a manner designed to satisfy the three primary needs of aged persons. These are the need for housing, the need for health care, and the need for financial security."

This ruling made it possible for an organization to claim tax exempt status if it provided market based, or even luxury, housing for the elderly with no require-

²¹ See Page 2 above.

²² <http://www.irs.gov/pub/irs-tege/rr72-124.pdf> accessed April 21, 2013.

ment that the enterprise offer “below cost” housing to anyone. Not-for-profit managers, who had previously been restricted to relieving the housing needs of indigent elderly people, now had the opportunity to expand their businesses to offer market priced housing which could support market compensation for executives and comfortable housing for upper middle class Americans.

Thus it was that “In the very early 1970s, a group of Quakers in the Brandywine and Delaware Valleys of southeastern Pennsylvania worried about the lack of good options for living in retirement years.”²³ They then obtained a \$300,000 grant from the Philadelphia Yearly Meeting of the Religious Society of Friends to start what today is known as Kendal Corporation, one of the most reputable CCRC organizations. They needed financial advice on how to structure the continuing care contracts financially and for that purpose they turned to David L. Hewitt, a graduate of Swarthmore College, who served as a pension actuary for Huggins and Company in Philadelphia.

Mr. Hewitt qualified as an actuary by experience. Based on his work with Kendal Corporation Mr. Hewitt published a paper in the *1981-82 Proceedings of the Conference of Actuaries in Public Practice*, and titled “Actuarial Amortization of Entry Fees for Life Care Communities.”²⁴ It is that paper which was adopted by Kendal Corporation initially as the basis for its accounting and that, subsequently, became the basis for what is today the AICPA guidance and the FASB codification. As an interesting aside Mr. Hewitt lives today in a Kendal community.

²³ <http://www.kendal.org/documents/KendalAnnualReport2006.pdf> accessed April 21, 2013.

²⁴ Paper appeared at pp. 506 to 523 of the cited journal and a copy is available on request from the author.

A reading from the actual process as proposed by Mr. Hewitt in the paper cited shows a process similar to the simplified methodology that the AICPA adopted,²⁵ and that FASB has endorsed. The primary difference is that Mr. Hewitt's methodology, in striving for integrity, includes complexities which the accounting standard eliminated.

Difficulties with this methodology were noted at the time by Alwyn V. Powell, Associate of the Society of Actuaries, and by Conrad Siegel, Fellow of the Society of Actuaries. Mr. Hewitt acknowledged this input at the time by writing, "A comment sent to me by Alwyn V. Powell says, 'I would be interested in understanding how you would modify this approach to accommodate the case in which a community . . . considers a portion of the entry fee as a prepayment of some future expenses which would imply increasing earnings per life.' Also, Conrad M. Siegel has expressed to me his discomfort that provision for interest credit is omitted from the amortization procedure discussed in this paper; he questions the argument at the end of Section IV."

Mr. Hewitt responded to these comments by considering modifications to his process. Despite these cautions, as the methodology was adopted by the AICPA as the accounting standard for CCRCs, the nuances were simplified rather than refined. The accounting process was never brought into line with the requirements for integrity. The accounting simplification made no allowance for the recognition of the multiplicity of contractual commitments. In other words, accounting prac-

²⁵ Op. cit., p. 514.

tice has favored simplicity and has ignored or overlooked the unfortunately misleading front ended earnings cited earlier in this paper.

Mr. Hewitt is a mathematician of considerable integrity, and his early involvement was evidently to try to work within the preconceptions of the accountants, as is signaled by his use of the word “amortization” in the title of his paper. He was clearly a leader among actuaries in reaching out to the accounting profession during the early years of the evolution of today’s market priced CCRC. Mr. Hewitt’s growing concern with the resistance of the accountants to actuarial insights is evident, however, in two successive reports on discussions between the two professions which he presented first at the International Association of Consulting Actuaries 1990 meeting in Auckland, NZ²⁶ and then, two years later at the meeting in Vancouver, CA.²⁷ In 1990 Mr. Hewitt wrote, “The accountants are attempting to develop more realistic and informative reporting of CCRC operations. Their principle setting bodies have recently invited actuarial input to their deliberations, and we actuaries are gratified at the opportunity for cooperation.”

That hopeful tone had changed by 1992 when Mr. Hewitt titled his report, “Continuing Care Retirement Communities Encounter Actuarial Progress, but Stiffened Tensions among Professions.” He then wrote as follows of the sorry state of mutual respect between the actuarial and accounting professions:

²⁶ http://www.actuaries.org/IACA/Colloquia/Auckland/Vol_2/Hewitt.pdf accessed April 22, 2013 (Meeting dates: February 18 – 23, 1990).

²⁷ http://www.actuaries.org/IACA/Colloquia/Vancouver/Vol_2/Hewitt.pdf accessed April 22, 2013 (Meeting dates: May 24 – 28, 1992).

“Accountants frequently accept the findings of other professions in matters requiring outside expertise. They thus recognize the place of actuaries in insurance and in retirement plans. But in SOP 90-8 they prescribe their own answers to problems that remain actuarial. The accountants still need our help to reach the goal of correct financial measurement and reporting for CCRCs. We should work together to solve mutual problems.

“We actuaries have been striving for improved methods of analysis; the accountants have been engaged in a similar effort, but took formal action before they were ready, affecting most CCRCs. Together, we need to construct a combined measurement system from which the two professions can extract harmonious answers.

“Meanwhile, CCRCs needing favorable audit reports, and also desiring to follow actuarial principles, must maintain separate records for each purpose. This creates confusion for the providers and the public.

“The state insurance commissioners who regulate CCRCs are attempting to make use of the advice of actuaries and accountants in developing their own specifications for financial reporting. They would like a single, unambiguous, generally accepted formula, to test the fiscal soundness of a CCRC.”

This sad circumstance of inter-professional dysfunction has persisted till today to the detriment of CCRC residents, managers, and regulators.

Review of the Existing Literature.

The adverse effects of this flawed accounting standard are evident in the discussion above. The literature on these matters is scant but it is authoritative. These misleading effects have been known and well-documented for over thirty years,²⁸ yet they have gone largely unheeded. Most of the existing literature has been cited in the course of this paper.

The reasons for the lack of judicious financial management, responsive to the evident issues raised in the literature, may lie in professional preconceptions or simple hubris. The consequence, though, is that GAAP is not a sufficient standard for CCRC regulation. There is a need for a Statutory Accounting Standard comparable to that for life insurance or at least to that required, in a rudimentary form, for the charitable gift annuities that many CCRC operators market to their residents.

Consequences.

Might a change to a stronger, public-interest regulatory standard for CCRCs result in a proliferation of identifiable impairments that are now hidden from public awareness? Perhaps. But, if so, the implicated CCRCs are already insolvent, or trending in that direction, based on the true underlying economics of the enterprises in question. In that case the public needs and deserves a program of rehabilitation. It can be done. Denial and concealment are not a valid forms of effective regulation.

²⁸ Ian A. Morrison, et al., *Continuing Care Retirement Communities: Political, Social, and Financial Issues*, (New York, 1986), p. 59 and Howard E. Winklevoss and Alwyn V. Powell, *Continuing Care Retirement Communities: An Empirical, Financial, and Legal Analysis*, (Homewood, IL, 1984), p. 197 et seq.

Conclusions.

For regulators and legislators, simply relying on GAAP audited CCRC financials as a standard for sound CCRC operation is insufficient to protect the public. There is a need for the NAIC to adapt the Statutory Accounting Standards for insurance to the analogous operations of CCRCs. An effort to elevate the regulatory standards for the CCRC industry to the higher level that has governed life and annuity insurers will provide vulnerable seniors with the protection that they need. Only then will regulators be able to give the public the assurance needed so that prospective residents can contemplate with confidence an Entrance Fee investment in continuing care.