The Actuarial Approach to CCRC Finance

Most Continuing Care Retirement Communities (CCRCs) today rely primarily on Accounting Standards Codifications as the basis for their financial management. This accounting reliance contrasts with the intrinsically actuarial nature of the assurances that CCRCs give to their residents. Although accountants rely on engineers for assessments of physical assets, they have been reluctant to rely on actuaries for CCRCs. The result is that CCRCs are not as financially sound as they might be. CCRC accounting statements are not as reliable an indicator of the ability of CCRC to provide the services on which residents rely as prospective residents are led to believe.

Accounting and actuarial practice differ in their philosophical underpinnings. Accountants are concerned with recording transactions and reporting the financial status of an enterprise and how it is faring as a going concern from period to period. Actuaries are concerned with the fulfillment of promises made to those served by an enterprise and equity in the financial value provided to cohorts among those benefitted.

The actuarial perspective has value from the time that a CCRC project is first conceived in the imagination of a dreamer. The dreamer is apt to be motivated by a perspective that there is a need for services to the elderly in a particular market area. The dreamer’s focus is on those to be served. This is an actuarial conception of the project. The founder is thinking of the people and how best to sustain them in dignity as they age.

The response may be to envision a community in which aging people can live together in mutual support and conviviality. In short, our dreaming founder is likely to envision what we know as a CCRC – a self-supporting community allowing people to flourish with peace of mind as they age, knowing that when the time comes that they need supportive services or care, those services will be there for them and that the transitions will be as seamless and stress free as is humanly possible.

It may happen that the founder, or a group of founders, is able to make available a site for a CCRC and to start the process to build the structures optimally suited to the intended purpose. That initial donation or the collective donation of a church or cluster of churches or other donors is the impetus that often gets a nonprofit CCRC project underway.

This is the point at which the actuarial and the accounting approaches often diverge. The actuarial approach stays focused on the future residents that the CCRC is intended to serve. Actuaries recognize the need for accounting and its value, but accountants often imagine that they have the financial skills needed to guide the project without actuarial input. They may not consider the actuarial perspective to be legitimate. Accounting trained CCRC Chief Financial
Officers (CFOs) have been known to remark that an actuarial study is not of much value and nonprofit boards, eager to save unneeded expense, may forego actuarial input.

The accounting focus is on the soundness of the enterprise as a whole and that is similar to the interests of the executives and the board. Actuaries share those concerns but they are also concerned for the fulfillment of the promises made to the residents; the equity of financial value provided to the various cohorts of residents; and for pricing adequacy to provide the promised benefits to the residents.

These are matters primarily of interest to residents. The executives and the board may also be concerned if they are seeking to fulfill their stewardship obligations toward the residents. They can also become interested if mistrust of the CCRC governance begins to impact resident perceptions and market acceptance. Actuarial practice allows a full understanding of the commitments made to residents.

Accounting involves many simplifications that depart from the underlying substance of what is reported. Accounting is largely determined by a set of rules developed by the Financial Accounting Standards Board (FASB) and promulgated as Accounting Standards Codifications (ASC). Although there is some correlation of the ASCs with value measurement, the resulting rules can be problematic which then calls into question the integrity of financial statements that accord with the rules. We need only think of the Enron debacle to realize the consequences.

This is difficult for nonfinancial people to understand. The prevailing perception is that accounting is principled. The term Generally Accepted Accounting Principles (GAAP) is used to describe the complex of rules comprised in the ASCs. So, some examples may help readers to understand how accounting can impact the residents of a CCRC. For instance, a car may be depreciated into expense on a straight-line amortization schedule even though it’s evident that the car has a major drop in value the moment it is driven off the car dealer’s lot. For such an asset even the double declining balance method is likely to overstate the value.

Recently, accounting has required that many transactions be “marked to market” on the premise that the market is the best determinant of value. Yet, we all know that the market is variable and even an efficient market is shaped from day to day by the inclinations of those few making trades. In a time of economic turmoil and market panic, market value is likely to understate the true value. For an asset that is to be held for use in an economic enterprise it is questionable that market value is ever in truth the best valuation for that asset.

Actuaries are mathematically trained to take into account as best as is humanly possible all foreseeable events that might impact an economic enterprise. For a CCRC this means that actuaries start by forecasting the current value of the future commitments made to the current
residents less the current value of the future fees expected from them. This then defines the assets that a CCRC would have to have on hand to be able to fulfill the promises that have been made to the residents.

The assets may consist in large part of the CCRC buildings but that is independent from the promises made, other than the rental-type commitment providing that a residency contract entitles a resident to occupy a particular residence. If the assets are less than the actuarially determined valuation, then the CCRC is impaired and a plan to correct the impairment is needed.

Debt may be incurred to facilitate the construction of the CCRC and the debt costs may be covered by the future fees modeled by the actuary or entrance fees may be used to reduce the construction debt burden, but these operating decisions do not alter the valuation of the commitments that the actuary has modeled. Actuaries anticipate that liquidity needs will be covered as they arise either from the management of cash flows or from a line of credit.

How does this contrast with how accountants look at a CCRC? Accountants think in terms of the enterprise so they look at the facility and the related operations. They view the residents primarily as a revenue source and accountants have sought to have a simplified way to recognize revenue similar to the simplification that straight-line depreciation represents in other contexts. For CCRCs this has resulted in a rule that entrance fees be amortized into revenue over the remaining life expectancies of the residents. At first this seems plausible just as depreciating a building over fifty years has the ring of plausibility though we know that many buildings are usable for more than fifty years. Fifty years is no more than an arbitrary, judgmental standard.

The problem with the CCRC example, though, is that residents have a right to expect that they will receive a benefit from their payment of a lump sum entrance fee that is greater than what they would have received if they had just paid the same amount in installments over their life expectancy. The difference now becomes clear; the accounting approach ignores the interest earnings on the entrance fee. The CCRC gets the benefit of those earnings either by investing them or by foregoing interest that would otherwise have to be paid on debt. This distorts the earnings picture for the CCRC and makes it appear more profitable in the early years with shortfalls that have to be made up later, often by fee increases above what would otherwise be required.

Consider pricing. Here the story is a little different. Many CCRCs use market pricing. That may mean that they retain a marketing consultant to survey the local market and advise them on pricing for entrance and recurring fees or the CCRC sales staff may work with the CFO to set the
pricing. The expectation is that competitive CCRCs are charging enough to cover costs so a competitively determined price is an adequate price.

How does this compare with pricing in other contexts? For a product to be sold to the public, the purveyor is likely to start with determining what price could compete in the market. So far, the methods are the same. But then the purveyor of a conventional product has to consider whether she or he can manufacture that product and still make a profit at the market price.

Generally, engineers are consulted to determine the manufacturing cost so that the margin can be discerned. Actuaries are the engineers for the CCRC product. Hence, there can be no assurance that CCRC pricing is adequate or justified unless it is confirmed by an actuarial analysis.

A well-managed CCRC will have actuaries intimately involved in its conceptualization, origination, pricing, contract drafting, and financial structure.

-- Jack Cumming, Fellow of the Society of Actuaries