

# Learning About CCRC Solvency

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Is your CCRC financially solvent? How is solvency defined? CCRC stakeholders may have varying opinions as to what solvency means. For CCRC residents, solvency may mean that cash inflows exceed cash outflows, with a minimal amount of cash on the balance sheet. Residents generally view large cash balances as an indicator that their fees should not be increased. They often do not realize the extensive liabilities that a CCRC may have under the resident contracts, which require significant cash and investments.

CCRC regulators and financial investors may define solvency as the ability to repay debt or pay expenses for a limited period of time. These parties generally rely on financial ratios such as the debt service coverage ratio and the days cash on hand ratio as indicators of solvency. But these ratios do not provide for consideration of future liabilities that a CCRC may have under the resident contracts.

CCRC management and Board Members should have the best understanding of how to evaluate the solvency of their CCRC. They should recognize that the cash and reserve needs of their community can be quantified based on the future liabilities associated with their resident contracts, and that the ability to fund these cash and reserve requirements is the true measure of solvency.

The general definition of solvency is to have assets that exceed liabilities, or positive net assets on your Statement of Financial Position. But what if an organization does not reflect all of its liabilities on the Statement of Financial Position? Such as a CCRC with entrance fees refundable upon unit re-occupancy? Or a CCRC that provides care at rates less than costs as a part of a contractual arrangement with residents? Or a CCRC that provides care at rates less than costs if residents exhaust their financial resources? Or a CCRC with significant deferred maintenance issues?

It is inappropriate to focus on the “bottom line” on a CCRC Statement of Activities to determine whether a CCRC is capable of meeting its financial obligations. A significant portion of the revenue recorded on this statement is non-cash revenue in the form of entrance fee amortization. Furthermore, the accounting definition of the future service obligation results in a Statement of Financial Position that may not indicate solvency either. Most CCRCs do not record a liability for future services because their deferred revenue exceeds the net cost of care as defined by SOP 90-8. But the net cost of care excludes certain ongoing costs of operation, so it is a liquidation liability rather than an ongoing operational liability. In addition, a deferred revenue balance does not indicate that reserves are available to fund the net cost of care.

There is a standard to measure CCRC solvency that is consistent, comprehensive, and automatically adjusts for variations in CCRC contract types, unit configuration, age of facility, and so forth. This

standard was developed by the American Academy of Actuaries’ Committee on CCRCs, and has a 20-year history of practical and meaningful use. It was adopted by the Actuarial Standards Board in 1994 and is known as “Actuarial Standard of Practice No. 3, Practices Relating to Continuing Care Retirement Communities.” This standard sets forth a methodology for assessing the financial condition of a CCRC. An actuarial study that follows these standards provides the best answer to the question, “Is your CCRC financially solvent?”

The actuarial standard for satisfactory actuarial balance defines three criteria to be tested.

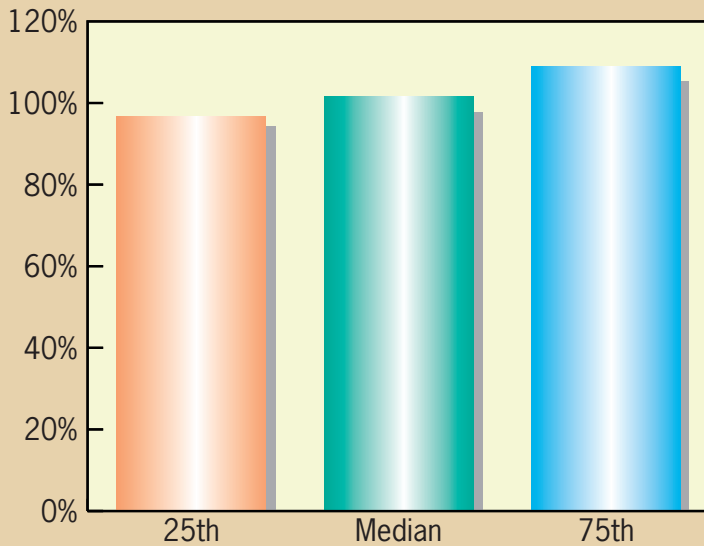
- Condition 1 - the funded status is greater than 100%
- Condition 2 - the new entrant surplus is greater than 0%, and
- Condition 3 - the projected cash balances are never less than \$0 and typically are increasing.

**Condition 1** relates to the actuarial balance sheet, or actuarial valuation. In this calculation, actuarial assets are compared to actuarial liabilities. Actuarial assets consist of liquid reserves, such as cash and investments, and non-liquid reserves, such as investments in fixed assets, net of debt and other accounting liabilities. Actuarial liabilities consist of refund obligations and the difference between future expenses and future revenues associated with existing residents. If a CCRC shows a funded status that exceeds 100% (the ratio of actuarial assets to actuarial liabilities), then the reserves plus future fees are adequate to cover the costs of care associated with residents of the community as of the valuation date.

**Condition 2** relates to the fee structure in effect for the contracts currently offered to new residents. This calculation is similar to that under Condition 1, in that actuarial assets are compared to actuarial liabilities. In this case, the actuarial assets are equal to the present value of the entrance fee (net of the refund liability) and the present value of the future monthly fees over a resident’s lifetime. The actuarial liabilities are equal to the present value of the operating expenses and share of capital expenses over a resident’s lifetime. If a CCRC contract shows a new entrant pricing surplus (actuarial assets for new entrants exceed actuarial liabilities), then the fee structure is adequate to cover the costs of care associated with a new resident.

**Condition 3** relates to the projected cash flow of the CCRC for a minimum of 20 years. The cash flows must show positive cash balances during the entire period, which means that sufficient cash is available to pay expenses. This calculation considers both existing residents and new entrants.

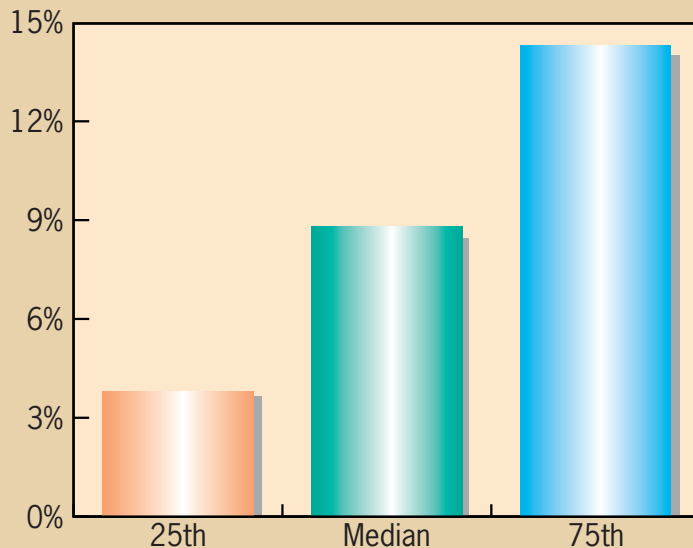
## Funded Status for CCRCs



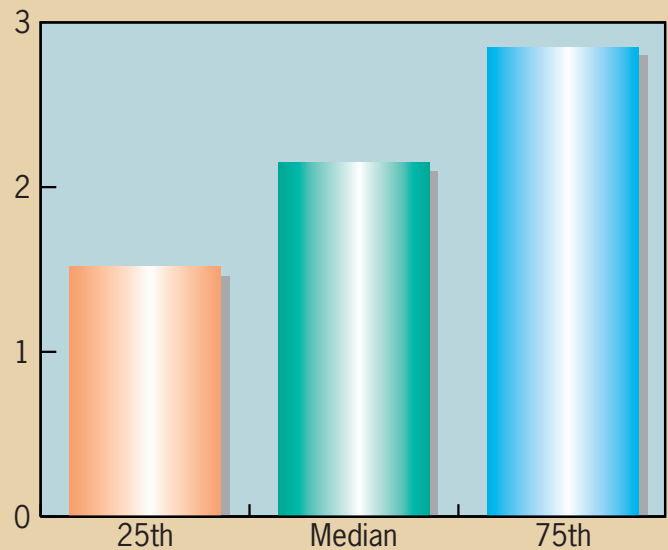
A.V. Powell & Associates LLC has developed a database of actuarial statistics. The database for fiscal 2000 actuarial studies contains statistics on 60 CCRCs across the country. This database shows that the median funded status for CCRCs is 101%. This means that about half of these CCRCs have reserves that are adequate to meet obligations to current residents. So, achieving a fully funded actuarial status is the standard position among our clients. Figure 1 shows the quartile distribution of the funded status.

The A.V. Powell database shows that the median new entrant surplus for CCRCs is 9%. This means that about half of these

## New Entrant Surplus



## 10-Year Increase Factors



CCRCs offer resident contracts that are priced with a present value margin of 9% or greater. Among our clients, charging fees to new entrants that are actuarially sound is acceptable to the marketplace.

Our database shows that cash balances (liquid reserves) are projected to increase significantly over the next 10 years. The median increase in cash balances is 2.0, which means that cash balances are projected to double in 10 years. Generally, reserves must increase at least as much as expense inflation to maintain the relationship between assets and liabilities.

When we began conducting actuarial studies in the early 1980s, there was a significant concern that the fees required to cover the true obligations for continuing care contracts would not be marketable. Therefore, it was thought that the application of actuarial science to this industry was not feasible. As can be seen from the statistics, more than half of our clients have achieved a satisfactory actuarial condition based on their current fees and costs. So a CCRC can be successful in the marketplace and also financially strong.

In our opinion, actuarial studies are the only appropriate method for evaluating the solvency of CCRCs. CCRCs need financial projection models that incorporate the criteria in the actuarial standards, because continuing care contracts are long-term commitments and an evaluation of solvency must consider long-term liabilities. The actuarial statistics provide a target for reserves and pricing adequacy that no other financial ratios address. ■

*Kathleen Harris has conducted over 100 CCRC actuarial studies since 1991. She is responsible for designing and testing actuarial software and providing training and support to software users.*