



**Ziegler**  
CAPITAL  
MARKETS  
GROUP

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# FSO: FACT OR FICTION?

Presented by

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**1:15 PM**

# Future Service Obligation (FSO)

- Intended to recognize a loss when it is incurred
- Project future fees and future operating costs for the current residents
- Compare net future cost plus depreciation to deferred revenue

# FSO Limitations

1. Most G&A and marketing costs are excluded from the calculation, so it is a liquidation liability only
  - As a result, most CCRCs do not record an FSO on their statements of financial position (over 95% of AVP clients have a negative FSO)

# FSO Limitations

## 2. Depreciation only reflects assets in service

- The calculation does not consider future replacement or maintenance costs so depreciation cost declines over projection period

# FSO Limitations

3. Net future costs are compared to deferred revenue
  - This implies that the community has assets sufficient to back up deferred revenue, but many CCRCs have negative net assets on statement of financial position

# FSO Limitations

4. Refundable entrance fees that meet the criteria to amortize over building life are not considered a liability
  - CCRCs that sell highly refundable contracts have large deferred revenue balances and huge negative FSOs (yet often have significant negative net assets)

# Empirical Observations

## Conditions that have caused positive FSOs:

- Significant increase in capital expenditures
  - May be realistic that this event caused a loss when it occurred, but what if the expenditures were funded by contributions?
  - If financed through borrowing, double effect on FSO due to interest expense and depreciation expense
- Significant increase in operating costs, not passed thru to monthly fees
  - Parent corporation allocates a larger share of costs to CCRC

# Empirical Observations

## Conditions that have caused positive FSOs:

- Debt incurred for future expansion
  - Interest expense is included in the calculation when it hits the financials, but deferred revenue expected from future expansion entrants is not included in the calculation
- Community moves towards rental contracts
  - As entrance fee population dwindles, deferred revenue continues to amortize and decline, and becomes insufficient to cover net costs for remaining group

# Common Fallacy

“CCRC net assets are really  
net assets plus deferred  
revenue”

# REALITY

- A positive FSO will reduce net assets
- No FSO does not necessarily mean that contracts are priced right or that the community is in good financial condition
- Negative net assets means that a CCRC is insolvent, just like with other entities, but not necessarily unable to meet its cash flow requirements

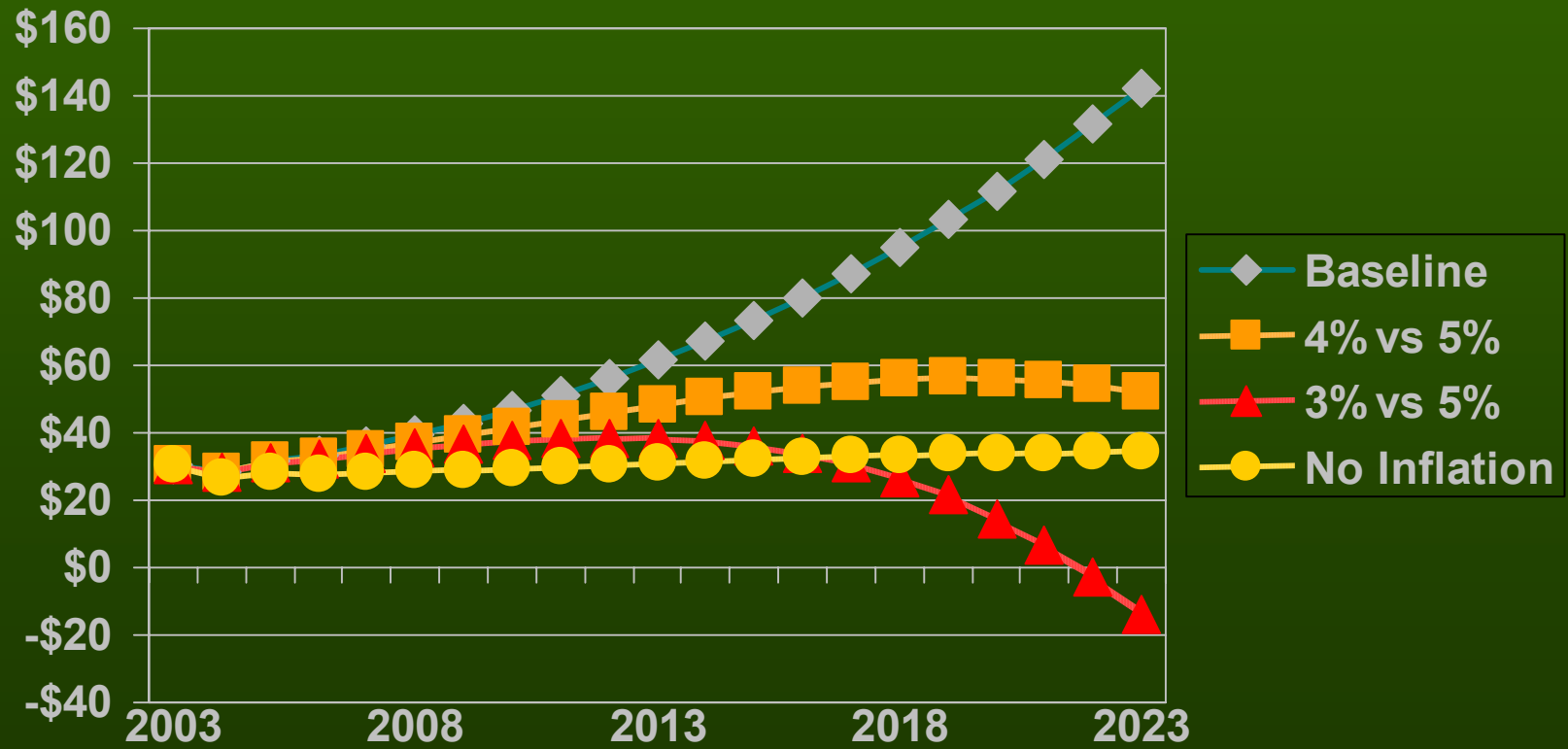
# The Crucial Financial Challenge

- Every year when setting the budget Board and management have to answer questions about *(1) how much cash the CCRC should have, and (2) whether the fees are adequate*
- Neither GAAP statements nor FSO can address this issue
- Actuarial studies are a necessity to make an informed decision

# Actuarial Studies for CCRCs

- Assess long-term solvency
- Provide early warning of potential problems
- Evaluate pricing and reserves adequacy
- Project cost of long-term liabilities such as health care and refunds

# Inflation Drives Future Increases in Reserves: Revenue versus Expense Sensitivity



# ASOP No. 3 Conditions for Satisfactory Actuarial Balance

- Developed by American Academy of Actuaries Committee on CCRCs
- Adopted by Actuarial Standard Board, July 1994
- Defines three criteria to be tested by:
  - **Condition 1—Actuarial balance sheet**
  - **Condition 2—Cohort pricing analysis**
  - **Condition 3—Cash flow projection**

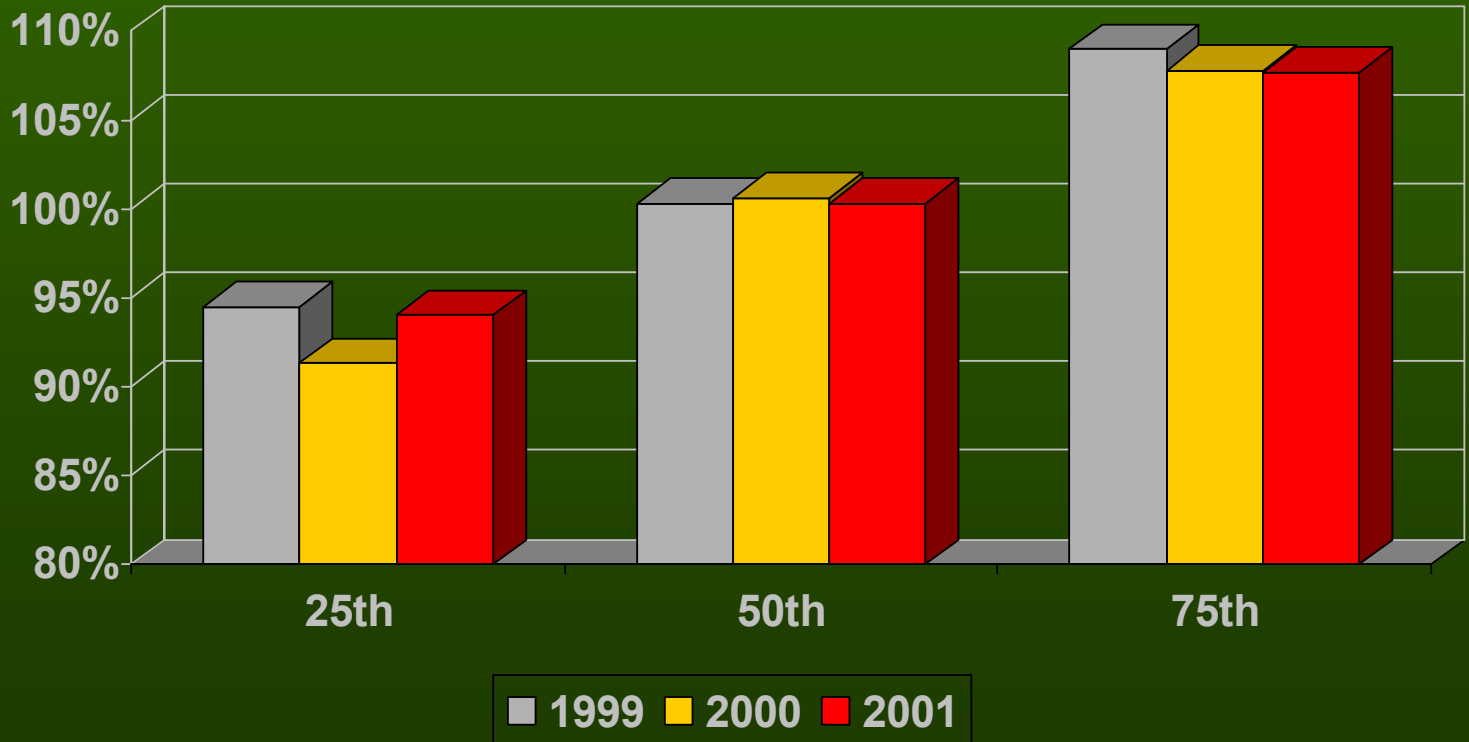
# Condition 1: Funded Status > 100%

- Are the resources available for current residents greater than or equal to the actuarial present value of the expected costs of meeting all remaining obligations to such residents under their contracts, with appropriate provision for surplus?
- Laymen's terms:  
*Do the reserves held by the organization, which include liquid assets and PP&E, cover the shortfall between future costs and fees?*

# Do Reserves and Fees for Current Residents Cover their Costs?

|                           |                           |
|---------------------------|---------------------------|
| <b>Monthly Fees</b>       | <b>\$ 77.1 million</b>    |
| <b>Actuarial Reserves</b> | <b>30.8 million</b>       |
| <b>Ind. Living Costs</b>  | <b>60.5 million</b>       |
| <b>Asst. Living Costs</b> | <b>21.0 million</b>       |
| <b>Nursing Costs</b>      | <b>26.6 million</b>       |
| <b>Refund Liabilities</b> | <b><u>0.6 million</u></b> |
| <b>Actuarial Deficit</b>  | <b>(\$ 0.8 million)</b>   |

# AVP Benchmarks on Condition 1: Funded Status



# Condition 2: New Entrant Pricing

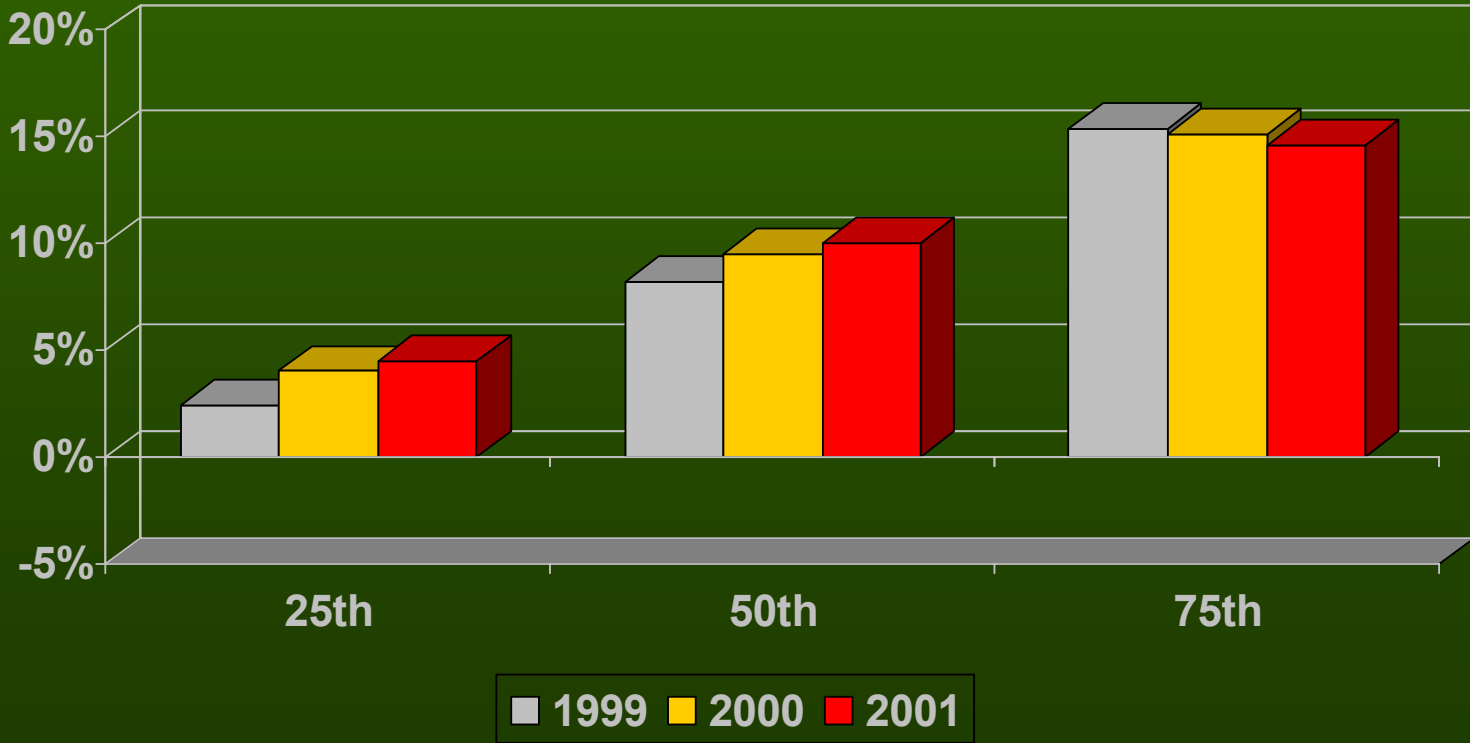
## Surplus > 0%

- Does the sum of entry fees paid plus the actuarial present value of monthly fees equal or exceed the actuarial present value at occupancy of the costs for meeting all obligations for a typical cohort of new entrants, with appropriate provision for surplus?
- Laymen's terms:
  - will the combination of future monthly fees and entry fees cover the expected future costs of care and entry fee refunds for a group of new residents?*

# Do Entry and Monthly Fees for New Entrants Cover their Costs?

|                               |                          |
|-------------------------------|--------------------------|
| <b>Entry Fee</b>              | <b>\$ 133,602</b>        |
| <b>- Expected Refunds</b>     | <b>( 3,699)</b>          |
| <b>Future Monthly Fees</b>    | <b>382,943</b>           |
| <b>- Cohort Liabilities</b>   | <b><u>( 505,590)</u></b> |
| <b>Actuarial Surplus (\$)</b> | <b>\$ 7,256</b>          |
| <b>Actuarial Surplus (%)</b>  | <b>1.4%</b>              |

# AVP Benchmarks on Condition 2: New Entrant Pricing



# Condition 3: Projected Cash Balances > \$0

- Are positive cash balances projected with respect to current and future residents for a period of at least twenty years?

- Laymen's terms:

*is the facility projected to generate sufficient cash to pay its expenses?*

# Calculation of 10-Year Projected Reserves

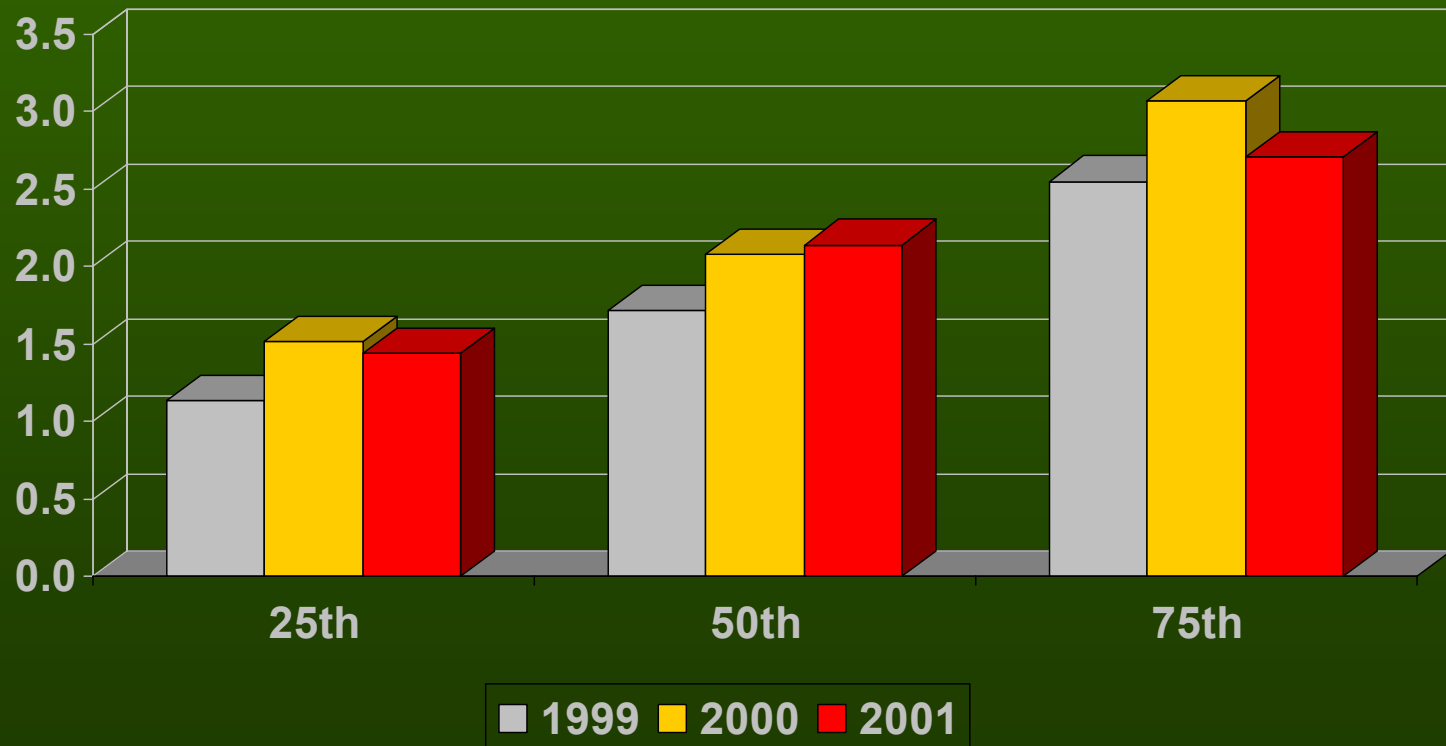
**Projected Liquid Reserve Balance** **\$ 31,472,000**

**Divided by**

**Initial Liquid Reserve Balance** **\$ 14,050,000**

**= 10-Year Reserve Change Factor** **2.24x**

# AVP Benchmarks on Condition 3: 10-Year Reserve Increase Factor



# Why Use the Actuarial Process?

- Consistent
- Comprehensive
- Robust in handling facility uniqueness (variations)
- Procedural and applicable in real life
- 20-year history of meaningful use

# Key Work Products from Actuarial Study

- Actuarial report card provides an objective assessment of your organization's results in comparison with others
- Mandate for Board-adopted pricing policies and objectives for management implementation

# Actuarial Report Card

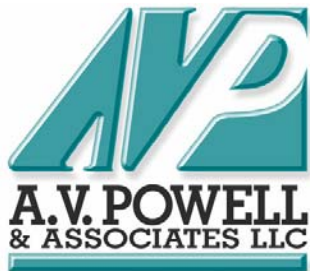
|                                    | <u>Result</u>  | <u>Quartile</u> | <u>Grade</u> |
|------------------------------------|--|-----------------|--------------|
| <b>Actuarial Funded Status</b>     | <b>99.3%</b>   | <b>Second</b>   | <b>B+</b>    |
| <b>New Entrant Pricing</b>         | <b>1.4%</b>  | <b>First</b>    | <b>B</b>     |
| <b>Projected Cash Accumulation</b> | <b>2.44x</b>   | <b>Third</b>    | <b>A</b>     |
| <b>Health Care Capacity</b>        | <b>Sufficient for Expected Utilization</b>   |                 | <b>A-</b>    |
| <b>Caveat:</b>                     | <b>Future fee increases must cover internal expense inflation or funded status may decline</b> |                 |              |

# How Do You Determine Future Fee Adjustments?

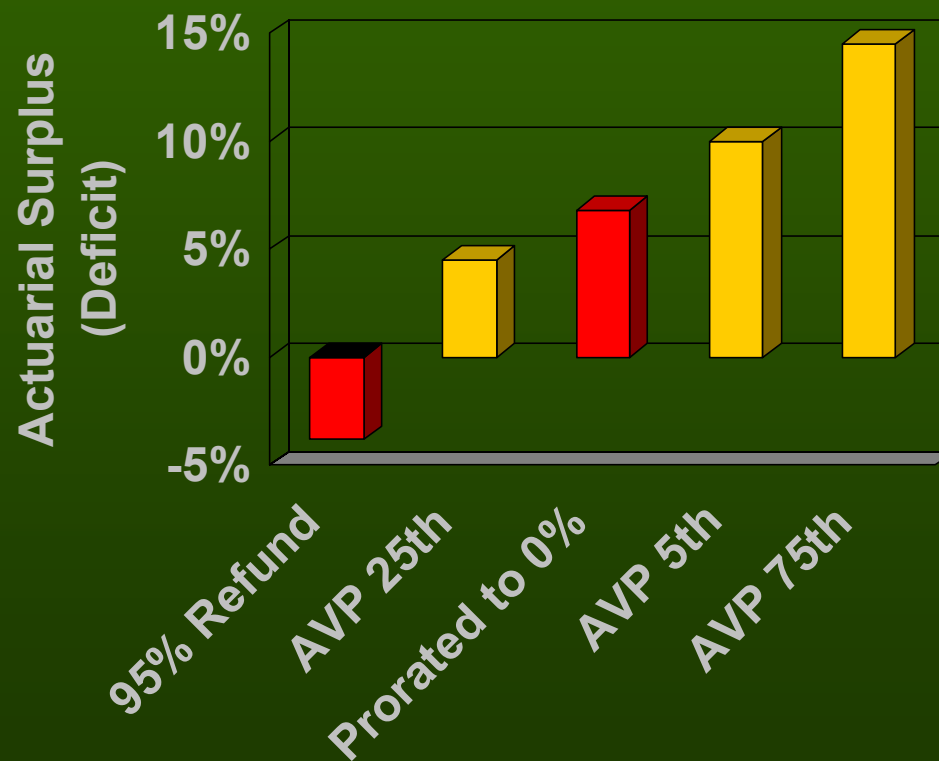
- Fiduciary responsibility of the Board to assure adequate fees for long-term solvency
- Board should adopt policies on ranges for acceptable actuarial results from year to year
- For a 100% lifecare facility, set target:
  - **Funded status of 103 to 105 percent**
  - **New entrant cohort surplus of 8 to 12 percent**
  - **10-year cash projection increase of 1.70**
- Targets will vary according to many factors
- Budget fee adjustments to meet these targets

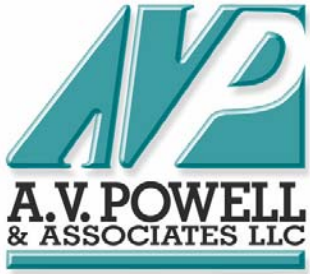
# #1 Reason for Seeking Actuarial Analysis

- Market pressures force continual adjustments to contract offerings
- Desire to develop new contracts that are priced adequately as well as actuarially equivalent to each other (revenue neutral over the resident's potential lifetime)
- Our experience is that residents choose contracts that best serve their financial interests

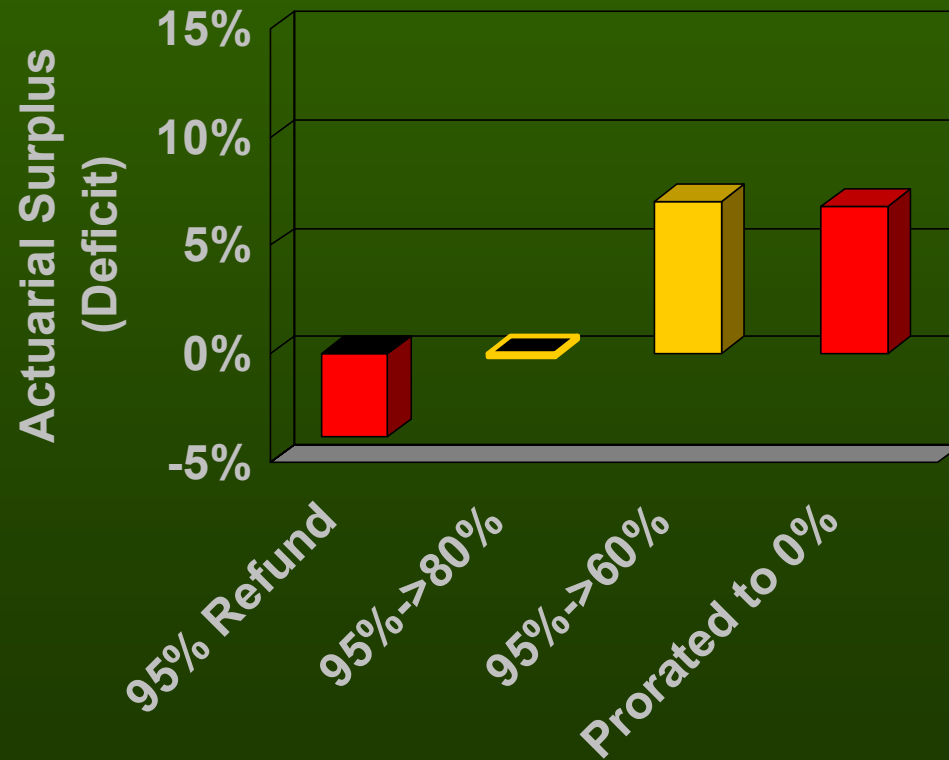


# Pricing Comparison of Case Study Contracts with AVP Benchmarks





# Minimum Refund Changes to “Equalize” Case Study Fees



# Summary

- Estimating the GAAP FSO is of minimal use
- Trending GAAP FSO has marginal value
- There is no known set of ratio criteria that ensures and validates solvency
- Methods to achieve satisfactory actuarial balance have become the de facto standard for prudent stewardship