Continuing Care Retirement Communities

An Empirical, Financial, and Legal Analysis

Howard E. Winklevoss
Senior Vice President
Johnson & Higgins
Adjunct Associate Professor
of Insurance and Actuarial Science
Wharton School

Alwyn V. Powell
Assistant Professor of
Actuarial Science and Insurance
Georgia State University

in collaboration with

David L. Cohen, Esq.
Associate
Ballard, Spahr, Andrews & Ingersoll

Ann Trueblood-Raper
Consultant in Gerontology

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Chapter Ten
Financial Reporting

■ The actuarial methodology for developing "actuarially adequate fees" presented in the preceding six chapters was not based on traditional accounting statements. Financial statements were not used because the correct method for determining the size of actuarial liabilities and of the corresponding fees for funding those liabilities requires *present value analyses* to equate future revenue and expense streams. It is not easy to incorporate this present value approach into traditional financial statements, whereas it is easy to incorporate it into the actuarial valuation methodology. However, it is important to determine the relationship between actuarially generated fees and the community's current financial position as reflected in its financial statements. Should these be inconsistent, appropriate modifications must be developed.

The impact of charging actuarially adequate fees on financial statements used by CCRCs is explored in this chapter and Chapter 11. This chapter presents an introductory discussion of basic financial statement preparation and the types of external reports generated by CCRCs. The goals of this chapter are to: (1) identify the financial statements prepared by CCRCs (and organizations in general) and describe their purpose, (2) explain the basis of preparation of these statements, and (3) discuss the points which limit the usefulness of the principal financial statements as management decision-making tools. This chapter presumes that the reader has little background in accounting and finance. The reader already knowledgeable in these areas may wish to go directly to Chapter 12, which presents recommendations regarding the statements that management should use to assess the current financial position of a community.

TYPES AND PURPOSES OF FINANCIAL STATEMENTS

This section describes four types of external financial reports used by continuing care retirement communities and then compares these reports to similar external reports prepared for organizations in general.

External versus Internal Reports

In the broadest sense, the financial reports generated by organizations can be divided into two categories: external reports and internal reports.

External reports are prepared for audiences external to the organization who have an interest in monitoring the organization's progress. Two key audiences are investors and regulators. These reports tend to be more standardized than internal reports because they are directed to a broad cross-section of individuals, some of whom have little or no understanding of the operations of the organizations whose reports they review. When management compiles the basic external reports, it generally has them reviewed by independent public accountants who are retained to express an opinion on the fairness of the statements and their conformance with generally accepted accounting principles (GAAP).[1]

Internal reports are designed for the use of management in carrying out its decision-making responsibilities. These "management tool reports" are not intended for external consumption and need not be prepared in accordance with dictates, principles, or rules set forth by any body external to management. The types of internal reports prepared by organizations vary with the type of business endeavor. One common set of internal reports consists of budget and budget variance reports. These reports require managers to estimate resource needs in advance, and on a periodic basis the reports identify actual resource use as compared with budgeted use. Another critical internal report is the cash flow projection. Cash flow statements are needed to monitor liquidity, predict peaks and valleys in an organization's cash balances, and identify how much cash can be expected to be generated from internal operations and how much will have to be supplied from other sources. This chapter does not consider internal reports.

There are at least three key differences between external and internal reports. The first difference applies to the level of standardization. External reports possess a degree of standardization as regards types of reports prepared, manner of presenting information, and manner of

[1] Typically, the governing body of an organization (its board of directors) retains the public accountants to review, independently, the statements of the organization.

ascertaining the values shown, while internal reports are highly individualized. Second, external reports are highly summarized, while internal reports may depict minute details. Finally, and perhaps the most important distinction, external reports provide summary data based on what has already happened on the assumption that the environment facing the organization in the past will exist in the future. Internal reports need not be constrained by this convention.

External Reports

The financial information made available by organizations for external audiences consists, typically, of the four documents listed below. The titles listed in the left-hand column are those commonly used by proprietary organizations. The right-hand column shows the terminology used by CCRCs to identify their financial statements:

Titles used by most proprietary firms	Titles used by CCRCs
1. Balance sheet	**1.** Balance sheet
2. Income statement	**2.** Statement of revenues and expenses
3. Statement of changes in owners' equity	**3.** Statement of changes in fund balance
4. Statement of sources and uses of funds	**4.** Statement of changes in financial position

Frequently, statements 2 and 3 are combined. Occasionally, the "sources and uses" statement is omitted.

Balance Sheet. The balance sheet is a summary financial statement prepared as of a given date. It depicts the organization's current wealth position in accordance with the accounting rules prescribed for the statement's preparation (these rules are discussed later). The left side of the statement lists all of the things owned by the organization that have a current "worth," referred to as assets. The right side of the balance sheet is divided into two parts—liabilities and fund balance. The items listed on the right side show who has a claim on the assets listed on the left side of the statement. Liabilities are listed before the fund balance because liabilities represent creditor claims. The fund balance represents the extent to which available assets exceed the claims of creditors. If liabilities exceed assets, the organization will show a negative fund balance, referred to as a deficit. The balance sheet does not specifically identify which assets belong to which creditors or owners. What it depicts is the relative claim on assets held by various creditor and owners.

Assets are usually shown in three groups—current assets, fixed assets, and intangible or other assets. The order in which assets are listed is from most liquid to least liquid. Current assets are shown first.

They are the most liquid and qualify as current assets because it is expected that all current assets not already in the form of cash will be converted to cash (i.e., "turned over") within the next accounting cycle (fiscal year). Cash, accounts receivable, and inventory are current assets. Assets within this group are listed in order of relative closeness to cash. For example, inventories follow accounts receivable because they typically become an account receivable before they become cash.

The next asset category, fixed assets, includes the plant and equipment used by the organization to produce goods and/or provide services. Such assets are long-term insofar as they will be utilized over more than one future accounting period. The portion of fixed assets "used up" during each accounting cycle is allocated to the appropriate accounting cycle by a depreciation charge. The final asset category includes "other assets." Such assets are usually a small portion of total assets and are often not physical assets. Most "other assets" would not have any value if the business were liquidated. Perhaps the most frequently encountered "other asset" is preopening and organization expense. This represents expenses incurred prior to opening which are established as assets (i.e., capitalized) and charged off as expenses, pro rata, over the time period benefited by the expenses.

Liabilities, the claims of creditors on the organization's assets, are shown in two categories—current liabilities and long-term liabilities. Accounts payable, taxes due, and the current portion of long-term debt constitute current liabilities. Long-term liabilities are made up of the organization's borrowings.

The fund balance identifies the amount of assets belonging to the owners of the organization. It is a residual figure insofar as it is the difference between assets and liabilities. The fund balance amount is a function of the asset and liability valuation practices employed by the CCRC.

The balance sheet provides a financial snapshot of an organization. It lists the stock of goods owned and owed at a given date. However, the balance sheet does not provide insight into how the organization attained its current position. For that, one must refer to other statements which tend to link successive balance sheets together. These are discussed later in this section.

The balance sheets prepared by other organizations are similar to those prepared by CCRCs. The differences found relate to the nature of a CCRC's business and to the nonproprietary ownership of most CCRCs. There are some differences in form and substance.

CCRCs often present separate balance sheets for various "funds." For example, one balance sheet may be prepared for the operating fund and another for the property fund. Some CCRCs prepare separate balance sheets for restricted and unrestricted funds.

The balance sheets prepared by most proprietary organizations do not refer to the excess of assets over liabilities as the fund balance. Instead, the difference between assets and liabilities is referred to as owners' equity. In investor-owned firms, owners' equity is segregated into two parts. Money supplied directly by owners is referred to as capital stock and paid-in-surplus, while the excess of prior years' earnings over dividends paid to owners is referred to as retained earnings. Regardless of the designation, this section of the balance sheet denotes the excess of assets over the claims of creditors whether or not the organization is operated for profit. In a sense, it represents the cushion of financial security available to the creditors of an organization.

The major substantive difference between the balance sheet of a CCRC and that of most other businesses relates to the liability side of the statement. It relates to the advance deposits of prospective residents and the entry fees paid by residents. These amounts, particularly in latter, are very sizable. They represent payments made by residents in advance of future services. They are earned in future years by the CCRC; until earned, however, the unearned balance is carried as a liability. The manner in which such fees are taken into earnings by a CCRC is subject to some discretion and is one of the most important accounting decisions facing CCRC management, as discussed later. Only a few firms, most notably life insurance companies, show liabilities that are similar in nature to those of CCRCs.

Statement of Revenues and Expenses. The statement of revenues and expenses depicts what has occurred over some specific time period (usually one year) rather than presenting information as of some specified date, as does the balance sheet. As such, it represents a "flow of activity" rather than a "stock of goods."

If one were to examine two balance sheets for a CCRC prepared one year apart, one would undoubtedly find some change in the fund balance reported in the successive statements. A key purpose of the revenue and expense statement is to explain the change in the fund balance from year to year. The revenue and expense statement provides the critical link between balance sheets. The balance sheet answers the question "What is the organization worth?" The revenue and expense statement answers the question "How much did the organization 'earn' this year?" However, it should be noted that the answers to both questions are only as good as the assumptions underlying the preparation of the statements.

The format of a statement of revenues and expenses is straightforward. The statement presents a listing of revenue items and expense items. Major revenue items are resident fees, investment income, amortized portion of entrance fees, and medical center collections, where applicable. The bottom line of the statement is usually referred to as excess of revenues over expenses (or vice versa).

The comparable statement prepared by most proprietary firms is called an income statement. (CCRCs, like most nonprofit entities, avoid proprietary-sounding statement names and account titles.) The largest revenue item found in most income statements is sales. Expenses are frequently grouped by type. Common expense categories, especially among manufacturing organizations, are cost of goods sold, administrative expenses, and general expenses. For-profit organizations usually show net income before and after federal income taxes.

Statement of Changes in Fund Balance. The third external report listed earlier was called the statement of changes in fund balance. Sometimes the purpose served by this statement is accomplished by extending the statement of revenues and expenses rather than showing a separate statement of changes in fund balance. Not all of the items that cause the fund balance to change during a year will be included in the "excess of revenues over expenses" figure discussed above. The fund balance of a typical CCRC is also impacted by such items as contributions, donated equipment, and transfers between funds. Such items cause an increase in assets and a corresponding increase in the fund balance to keep the balance sheet in balance. Since receipts of this kind cannot be considered "earnings," they are excluded from the statement of revenues and expenses. The transactions shown in the statement of changes in fund balance are unusual, nonrecurring items which typically do not arise from a firm's normal operations. A statement of changes in fund balance typically shows the beginning-of-year fund balance excess of revenues over expenses (or vice versa) followed by other transactions impacting on the CCRC's fund balance during the year but not reflected in the statement of revenues and expenses. A CCRC may have several such statements, depending on the number of separate funds maintained.

The corresponding statement issued by proprietary firms is called the statement of changes in owners' equity. Two key items often reflected in this statement are the receipt of cash for the issuance of additional shares of stock and the payment of dividends to shareholders. The format and purpose of the statement are exactly as described above.

Statement of Changes in Financial Position. The final statement included in the typical package of external reports is the statement of changes in financial position. "Financial position" is defined, for the purpose of this statement, as "net working capital." Net working capital is the difference between a CCRC's current assets and its current liabilities. Working capital is an important concept. It identifies the amount of money readily available to fund operations. A working capital ratio (i.e., current ratio) of 2 to 1 implies that an organization has $2 of relatively liquid assets for every $1 needed to meet its current needs. Working capital provides an important measure of a CCRC's liquidity and identifies the ability of the organization to take advantage of new opportunities or to weather bad times.

The statement of changes in financial position supplements the balance sheet. In a sense, it is like the statement of changes in fund balance. However, instead of explaining the change in the fund balance, the statement of changes in financial position explains the year's change in net working capital.[2]

The statement's format is straightforward. The first section lists the sources of working capital during the year. Key sources include excess of revenues over expenses (if any), entry fees received, donations, and interfund transfers. Excess of revenues over expenses has to be adjusted for deductions from revenue which do not require working capital funds during the year and for revenue items not adding to working capital funds during the year. A key item requiring adjustment is depreciation. Since depreciation reduces reported operating income, it must be added to the sources of funds because it does not require an actual expenditure of funds during the year.

The second section of the statement lists the uses of working capital. Key uses would be any operating loss incurred during the year, repayment of debt, and/or acquisition of fixed assets.

The difference between the sources and uses of working capital is then shown. It is usually labeled increase (decrease) in working capital. The net change in working capital has to be reflected in current asset and current liability account balances. The changes in these balances are shown as the third section of the statement of changes in financial position.

The external reports issued by proprietary firms typically include a statement that summarizes the change in working capital for the year. The statement is most often referred to as the statement of sources and uses of funds. In this statement, "funds" is defined as "net working capital." Regardless of the difference in name, the purpose and appearance of the statement are the same as those of the statement of changes in financial position, described above.

In summary, the external reports issued by CCRCs are consistent with those issued by other business organizations. The major distinctions are terminological and stem from the nonprofit sponsorship of

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[2] Sometimes the statement of changes in financial position is limited to explaining the change in a CCRC's cash balance over only a year instead of serving the more comprehensive purpose discussed here.

most CCRCs. Examples of the external statements discussed above, as prepared by one CCRC, are included in Appendix E.

BASIS OF FINANCIAL STATEMENT PREPARATION

The previous section has described the purposes of external financial reports. In order to evaluate how well the various statements accomplish their intended purposes, it is necessary to understand the assumptions and conventions underlying statement preparation.

The role of the independent accountant is to verify that the financial statements prepared by management are based on generally accepted principles of accounting. After the independent accountant reviews (audits) the statements, an opinion is expressed on the fairness of the financial statement presentation in accordance with generally accepted accounting principles.

Accounting principles, whether generally accepted or not, cannot be applied in a vacuum. In other words, generally accepted accounting principles are applicable only when some other basic concepts or assumptions hold. Many persons confuse and/or fail to distinguish the underlying assumptions or basic concepts of accounting from generally accepted accounting principles.

Fundamental Concepts

One basic assumption is that the business venture being reported upon is viewed as an *entity* in its own right. It is viewed as distinct from those who furnish the capital to operate the *business,* and the statements prepared are those of the business entity, not the managers, the owners, or any other individuals concerned.

A second basic assumption is that the entity will continue to operate, that it is a *going concern*. The preparation of external financial reports rests on normal conditions and not on the assumption that the entity is to be liquidated, unless there is strong evidence to indicate that such is the case.

Accounting statement valuation is also based on the notion that the *cost* of acquiring an asset is the appropriate measure of the asset's worth. Cost is usually readily determinable and provides some objective evidence of an item's value—at least to someone at some time.

Another basic concept is that the production of revenue is the underlying reason for incurring cost. *Therefore, costs incurred should be properly matched against the revenues for whose production the costs were incurred.* This concept of proper *matching* of revenue and expense items is embodied in an accrual accounting system rather than in accounting done on a cash basis. Accrual accounting charges expenses to the time period in which associated revenues are recognized, regardless of when cash is distributed or received.

Other basic concepts or conventions important to accountants include the following:

Materiality: If disclosure of an item would probably influence the judgment of a reasonable person, it should be disclosed.

Conservatism: Uncertainties and risks should be given adequate consideration, and gains should not be anticipated.

Consistency: Principles and practices should be uniformly applied from one period to the next.

Full disclosure: Necessary information should be added to financial reports to prevent them from being misleading.

Principles of Accounting

Accounting principles are statements of accounting practice that arise from the basic concepts enumerated above. An accounting practice becomes a principle when it enjoys substantial "authoritative support." This support can come from various quarters: practices commonly found in business, statements of the Financial Accounting Standards Board (FASB) and its predecessor organizations, affirmative opinions of practicing and academic accountants, and so forth.

An example of a generally accepted principle of accounting is the principle that extraordinary gains and losses and nonrecurring items should be shown separately from usual operating results. This principle upholds the basic concepts of full disclosure and proper matching discussed above.

Generally accepted accounting principles are numerous. It is neither possible nor appropriate to state them all in this brief discussion.

Caveats Attending Interpretation of Reported Results

If a business enterprise is indeed a going concern, it follows that its financial condition and results of operation at any time, or for any short interval, will be impacted upon by past as well as future activities. The eventual results produced by a business cannot be measured accurately until liquidation. For a number of reasons, however, not the least of which is the assessment of taxes, results are reported periodically. Too often, individuals reading financial statements attribute too much finality to reported results. In fact, the financial results presented should be viewed as provisional, and any decisions based on the reports may have to be changed in light of future developments.

The assumption that recorded historical cost measures the value of assets implies a stable monetary unit. It follows that in periods of significant price movements, financial reports can present unrealistic asset and liability values and, as a result, inaccurate portrayals of fund balances, or owners' equity.

The meaning and application of accrual accounting have significant implications for interpreting reported financial results. The fact that there can be significant time lags between the receipt or disbursement of cash and the recognition of income or expense means that the income statement can present an unduly comfortable or uncomfortable picture of an organization's well-being. No matter how large an organization's income as reported under accrual accounting, it can face bill-paying problems if its cash receipts fall short of reported income. Conversely, an organization with large cash receipts in spite of operating losses may be lulled into a sense of complacency because of its ability to meet its cash requirements. In the long run, results reported on an accrual basis will be identical to net cash flow. Temporary imbalances between the two due to the existence of period accounting will evaporate over the life cycle of the organization.

Another noteworthy aspect of accrual accounting is that the matching process is one of allocation, not valuation. When the cost of fixed assets, for example, is apportioned over future periods by means of depreciation charges, the goal of the apportionment process is to allocate historical cost and not to estimate the current value or replacement cost of the portion of the productive asset consumed during the period under review.

Finally, many important features of an organization are not reflected in its financial statements. For an item to appear as an asset of an organization (and thus be included in the calculation of the fund balance or net worth), it must have been acquired for some consideration. This means that any potential infusions of resources from the organization's sponsor(s) or investors cannot be reflected, nor can the significant value attaching to the organization's human resources be included, in the organization's financial statements. Without some knowledge regarding these factors, it is impossible to gauge accurately an organization's true condition.

USEFULNESS OF BASIC FINANCIAL STATEMENTS FOR MANAGEMENT DECISION MAKING

The traditional external financial reports prepared by organizations typically are of limited use to the managers of such organizations for management decision making. This statement holds greater validity for managers of CCRCs than for managers of many other types of businesses. In the first place, CCRCs face more future contingencies outside their control than do most businesses. The analysis of resident mortality and morbidity rates is just beginning to reach the point where comfortable predictions can be made about turnover rates and future health care costs. Current per capita health care costs will often be significantly less than future per capita costs because of the maturation of the resident population, changes in methods of delivering health care to the aged, and general health care cost escalation. Changes in turnover rates impact sharply on the collection of entry fees which may have been counted upon heavily to finance needed capital improvements, retire debt, and so forth.

CCRC management has to recognize the deficiencies inherent in the financial results currently generated by the application of generally accepted accounting principles when setting fees—both entry fees and monthly fees—and planning future capital requirements. The reported income of CCRCs may overstate actual performance by a significant margin. Depreciation charges based on constant dollar assumptions, even if funded, will not produce enough money to replace equipment and buildings, let alone to provide capital funds for expansion. Even if cash equal to each year's depreciation is put into a restricted building and equipment fund and invested at a rate equivalent to the rate at which capital asset prices are appreciating, the funds set aside will be insufficient to replace the capital assets that require replacement. Inflation impacts the total price of an asset, not just the portion of the asset assumed to be used up during each accounting period. If entry fees and monthly fees are to provide funds for capital asset replacement, a capital charge based on constant dollar depreciation is inadequate.

Income may also be overstated because of too rapid amortization of entry fees. Typically, entry fees are taken into income over the life expectancies of residents.[3] This is *not* consistent with the matching concept discussed earlier, whereby revenues and related costs should be matched in the same period, regardless of the actual collection or disbursement of cash.[4]

There are two problems with this approach. Because those individuals who choose to live in CCRCs are required to make a sizable upfront deposit of funds, they may exhibit what insurance people refer to as adverse selection. If they expect to live a long life, they will view the size of the entry fee as an attractive price to pay for the promises made by the CCRC. The life expectancy rates used by accountants in recog-

[3] The 1981 CCRC survey showed that approximately 47 percent of CCRCs use amortization schedules based on the life expectancies of their residents.

[4] See Chapter 11 for a method of amortizing entry fees that is consistent with the matching concept.

nizing entry fees as income may be too optimistic inasmuch as residents may live longer than assumed in the mortality assumptions. One CCRC recently revised its life expectancy assumptions and, as a result, reduced 1981 revenues by $700,000. (Under the new assumptions, amortization of entry fees required $2,200,000 rather than the $1,500,000 reported.)

A second problem related to entry fee amortization deals with the question of whether or not entry fees should be amortized evenly over residents' life expectancies. Equal annual amortization implies that the expense of maintaining a resident, which an entry fee may be designed to support, at least in part, is constant from year to year. If this assumption holds, equal annual amortization can be justified. However, many of the costs of maintaining a resident increase with age. If the entry fee, as opposed to the monthly fee, is designed to underwrite some of the expenses that increase with age, the matching concept would seem to dictate other than equal annual entry fee amortization. If entry fees will be needed to support health care service costs, an amortization function that increases with age would seem more appropriate.

The discussion concerning depreciation and entry fee amortization has focused on the income statement consequences of current accounting practices. The balance sheet is also impacted by these practices. At any point, the fund balance measures the excess of CCRC assets over liabilities. This is a reliable figure only to the extent that all assets and liabilities are reflected in the balance sheet and shown at their appropriate value.

Past depreciation charges are reflected in the balance sheet as accumulated depreciation and reduce the carrying value of fixed assets by the amount of accumulated depreciation charges. The fund balance is also impacted by accumulated depreciation, since the fund balance represents the excess of assets over liabilities, and assets are reduced by accumulated depreciation. However, it can be argued that since depreciation represents an allocation of historical cost rather than a measure of replacement cost of assets used up in providing services, accumulated depreciation is an inadequate estimate of capital consumption for an ongoing business venture. If accumulated depreciation reflected more realistic estimates of capital consumption, a CCRC's fund balance would be reduced.

The discussion of depreciation is but one example of the deficiencies of historical cost, constant-dollar reporting. Other items included in an organization's financial statements are also impacted by price-level changes which are not reflected in reported results.

The fund balance is also overstated if the present value of the future costs of providing CCRC services exceeds the present value of future resident fees and the unamortized portion of entry fees. The deficit will have to be made up out of existing fund balances. Realistically, any such deficit should be reflected currently as a liability.

The level of summarization contained in the financial statements discussed in this chapter presents management decision-making problems. The financial operations of a CCRC's apartment complex are almost always combined with the operations of the health center. Hence, it is difficult to determine from reported results whether both activities are financially sound. Effective management requires the reporting of divisional and/or departmental results. In the case of a CCRC, costs and revenues should be allocated to major activity areas in order to set equitable and adequate fees as well as to maximize reimbursement from other parties that are responsible for making payment to the CCRC.

Summary

This chapter has identified the types and purposes of external financial reports prepared by business entities in general and by CCRCs in particular. The assumptions underlying the presentation of financial results have also been described, along with the implications of those assumptions as regards interpretation of reported financial results.

Some of the deficiencies of generally accepted accounting principles from the standpoint of management decision making were pointed out. Deficiencies result both from the principles themselves and from the application of those principles to CCRCs. It seems clear that improvements can be made in the financial reports of CCRCs even within the context of current generally accepted accounting principles. The implementation of such changes awaits appropriate experience, or what the accountant would refer to as "objective evidence."

However, even if more satisfactory financial reports are ultimately generated by CCRCs for the public, they will still be deficient as complete management decision-making tools. Appropriate data for decision making cannot be limited to information produced by the application of generally accepted accounting principles in the context of CCRCs. Actuarial assumptions, recognition of the time value of money, and greater detail must be incorporated into the data generation activity.

The following chapter deals with two of the problems noted above: (1) suggestions to improve the application of generally accepted accounting principles to CCRCs and (2) the development of a set of financial data more appropriate to management decision making. ■