A Negative Net Asset Position Is Not Positive

Many CCRCs now operate with a negative net asset position. That means that liabilities are greater than assets. If liabilities and assets are properly measured, a negative net asset position means that future revenues will, at least in part, be needed to make up past revenue shortfalls. In other words, the fees that residents pay will not fully benefit them. Let us explain.

It's Like Your Home Value.

Most people are familiar with home purchases. Let's say that you've saved $200,000 which you're going to use as equity to buy a $1,000,000 home. Your mortgage will cover the additional $800,000. Here's how your balance sheet will then look for that transaction.

	Assets	Liabilities
Home Value	$1,000,000	
Mortgage		$800,000
Net Asset Position		$200,000
Balance Sum	$1,000,000	$1,000,000

That's why it's called a balance sheet. The assets are equal to the liabilities plus the owners' equity. The Net Asset Position, which is also called Net Worth or Equity Position or Owner's Value, is the balancing item. In this case, it's the $200,000 down payment made to buy the home.

But now, let's consider that you borrow an additional $100,000 to fix up the home to your specifications. The investment, though, doesn't change the value of the home since that is established by comparable competitive prices in the neighborhood. It will be a better home to live in but the cost of the changes is an expense, not an investment, so the balance sheet will change to:

	Assets	Liabilities
Home Value	$1,000,000	
Mortgage		$800,000
Remodeling loan		$100,000
Net Asset Position		$100,000
Balance Sum	$1,000,000	$1,000,000

That means that the home owner's equity has dropped by $100,000 as a result of the expenditure, but let's go one step further and imagine that the market value of the home drops, as home prices did in 2008, to $700,000. Now the Balance sheet looks like this.

	Assets	Liabilities
Home Value	$700,000	
Mortgage		$800,000
Remodeling loan		$100,000
Net Asset Position		Negative ($200,000)
Balance Sum	$700,000	$700,000

That's the meaning of a negative net asset position. If a buyer now comes along and buys the home for $50,000 over the Mortgage value, i.e. for $850,000 with the buyer assuming the full mortgage, that unsuspecting buyer will immediately lose $150,000 of value on the transaction.

In the case of our home owning example, the new owner's balance sheet would look like.

	Assets	Liabilities
Home Value	$700,000	
Mortgage		$800,000
Net Asset Position		Negative ($100,000)
Balance Sum	$700,000	$700,000

The buyer has lost the full value of the $50,000 investment plus an additional $100,000 by assuming the debt obligation which exceeds the value of the home. By an ill-considered transaction, the buyer has shielded the mortgage lender from a loss on the loan.

CCRC Situation.

That's the impact of paying an entrance fee into a CCRC with a negative net asset position. The entrance fee strengthens the financial position of the lenders, since they have a claim on the enterprise that is senior to the residents' interest. The residents won't notice their loss right away, any more than the overpaying home owner may recognize the home loss, but the residents' financial security for the benefits promised in return for the entrance fee investment has been compromised. In effect, the lenders are advantaged by a deception. The bankruptcy alternative could require the lenders to write-off part or all of their loan.

NaCCRA Position.

NaCCRA reasons that a provider with a "negative net asset position," i.e. GAAP or statutory liabilities greater than assets, dilutes the financial security needed for the assured fulfillment of lifetime continuing care contracts. Current practice allows such CCRCs to continue to solicit entrance fee investments in exchange for continuing care contracts promising future benefits. That is a questionable practice which needs scrutiny.

It raises the larger question, "What should be the minimum capital required for the sound operation of a business accepting entrance fees in return for promises made to older consumers who may not have the knowledge or discernment to make that determination for themselves?" That is a question for the industry, regulators, and legislators to address.

This also raises additional questions, specifically, "How should assets and liabilities be properly measured?" Today's GAAP Accounting follows rules, and auditors judge financial statements for conformance with the rules, but the rules may lead to valuations that depart from the true current economics of the reporting enterprise.

Technicalities.

Some CCRCs with a negative net asset position point to the current market value of the physical property, which may greatly exceed the GAAP valuation, as justification for the evident shortfall. That might be valid if the liabilities, too, were marked to market, but GAAP accounting for entrance fees does not insist on full matching of revenue recognition to fulfillment of performance obligations.

That would require actuarial modeling, and the accounting profession has not insisted on actuarial determination of the actuarial liabilities of CCRCs (which accept an entrance fee in return for lifelong commitments, a clearly actuarial undertaking which is comparable to insured life annuities). Actuaries are required by their professional standards to consider the experience of the particular CCRC in the selection of prognosticating parameters to determine liabilities for contingent future events, such as the mortality implicit in lifelong entrance fee obligations.

To make this simple, it’s obvious that a CCRC that routinely admits older, frailer residents will have higher average mortality, than will a CCRC that screens incoming residents and only admits those who are capable of full independent living after admittance. The one admittance model trends toward assisted living, while the other retains a vibrant functioning residential community, but from a financial perspective, the assisted living model allows more rapid turnover of apartments, a greater cascade of fresh entrance fees, and high mortality, while the independent living admittance model does the reverse. These distinctions are financially material.

The accounting profession has adopted rules that give accountants license to model these actuarial obligations even though they may lack the professional skills required and may simply use a convenient actuarial average rather than professionally adapting actuarial tools to the liabilities specific to the enterprise. Accountants work for their clients, who pay their fees, and will accept the permitted accounting outcome that is most favorable for their clients.

While this is a challenge for insurance companies as well, as indicated by the annuity comparison to entrance fees, insurance companies are bound by statutory accounting (as well as GAAP) and that serves to better protect customers than is now the case for CCRC entrance fee investments. NaCCRA urges support for customers balanced with that given providers.

Statutory accounting is developed, applied, and reviewed independently of the enterprise and so it achieves a standard of independence that is not found with GAAP accounting.

Need for Rehabilitation.

What can be done to restore a CCRC with a negative net asset position? The aim is to have a financially sufficient balance sheet to assure the ability of the enterprise to meet fully the contractual obligations that it has taken on and to preserve equity among successive generations of CCRC residents.

There are many tools which can be deployed and they are more readily used, with less dislocation on those who trust the enterprise, if rehabilitation is initiated sooner when a weak balance sheet is first identified, rather than later after the deficiency has deepened. There have even been some intimations that individual board members may have personal liabilities if they fail to act to avoid allowing the deficiency to deepen.

In most instances, it will be necessary for there to be a full corporate reorganization. It's unlikely that the executives (or their advisers), who allowed the deficiency to develop in the first place, will have the requisite business judgment to execute the turnaround. Corporate reorganization may occur with the sale of assets or with a voluntary restructuring of the debt.

Since a negative net asset position directly means that there is insufficient net worth to ensure that the enterprise is able to meet its contractual obligations, it's likely that the enterprise will need to be reorganized to strengthen its equity position. This can be accomplished by giving the residents, whose entrance fees have allowed the negative net asset position to develop, to take over ownership authority.

For a nonprofit organization, entrance fee investors can be given authority as voting members in the enterprise. The organization can then retain its tax-exempt status but the operating executives would be accountable in the first instance to the residents, and the residents would have a voting say in the selection of board members.

Alternatively, the deficient enterprise might be sold to investors. This requires that the enterprise accept an obligation to pay taxes. The residents could become owner-investors, either fully as in the case of a cooperative organization, or partially alongside other equity investors.

In the extreme, the CCRC may have to repurposed to be able to attract a broader spectrum of potential customers so that the assets can be fully utilized and positioned to earn a positive return. Repurposing can be accomplished within the context of a CCRC, though there may be a need for regulatory waivers to enable that, or the CCRC residents may have to be relocated elsewhere. Relocation can be traumatic, especially for older, frailer residents.

Some impaired entities may try to grow their way out of the deficiency. Turning to growth as an antidote to a negative business position can be effective if the rate of growth is dramatic but it is also fraught with danger. Many years ago, Pacific Homes tried to grow its way out of difficulty by using entrance fees from new residents to meet commitments to existing residents. That generated a Ponzi dynamic in which accelerating expansion rates were need to offset spiraling deficiencies. Eventually, it resulted in bankruptcy and when the church sponsors were sued, it led to a nearly universal practice by church organizations of denying any financial liability in connection with CCRC organizations they sponsor.

Suffice it to say that each situation is unique. It requires astute analysis by a person of vision and business judgment to discern what form of rehabilitation is appropriate for any particular enterprise. What is not desirable is to allow an enterprise with a negative net asset position to continue business as usual as the deficiency grows in the hope that something may arise (perhaps a dramatic rise in property values) to salvage the situation. Hope is not a responsible business strategy.

Industry Position.

The CCRC industry is in a difficult position since many CCRC organizations have been operating with negative net asset positions. If the industry were to endorse the principle that a CCRC should have a balance sheet sufficiently strong to ensure that they will be able to meet all obligations regardless of economic vicissitudes, it would cause enormous disruption to the existing business model. To the positive, it would mean that the industry would keep faith with its customers in a way that it doesn't now.

It's likely that those enterprises which are under financial strain, and which would be required to reorganize, will be more vocal in industry circles than will those financially stronger enterprises that would be unaffected. Moreover, there are industry support businesses – debt financiers, accounting firms, consultants – who have benefitted from these weaker organizations. Hence, it's unlikely that the industry will embrace the need for change no matter how compelling the need for change may be.

In the meantime, prospective residents would be wise to avoid CCRCs with a negative net asset position, and existing residents should be challenging their managements to take steps to restore the residents' interest in their CCRC to full value, meaning simply that assets should be brought to levels sufficient to fully cover the CCRC's liability for future commitments to residents.

Guaranty Proposal.

NaCCRA has also proposed a guaranty plan that would give entrance fee CCRC residents protections similar to those for bank deposits, insurance policies, stock brokerage accounts, and pension benefits. While the bank guarantees through the Federal Deposit Insurance Corporation (FDIC) are the best known, NaCCRA has recognized the industry interest by suggesting a more complicated approach which is likely to be less costly for the industry and less disruptive for residents.

NaCCRA's interest is in protecting residents lives as well as their financial welfare. The proposed approach would encourage and incentivize early intervention to avert financial weakness thus avoiding the disruptions of regulatory takeover or bankruptcy. By thus galvanizing the industry to maintain a financially solid enterprise platform, the complexity is introduced of bringing together industry leaders who are otherwise competitive.

The mechanism chosen means that there are no assessments (beyond those needed for administrative costs) unless the industry is unable to avert the financial shortfall. This differs from the FDIC model in which the industry is assessed to build a reserve fund regardless of whether there are shortfalls needing to be covered. With the FDIC model, the industry is still assessed further if the reserve fund falls short, but the management of the system is in the hands of Federal officers.

The proposed CCRC Guaranty system, which has proven itself effective in the case of life insurance, avoids the political temptation to divert reserve funds to other purposes and, further, allows the industry to avert assessments altogether through early intervention. For residents, averting disaster, means that their interests are preserved; there is less erosion of their entrance fee investments; and there is less likelihood that they will have to relocate elsewhere late in life.

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