Dialogue on Concepts in NaCCRA's March 1, 2012
Submission to the Financial Accounting Standards Board (FASB)

Feb 22, 2012, at 2:34 PM (Proposal):

Earlier this week, one of our members brought to our attention proposed changes in CCRC accounting and the opportunity for comment. The comment deadline is March 13, 2012, though it would be desirable to submit our comments sooner. Accounting in the United States is governed by the Financial Accounting Standards Board (FASB) which promulgates codified rules which auditors are directed to follow.

The immediate impetus for the changes is criticism of U.S. accounting practices by the international accounting community which has impelled FASB to try to bring its accounting standards more closely into line with the international standards.

Attached is a proposed submission to FASB for which I am asking NaCCRA Board authorization. I want to thank our member for bringing this opportunity to our attention. I've shared this with the wider company of interested people to whom the member addressed his message, and some others, in the hope that there will be wide commentary on the proposed content.

If some of this seems unclear to you, then please feel free to ask questions and we will respond to all questions or modify the proposal accordingly. Without unduly burdening you with the technical mathematics, suffice it to say that today's accounting has the effect of making a CCRC appear more profitable in its early years of operation with the consequence that predictable shortfalls must later be made up by rate increases above what would otherwise be economically required.

Incidentally, if any of you are interested in reviewing the projection mentioned in the proposal, just let me know and I'll send it to you. It is in the form of an Excel spreadsheet though the size of the projection requires that you have Excel 2010, the latest version, to be able to fully open the document.

You may wonder how this strange accounting came about. I know I wonder though I can only speculate. CCRCs involve lifetime commitments. Most enterprises operate on a year to year basis. Hence, it may have seemed plausible to accountants to amortize lifetime commitments using a life expectancy in the same way that depreciation, for instance, is amortized based on a presumed building lifetime.

One effect of this approach, which will resonate with CCRC residents, is that today's CCRC accounting does not give residents credit for the interest (or other investment) earnings on their entrance fee payments. Clearly, residents in a month-to-month rental facility can keep what would otherwise be paid in an entrance fee and they can earn interest or other returns on the investment of those funds. Today's CCRC accounting assigns all interest effects from entrance fees (i.e. either reduced debt service costs or increased investment earnings) to current revenue rather than reserving any of those earnings to fund deferred future costs, e.g. nursing care and the like, which the accountants refer to as "performance obligations."

The submission that I am asking the NaCCRA Board now, after full discussion, to authorize addresses this and other CCRC accounting anomalies. The intent is to return CCRC accounting to the same principled accounting basis that applies to accounting generally.

Since portions of the submission are actuarial, I've suggested that the letter go over my signature. Some of the content is inherently technical though I think you will understand the significance of the message. Because of the technical nature of the issues I thought it best for someone with appropriate credentials to sign the letter.

It's important, though, that NaCCRA as an organization stand behind the submission. The providers want to have sound accounting as much as we do, so I see nothing controversial in this proposal. CCRC managers generally rely on GAAP accounting to guide them in their management of CCRC finances and it is in our, and their, interest that CCRC accounting be as valid as possible; that CCRC accounting figures have integrity; and that a CCRC that appears to have a financially sound balance sheet is, in fact, solid and unlikely to become impaired.

Hence, I'm asking that after a brief time for comment and discussion, say, a week, and after appropriate revisions to our proposal, that the Board be polled for concurrence with this submission. Not only do we now have a unique opportunity to try to improve the soundness of CCRC accounting but we can enhance the welfare of CCRC residents by being the advocate for accounting integrity.

For those who may not have a sense of how FASB functions I append below FASB's statement of its position on accounting principles. Most people interpret principles according to the following dictionary definition of "principle": "a fundamental, primary, or general law or truth from which others are derived." By that standard accounting would be consistently practiced to provide a just interpretation of the current financial condition of an enterprise according to universal principles which would apply equally to all enterprises.

FASB appears to be following a lesser included definition of "principle" as, "an adopted rule or method for application in action: e.g. a working principle for general use." As a result some industries are singled out for differentiated treatment and the CCRC industry is such a special industry with rules that apply differently from the principles and rules that govern other enterprises in other industries.

I believe that NaCCRA should stand on the side of principle in the sense of what is universal and just and that we should, therefore, advocate that issues be determined on their merits rather than on the basis of countervailing political interests. This premise underlies the attached proposed submission.

Tuesday, February 28, 2012 2:53 PM (Questioning):

I am responding to your proposed comment on proposed changes in CCRC Accounting (submission due by March 13, 2012). In the interest of transparency, I admit to no expertise in either the fields of accounting or that of the actuary. My background and experience is that of 31 years as a naval officer with a specialty in ordnance research and development. My primary graduate education was in nuclear

(particle) physics, and I also spent 12 months at the Univ. of Rochester studying business administration, which included a course in econometrics (all much enjoyed, but mostly forgotten over time).

I have not seen the changes being proposed at the FASB level. So what I have to say may be totally in error. However...

The issue appears to be what the entry fee is for and how it should be accounted. Some critical observers (e.g., A. V. Powell) say that it is an advance on lifetime care, in essence (as you describe) funding 'a level monthly life annuity toward the monthly rental that would otherwise be required'. Today, on the other hand, many (if not most) CCRCs provide a contract obligation to return a portion of a non-refundable entry fee (usually discounted at 2% per month), should the contract be terminated during that period. An example you provide assumes that the CCRC also recognizes revenue income on the same schedule, which grossly distorts revenue recognition from that of a lifetime annuity.

I discussed this question with my CFO. His response was that although our CCRC does provide similar contract provisions, they account for all the income as received when received, and not amortized over time. They add to their accounts as restricted reserves, a refundable contract obligation line, which accounts for the refundable obligations (on both refundable and non-refundable contracts). My CFO questioned GAAP allowing amortized income streams as you describe in the paragraph at the top of page three of your comments, saying he did not think it would be accepted today during an audit by a major auditing firm such as Larson Allen.

Does immediate revenue recognition with declining future obligations change the nature of the curves you show in your chart on page 2?

I personally have philosophical concerns for the life annuity accounting philosophy, even as I agree with its moral attributes, which are indeed many and strong.

There are a lot of "up-front" costs for CCRCs, such as facilities, staffing, and collateral for loans to provide those up-front things. Most lending institutions expect to see evidence of a strong income flow, and initial cash on hand to cover immediate contingencies as a part of a loan negotiation. My concern is, to what extent would lending institutions consider lifetime annuity income flow as adequate justification/collateral for loans to build new facilities or bring older ones up to modern standards?

Most CCRCs that I am familiar with do operate in something like a modified Ponzi scheme (I hate to use that analogy, but it fits), albeit one in which there is an immediate return for the investor in the form of shelter, food, care, a reasonable life style, and the expectation that this will continue for the remainder of their lives. Never-the-less, they are dependent, expectation-wise, in addition to wise management, on the CCRC's future income stream (including that from others and that of new investors) to continually provide all the services for which they have contracted.

This is an approach which has been historically successful, thus far, at least 99.44% of the time. Is it wise to make a change in this paradigm, now? Would lifetime annuity accounting really fix the few financial failures that we see today? Or, through reduced current income flow, would it create more problems?

Would paradigm change bring new problems in CCRC financing that we may not fully anticipate at this juncture? Are there alternative ways to appropriately protect a resident's investment in his/her future care against contract default that we should consider? As we go forward, we need to keep these and other questions in mind.

My CFO fully agrees with and supports your contention that the actuarial elements of any CCRC financial statement should be determined by qualified actuarial professionals, and not reflect the judgment of reporting accountants. And I concur.

Tuesday, February 28, 2012 3:54 PM (Response):

Thank you for your very thorough and thoughtful reflection. The central question you raise is: “Does immediate revenue recognition with declining future obligations change the nature of the curves you show in your chart on page 2?” It would depend on how “declining future obligations” are calculated. If they are actuarially determined, then the revenue recognition would follow the annuity example in the chart. If they are calculated using the reciprocal of the life expectancy, then they would follow the “FASB” curves.

For the record what is labeled “Income by FASB Rules” in the graph on page 2 to which you refer is not based directly on the refund provisions in a contract. What I am advocating is that at the outset of a new CCRC, for the entering cohort of first generation residents, the Present Value of Future Benefits be equal to the Entrance Fees plus the Present Value of Future Monthly Fees and that the recognition of Entrance Fees in income be matched to the services that they fund. The Present Value equality is maintained after the entering cohort in the form: Present Value of Future Benefits equals Asset Value plus new Entrance Fees plus the Present Value of Future Monthly Fees. This is classic accounting. For this purpose refund provisions become just another benefit to be included in the present value calculations.

You voice qualms about what you concede to be an accounting change to bring greater integrity to CCRC financials. Your concern is a practical one, namely: “There are a lot of ‘up-front’ costs for CCRCs, such as facilities, staffing, and collateral for loans to provide those up-front things. Most lending institutions expect to see evidence of a strong income flow, and initial cash on hand to cover immediate contingencies as a part of a loan negotiation.” In short, you put forward the proposition that earnings should be distorted as a way of fooling (my word) lending institutions into taking risk that they wouldn’t take if there were full and fair disclosure of the truth of the underlying economics.

The same, of course, is true of residents. There is a question whether residents would be willing to pay over their life savings in the form of entrance fees, or sell their homes to raise the money to pay entrance fees, if they knew that there was to a false stewardship for their investments and that the investment was a risky one. One only need to look to the article by Mike Cherney in today’s Wall Street Journal to see a discussion of how risky today’s CCRCs are.

Your practical concern is similar to what Bill Root expressed. If I understand you correctly, you favor the CCRC lifestyle enough that you would be willing to make the financials appear deceptively more

attractive so that people could be lured into financing CCRCs either through the payment of entrance fees or through debt regardless of the merits. I doubt that you would state it as starkly as I just have, but if you reflect a bit, you will come to recognize that anything other than a high standard of financial integrity begins to border on deception.

I don't think that NaCCRA should condone anything that is remotely deceptive in the depiction of the apparent financial condition of a CCRC. Well managed CCRCs can rise to a truthful standard and will have nothing to hide. I would not want NaCCRA to stand for anything other than sound CCRC accounting and for accounting integrity. NaCCRA should stand on the side of principle and for what is true and just. We should, therefore, advocate that issues be determined on their merits with full and fair disclosure rather than on the basis of deceptive argumentation.

As you suggest there are other steps that can be taken to protect resident investments and I hope that we will develop those mechanisms over the coming months, but first we need to be sure that we stand on the side of what is right and that means that financial statements reflect the true economic condition of the organization fairly presented.

I hope that you will reconsider what I deem to be an objection to our advocating for a less deceptive accounting standard and that you will join in support for our position with FASB. I have no doubt that there will be no dearth of special interests, including some less scrupulous CCRC operators, advocating before the Financial Accounting Standards Board for special treatment before FASB adopts new rules. If you want to argue there that the matching principle should be set aside because too many CCRCs depend on the false elevation of apparent earnings in the early years and use of resident entrance fees for purposes other than the best interests of the residents, the proper forum would seem to be the councils of FASB in Norwalk.

I agree with your CFO that the two actual CCRC accounting examples that I cite on page 3 are flawed and would not be condoned by a reputable audit firm (you mention Larson Allen). The fact that these are positions taken by working CCRC CFOs who are CPA trained shows the need for the very kind of clarification that we are advocating. If the FASB rules have become so complex that working level CPAs are unable to follow them and simply have to "wing it", so to say, then there is a strong need for accounting to return to the principled profession that it has been historically.

Tuesday, February 28, 2012 5:23 PM (Further Questioning):

Since I really do not know specifically what accounting rule changes are being proposed, I cannot say whether I agree or not with your letter. The example you provided left me with the impression that the use of entry fees might be adversely constrained in some fashion by these rule changes.

For example, I would not want entry fees placed in some form of escrow which would preclude a CCRC using that income for legitimate current operating expenses. If, on the other hand, entry fees are to be complimentarily accounted in some manner as a future life care obligation, I do not object. Along with that thought, I strongly favor and support the recommendations for continuing professional actuarial

analysis. I firmly believe, that properly done, actuarial analysis can help smooth out the revenue curves that bother you. If actuarial analyses are the rule changes you are requesting, go for it.

Tuesday, February 28, 2012 5:53 PM (Further Response):

The letter to FASB is actually independent of the changes proposed other than that it supports the notion that refund amounts that are fully callable ought not to be taken into revenue and spent as though there were no residual liability or need for liquidity.

I agree that escrow is not desirable and I'm surprised that it's arisen as a bugaboo to haunt us. My best guess is that it is simply a kneejerk reaction to the fiasco at the Covenant at South Hills and the cavalier dismissal that the industry as a collective gave to the understandable distress of the residents there. I believe strongly that, if the industry gets established on a sound and responsible basis, more astute risk and financial tools will come into evidence and the potential strains that I sense now make you and your CFO uneasy will be less of a problem.

It's important not to mix the asset and the liability sides of the balance sheet. It's misleading to simply call a negative liability, for instance, an asset. The contractual and other obligations undertaken by providers toward the residents they invite into residence are liabilities and inherently different, for instance, from the buildings that house the residents and that enable the provider to fulfill its commitment to provide lifetime residence.

Liabilities need to be recognized and proper allowance made for their fulfillment. Assets need to be husbanded, managed, and maintained. Clearly, the assets should be sufficient to cover the liabilities with some margin for contingencies. As the provider fulfills all the commitments made to the residents, the provider is released from the corresponding liabilities. That release from liability combined with new revenues should be sufficient to cover the expenses plus the depreciation of the assets. In short, liabilities are numbers on their way to becoming revenues while assets are on their way to becoming expenses.

If the revenues determined in accordance with the matching principle are not sufficient to cover the expenses, then the enterprise is in trouble in the Dickensian sense, and it's best for managements to be alerted to the deficiency so that they can take corrective action. If the revenues are greater than the costs, hallelujah, and the Board may eventually decide to moderate charges. If the revenues are exactly sufficient to cover expenses and to give a fair return on invested capital, then that is nirvana and is the aim of both for-profit and nonprofit operators.

Since our proposal is highly principled, it avoids the pitfalls that you fear relative to what FASB is proposing. Our proposal is proactive and not reactive to the details of the FASB deliberations. In fact, if you delve into FASB's work product, I think that you'll be somewhat appalled at the turgid use of language, as though the authors were not well versed in the skills of articulation.

Thanks for your interest and support. I know that this is complicated stuff and I greatly appreciate your making the effort to get into it and I particularly appreciated the willingness of your CFO to talk about it.

One of the CPAs that I referred to earlier rejects all resident discussion, glibly deflecting questions by saying that she follows the guidance of the auditors. The provider changed auditors last year. Changing auditors is rarely a good sign.

I hope that this explanation gives you sufficient comfort that you will feel that you are able to add your consent to our sending the letter. I'd like a decision like this to be unanimous if at all possible… well, unanimous is a bit of a stretch… I guess I'm thinking that we should wait to send something like this until we have consensus about the underlying concepts even if not everyone can understand the technicalities nor be able to reproduce the mathematics.