Sustaining CCRCs in Difficult Times:
Focus on Board Governance and Leadership

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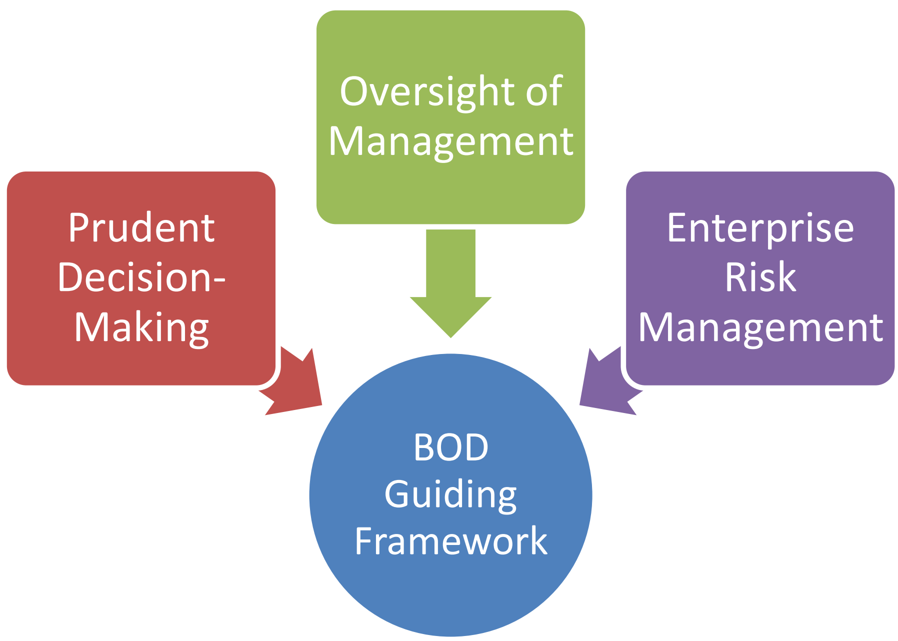
The foundation on which the long-term viability of a not-for-profit Continuing Care Retirement Community ("CCRC") is built is the quality of its board governance and leadership. While other factors (e.g. financial and operational performance) are important to a community's ongoing success, these are implicitly and explicitly guided by an engaged Board of Directors that lives by the guiding principles of a strategic framework. And here lies the problem, in times of economic pressure this strategic framework is unwittingly pitted against mounting demands on limited resources. The intent of this paper is twofold: (1) articulate this strategic framework and its application, and (2) to discuss its common threats.

Introduction and Application of the Strategic Framework

The challenge in articulating the framework is not in its complexity but in its application. As illustrated in the graphic below, the core principles of an effective Board of Directors' ("BOD") guiding framework include: Prudent Decision-Making, Oversight of Management and Enterprise Risk Management ("ERM").



PRUDENT DECISION-MAKING supports the board's responsibility for ensuring that the CCRC, as a not-for-profit organization, fulfills its obligations to all stakeholders (e.g., residents, creditors, donors, third-party payors, and community representatives). Three primary duties of board members are to (1) protect the CCRC's assets; (2) establish policy; and (3) determine strategic direction for the organization to achieve its mission. The board needs to be actively engaged in the strategy, planning, sustainability, and approval of any decision that may alter the mission or risk the organization's resources. These responsibilities require the board members to act at all times in the best interest of the organization.

OVERSIGHT OF MANAGEMENT is a key responsibility that obligates the board to determine if the Chief Executive Officer ("CEO") and other senior leadership team members are meeting the strategic and operational goals for the mission of the organization. The board delegates the management of daily operations to the CEO and is required to perform ongoing supervision and evaluation of this individual's leadership capabilities. Therefore, it is imperative that the board establish a level of accountability for the CEO and senior leadership to meet the organization's mission, goals and carry out board directives as instructed. The board should conduct periodic meetings to communicate expectations to the CEO and measure performance against goals and benchmarks through an annual written evaluation process.

Some CCRCs have faced tough decisions during the past three years because of declining occupancy or new risks associated with development projects. These difficult circumstances may have resulted in the need for a review of operating efficiencies, cost reductions and staffing analyses. The corrective action plans may have also called for drastic changes because the board did not have a mechanism in place to hold the CEO and management accountable for their actions. Situations such as these are unfortunate as the board needed to focus its attention on both internal personnel challenges and the financial and operational needs of the organization. This area remains a key concern among creditors and industry specialists in the senior living sector.

ENTERPRISE RISK MANAGEMENT is new concept to senior living; however, business leaders in many sectors embraced this model over a decade ago. The implementation of ERM requires the board and management to perform a full assessment of risks across the entire spectrum of the organization, including occupancy challenges (competition), cost of capital, reimbursement and payor mix, compliance, strategic planning and reporting. ERM involves adopting a risk management philosophy for determining how board actions and decisions related to the organization's existing resources are managed to sustain future growth. Ultimately, ERM acts as a method for the board and management to identify the organization's vulnerability for areas of risk and a means to improve strategic flexibility.

These critical principles play a significant role in the sustainability of the CCRC, as evidenced by key outcome measurements based on their performance over the last three years. The disruption in the marketplace cannot be ignored by boards and senior leadership teams. A greater emphasis is now placed on board governance by stakeholders and postponement of corrective action by a board can be a costly misstep for the organization, as shown by stakeholder pressure to improve operating and financial performance, the rise in lender forbearance agreements, and recent CCRC bankruptcy filings.

Under board direction, senior leadership is charged with allocating finite resources and delivering services in a cost-effective and efficient manner. Occupancy levels throughout all continuums of care must remain high to ensure positive cash flows and healthy net operating margins ("NOMs").

Strong financial performance allows the organization to build cash reserves and continually reinvest in its campus to successfully compete within the marketplace. A breakdown in any one of these components can result in the failure to sustain the long-term viability of a CCRC, especially in today's environment.

CCRCs that have adopted a strategic framework similar to the one described above have continued to successfully weather the recessionary storm of recent years. These high-functioning organizations have healthy balance sheets and strong leadership teams that use effective management tools to adapt to changing economic conditions. Board and management have a history of partnering together to revise core strategies and deploy necessary resources to improve the effectiveness of their operations. These organizations have:

- Maintained NOMs and built cash reserves above industry benchmarks, providing resources to consistently reinvest in property and plants;
- Maintained occupancy levels at or above 90% during the last three years;
- Routinely evaluated pricing and contract provisions for actuarial soundness; and
- Diversified revenues by development of transitional care units and home and community-based services, an earmark of a successful business model.

The economic strains of today's environment require a not-for-profit board to actively demonstrate its ongoing fiduciary role in oversight of management's decision-making, accountability, and evaluation of risks to the organization. The board member's duty to achieve the organization's mission for the benefit of its stakeholders is largely dependent on the long-term financial viability of the CCRC's operations. The inherent threats that continue to emerge in the marketplace challenge the board to meet its commitment to the organization, and test the board's ability to operate within the core principles of the framework.

In hindsight, some board members of these troubled communities would agree they did not have the proper framework in place to face the current economic environment and challenges that exist today. Although many organizations are aware of the warning signals associated with financial difficulty, procedures to identify areas where financial and operating issues may exist prior to trouble are not in place. The best practices presented in this white paper will enhance your organization's "safety net."

Management uses benchmarks as a metric to measure performance over a period of time. Benchmarks are typically reported for occupancy, net operating income and other statistics, including ratios, such as the Net Operating Margin ("NOM"), Liquidity (Days Cash on Hand), and Capital (Debt Service Coverage). The table below presents key ratios used in the senior living sector for high performers in the 75th percentile, under CARF-CCAC Accredited Organizations.

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[1] CARF-CCAC represents the Commission on Accreditation of Rehabilitation Facilities-Continuing Care Accreditation Commission, which is the accrediting body for CCRCs. The 75th percentile represent the 2010 amounts for single site providers as published in the 2011 Financial Ratios & Trends Analysis.

Benchmark	**What It Means?**	**75th Percentile**
Net Operating Margin (NOM)	Measurement for operational performance	12.20%
Days Cash on Hand (DCOH)	Days cash to cover operating expenses	524
Debt Service Coverage (DSC)	Ability to fund debt service with cash flow	3.58x
Average Age of Physical Plant	% of annual depreciation expense spent	11.5

Board members may elect to establish a reporting mechanism that requires an external third party review of operations if any of the ratios above deviates from the benchmark by more than 20% for a one-year reporting period. This self-reporting tool supports the board and management's risk assessment process and provides new information so that corrective action can be taken as early as possible, before conditions deteriorate and a problem persists.

Common Threat #1 – Important versus Urgent

Some not-for-profit CCRCs operating with limited resources and NOMs below industry benchmarks in today's economic conditions are faced with additional challenges: The convergence of capital reinvestment in older campuses, slow unit turnovers for independent living, and subpar NOMs place enormous pressure on boards and management. The liquidity demands are difficult when management is allocating resources to deferred capital improvements, multiple or deferred resident refunds from higher attrition rates, and routine operating expenses for the campus. These organizations rely solely on internal funding sources from working capital and investment reserves, due to limited access for new borrowings in the credit market and stricter underwriting standards. In addition, pressure from changes in consumer demands and market competition require boards and management to be nimble and move quickly in evaluating new revenue growth strategies to improve its position in the marketplace. How does senior leadership make the tough decisions to manage cash flows and determine whether a resident refund is paid or capital improvements are performed instead? The matter is exacerbated by the board's commitment to exercise its fiduciary duty and maintain financial oversight for the assets of the organization.

In addition to the ongoing capital required to operate in the senior living sector, many organizations have seen a rise in demand for reporting by various stakeholder groups. A greater need for transparency and information sharing exists now between CCRC board members, the senior leadership team, residents and creditors. For example, a technical debt violation may require monthly financial statements for the lenders with follow up conference calls to review operating statistics. Debt covenant violations resulting from changes in the economic conditions, for actual operating results compared to the forecasted plan, may also compromise the relationship between the leadership team and the lenders. Certain types of breaches in debt covenants require management consultant reports, causing an increase in outside professional services, management time and costs.

Many CCRC residents and representative committees are also requesting access to financial data and management meetings to understand operations, financial statements and monthly fee increases. This stakeholder group has a unique vested interest in their refundable entrance fees, especially with the rise in recent bankruptcy filings of CCRCs.

Most likely, the residents will want to understand if the current operating statistics are within acceptable industry norms and expect full explanations for operating budget deviations. ***The new demands for financial disclosure place additional burdens on the board and management to scrutinize both the types of reports and manner in which information is communicated to internal and external third parties.***

The complexities of operating in the senior living sector have grown more cumbersome with the changes over the last three years making board leadership critical to the future success of the organization. While the urgent demands of management must be understood by the board, they cannot supersede the importance of maintaining a strategic framework and setting a tone of stability in these difficult times and in the future.

COMMON THREAT #2: REFUNDABLE ENTRANCE FEE

The board and management are challenged by meeting future demands of the changing consumer to guarantee that occupancy levels remain stable, positive cash flows continue, and the organization serves its ongoing mission. Overall, the future success of the CCRC depends on the board and management's prudent planning and decision-making, policy guidelines and board oversight.

The Board of Directors has a stewardship responsibility for the assets it holds related to the refundable entrance fee contracts. Under the terms of the organization's residency agreement, the resident pays an entrance fee in exchange for the right to live at the CCRC and use the campus amenities. Both the board and management share the obligation of safeguarding entrance fees as resources and the existing residents are provided a lifestyle which meets changing health needs and promotes wellness.

The most popular type of CCRC resident contract is the refundable entrance fee agreement, typically with a limited assisted living or health care benefit. Most CCRCs with these contracts are permitted to use the entrance fee proceeds for operations, debt service, capital improvements, and working capital (any unrestricted purpose, including investments). Some debt financing structures associated with the original construction of the CCRC campus allowed the first generation resident entrance fees to be used as a pay down for the principal portion of the bonds, which impacted the amounts available for resident refunds. In addition, a few states have statutory entrance fee reserve requirements that require a portion of the entrance fee proceeds be set aside from the organization's operating funds.

The CCRC's finance department tracks the entrance fee information by documenting the ILU number, resident name, occupancy date, vacancy date, turnover, and resident movement through the continuum of care. CCRCs also engage actuarial firms to assist in projecting resident health care service usage to estimate future ILU turnover and average length of stay for assisted living and skilled care in the health center. The summary reports prepared by the finance department are shared with management to communicate census, ILU turnover statistics, and entrance fee proceeds and refund obligations. This information is valuable for providing key indicators to the CCRC's operations and marketing departments.

The financial information related to entrance fees is reported in the financial statements each month as "*deferred revenue from refundable entrance fees,*" a portion classified as current liabilities to indicate the estimated amount that will be refunded in the next 12 months to residents moving out of the community whose units have/ or will be reoccupied.

The remaining amount is classified as a long-term liability to designate the deferred liability for refundable entrance fees due to residents. CCRCs are required to conform to financial reporting standards issued by Generally Accepted Accounting Principles (GAAP).

Current entrance fee refund obligations may become a disclosure issue when CCRC residents move through the continuum of care (a resident transfers from ILU to the health center) and their apartment or townhouse is reoccupied. Under the contract terms outlined previously, the organization is not required to refund the entrance fee until the resident has met all the criteria. When a former ILU resident transfers to the health care center and their unit is resold, the organization *now has two refunds due for the same ILU*. If the cash from the entrance fee proceeds is not set aside in a separate account for the health center resident, but instead is used by the organization for another purpose, the entity has an obligation for two refundable entrance fees. The immediate repayment of the refund for the health center resident, assuming a life expectancy of less than 12 months, will need to be funded from the organization's existing cash reserves.

For accounting purposes, the finance department records the amount in the deferred revenue from entrance fee liability account and includes it in the current liability section of the financial statements. However, the refunds due to health center residents should be specifically segregated or referenced with a footnote on the reports distributed to third parties. Readers of the financial statements will understand the current obligations owed for entrance fee refunds if these amounts are segregated or a separate footnote explains the current resources available to pay the health center refunds. ***This recommendation is considered a "best practice" for financial disclosure purposes. A final accounting and summary report of the health center refund obligations should be shared on a quarterly basis with the Board of Directors.***

For budget and forecasting purposes, the organization should also include an assumption for entrance fee refunds due to health center residents, in addition to the estimated refunds paid for ILU turnovers. This type of refund item maybe overlooked during the annual budget process.

COMMON THREAT #3: CAPITAL IMPROVEMENT RESERVES

The Board of Directors' financial oversight includes direct involvement in the review and approval of the organization's operating and capital budgets. A key ingredient to the ongoing success of a CCRC is its ability to reinvest in the property and plant. The modernization of the campus serves two purposes: (1) the board and management "promised" its residents a community with continuous wellness and quality of life. A fulfillment of this promise requires updating the campus buildings, grounds and amenities; and (2) many providers recognize the importance of maintaining a competitive position in the marketplace, and cannot risk a future decline in occupancy levels.

Senior living providers also recognize the importance of allocating resources to reposition their campuses to ensure the long-term viability of the organization. Organizations that proceed with changes to the footprint of their existing campuses usually continue down this path after a lengthy master planning process that involves multiple financial feasibility studies and risk analyses. The board and management have a responsibility for stewardship of the entrance fee assets received when the existing residents moved in, and the overall allocation of the organization's current and future resources. The board's final decision should be a result of prudent planning and fiscal discipline with the ability to reframe competing demands in a synchronous way, meeting the obligations with creativity governed by accountability.

Many CCRCs engage a qualified engineering firm or independent building consultant to perform an assessment study of their campus buildings and systems. The study is used to prepare a 20- to 30-year Capital Replacement Plan (CRP). The organization uses the CRP to determine the amount of capital improvements for annual budgeting and long-term forecast purposes. ***The CRP method is considered a "best practice" in the senior living industry, as it provides a management tool for anticipating future capital improvement needs.***

Certain organizations practice stricter financial discipline by funding the current year's depreciation expense. This funding method is a process that requires a separate board-designated reserve account to segregate cash for future capital improvements. The cash reserves are considered unrestricted for calculating the DCOH ratio under most lender covenants; however, the establishment of a separate reserve account provides a method for management to follow under the framework established by the board.

Some organizations follow the Commission on Accreditation of Rehabilitation Facilities-Continuing Care Accreditation Commission (CARF-CCAC). CARF-CCAC published an Average Age of Facility Ratio of approximately 11.5 years as the median for accredited communities in its 2011 Financial Ratios & Trend Analysis Book. The ratio is a measurement of the capital investment made by the community as compared to annual depreciation expense. Communities should be striving for less than 11.5 years, since the ratio is a key indicator of the modernization efforts made by an organization.

Communities that have postponed capital improvements in the past few years because of a decline in occupancy levels and tighter cash flows have difficult choices. Management will not be able to fulfill its commitments to the existing resident population with new amenities and attract new residents to fill the ILUs. Deferred capital expenditures may result in life/safety issues to the existing residents, noncompliance with state licensure requirements, along with costly replacements, instead of routine maintenance expenses. Organizations are not required to maintain capital improvement reserves; however, stakeholders may not be aware the campus has contingent liabilities for deferred capital costs unless management discloses this situation. This situation is a significant risk management issue for the board and jeopardizes the current and long-term financial viability of the organization.

The senior living sector publishes market data on future consumer expectations for CCRCs, increasing the pressure and demands for many boards and management to look beyond existing campus renovations. Organizations that allocate resources to new expansions and development plans and *exclude or postpone* capital improvements to their primary campus buildings risk a decline in future occupancy levels and deterioration in their NOM. The ongoing success of the primary campus is based on the board and management's commitment to its current residents to maintain an updated building with amenities that can be continuously remarketed to future residents. The board and management's stewardship extends beyond the current residents to continue its charitable mission to serve future residents of the community.

Organizations facing financial challenges may also be under intense pressure to improve financial performance, including the DCOH ratio. The annual capital improvement budget is one area scrutinized for additional liquidity resources, since management controls the timing of these expenditures. Board members and the leadership team should be cautioned on the implications of deferring necessary capital repairs and replacement to the campus plant, as the consequences may pose a greater risk in the future.
In addition, the postponement of capital funding only mask the symptoms of a much deeper financial issue for the entire organization, and will be easily detected during a full read of the financial statements.

Board and management should carefully evaluate any capital deferrals, assess the associated risks, and disclose their plans to the stakeholders of the organization to ensure the highest level of transparency.

CONCLUSION

The economic and environmental threats that are present today pose greater challenges to the CCRC's long-term viability than at any other time in the history of CCRCs. A sustainable CCRC is dependent upon the framework that the board members incorporate to ensure prudent decision-making, Enterprise Risk Management and oversight in their fiduciary capacity as they act in the best interests of its stakeholders. An engaged board performs consistent review and analytics of operations with management to test the NOM, update its ongoing strategic plan, identify risks to the organization, and constantly asks the right questions. When the board and management's decisions step away from these guiding principles, it compromises the organization's mission, vision and values. More importantly, it demonstrates the board's failure to recognize its commitment to the residents and other stakeholders.

Joan Lampe has over 25 years of experience in the Senior Living and Finance industries, including health care, long-term care, and management companies, spanning not-for-profit and for-profit organizations. Ms. Lampe is the owner and principal consultant of a firm specializing in financial models, operations analysis, and providing senior financial executive services to Continuing Care Retirement Communities (CCRC). She collaborates with boards, management, and creditors to create solutions and execute business strategies that align goals and outcomes for all involved parties. Her past experience includes Chief Financial Officer position for two multi-site CCRCs. She was a member of the Financial Advisory Panel of the Continuing Care Accreditation Committee's Policy Committee for six years. Ms. Lampe has a Bachelor of Arts in Business Administration from Baldwin Wallace College and is a Certified Public Accountant.

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