

Are You Prepared to Address the Auditor's Concerns?

by Jeff Goolsby, CPA

June 11, 2009

Senior housing providers are keenly aware of the challenges of the current economy and declining real estate market. Wait lists are being depleted, new residents are slow to commit, and average occupancies have declined. Additionally, once promising investments have sustained significant losses from depressed financial markets, and the credit markets have seemingly "closed shop" resulting in a lack of options for new financing or extending existing financing. With revenues and cash reserves declining, board members and management teams alike are working longer and harder to make critical marketing and operational decisions. Senior housing providers have seen the impact of these items on the reported operating results; but, have you considered the impact on your annual audit?

Potential Impacts

Tough economic times and declining operations generally result in increased audit and fraud risks. As a result, your auditor may expand testing, increase inquiries, and request additional cash flow information. Moreover, professional standards require the auditor to evaluate your financial results and other information to determine if conditions are present to indicate one or more of the following:

Condition	Description
Asset Impairment	Impairment is the condition that exists when the carrying amount of a long-lived asset (e.g. property and equipment) exceeds its fair value based on the undiscounted cash flows expected to result from the use and eventual disposal of the asset. The enterprise's management, not the auditor, is responsible for determining these estimated cash flows. If impairment has occurred, a loss is recorded directly to the statement of operations.

Other Declines In Value	<p>Generally, when an item is recorded at fair value, a decline in fair value is recognized as an unrealized loss in the statement of operations. A realized loss would be recognized if a decline in value is anticipated to be permanent.</p>
Debt Covenant Violations	<p>A number of unanticipated problems with debt agreements have occurred as bond trustees and lenders have been more diligent in following the agreement provisions (e.g. misinterpretation of financial covenants and reporting deadlines). In addition, the difficult operating environment has caused some providers to violate financial covenants of their debt agreements. A violation of a debt covenant may impact its balance sheet classification from long-term to current.</p>
Special Issues For Continuing Care Retirement Communities ("CCRCs")	<p>CCRCs must evaluate whether there is an estimated obligation to provide future services (i.e. the present value of advanced and periodic fees are insufficient to meet the costs to provide future services). The calculation is negatively impacted by declining occupancies, aging in place, and rising healthcare costs. A loss would be recognized in the statement of operations in the event of a forecasted liability.</p> <p>Additionally, Florida Statutes Chapter 651 requires CCRCs to fund a minimum liquid reserve. Funds held in reserve, not available for operations, may impact the auditor's view of the liquidity of the enterprise.</p>
Going Concern	<p>The auditor is required to evaluate whether there is substantial doubt about the enterprise's ability to continue as a going concern for at least one year beyond the balance sheet date. Substantial doubt occurs when there is a likelihood that the enterprise cannot continue to meet obligations as they become due in the absence of substantial disposition of assets outside the normal course of business, restructuring of debt, or externally forced revisions of operations. The auditor is required to obtain management's plans to mitigate the effect of such conditions and assess the likelihood that such plans can be effectively implemented. In the event that the auditor determines that substantial doubt exists, the audit opinion will be modified to include an explanatory paragraph and footnote wording will be added to explain the condition.</p>

Your Response

1. **Understand that many of these considerations are a matter of professional judgment and your input matters.** Contact your auditor in advance to understand their concerns. Perform your own assessment of the financial condition of your enterprise and specific assets. If you believe that a question may be raised, prepare a cash flow projection using your assumptions to support your conclusions. Be prepared to discuss any mitigating factors that should be considered.

Example: Many enterprises have development and expansion projects underway that have now been placed on hold. Expect your auditor to ask how these costs are to be justified with no immediate cash flows to be generated. Update your project forecast to include the impact of the delay. Segregate costs to identify those that are subject to expiration or that are project specific versus those costs that are transferrable to a new or amended concept. Thus, if a change in plans is made or the project continuance is delayed, you may not have a total loss.

- 2. Be pro-active with respect to debt covenant issues, maturities of long-term debt, and letters of credit.** Start the process early to obtain renewals and waivers. Be prepared to discuss with your auditor and disclose to the public the impact if you are not able to renew or replace a debt instrument. Review your debt covenant calculations to ensure they are consistent with the debt instrument, and schedule the audit to allow sufficient time to meet the required timeframes. Also, consider whether any commitment letters for funding can be obtained.
- 3. Consider voluntary disclosures to provide additional information to financial statement users.** Consider adding language which addresses management's plans to improve operating results if the year-end "snap-shot" is not a fair representation of the health of the enterprise. This disclosure may include marketing efforts, cost-cutting initiatives, and the status of financing negotiations.

Conclusion

In light of the current economic conditions, senior housing providers may find the auditors asking questions about your operations that have never been asked before. By anticipating these questions and developing your own conclusions, you will be well prepared to address your auditor's concerns.

OFFICE LOCATIONS

Tampa Area

311 Park Place Boulevard, Suite 100
Clearwater, FL 33759
Tel: 727.531.4477
Toll Free: 800.929.2981
Fax: 727.538.2154

Orlando

1201 South Orlando Ave, Suite 400
Winter Park, FL 32789
Tel: 407.740.5400
Toll Free: 800.683.5401
Fax: 407.740.0012

Miami Lakes

14400 NW 77th Court, Suite 306
Miami Lakes, FL 33016
Tel: 305.819.9555
Toll Free: 800.726.1735
Fax: 305.819.9955

Tallahassee

307 West Park Ave., Suite 202
Tallahassee, FL 32301
Tel: 850.224.4407
Toll Free: 877.408.0753
Fax: 850.222.3044

Macon

577 Mulberry Street, Suite 500
Macon, GA 31201
Tel: 478.474.5401
Fax: 866.253.3452