



New M&A accounting rules for not-for-profit entities

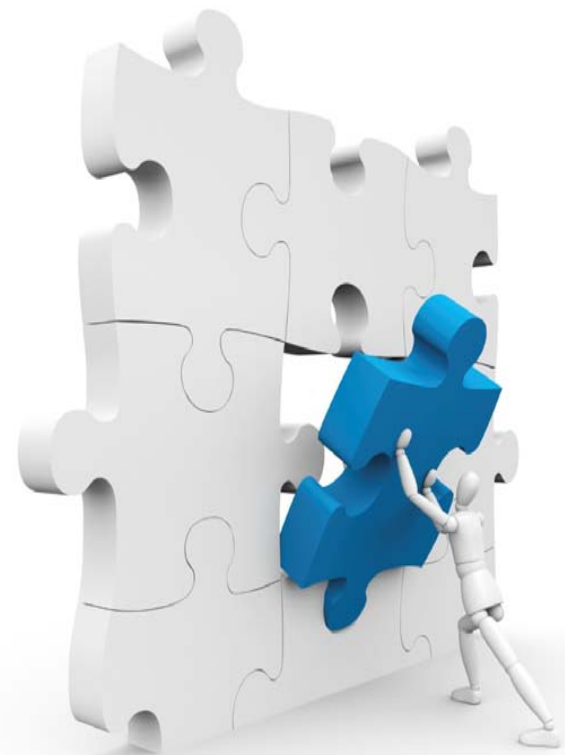
What not-for-profit buyers need to know about the changing landscape

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NFP hospital market overview



NFP hospital market overview

- Not-for-profit (“NFP”) hospitals are a large part of the health care system
 - NFP hospitals account for approximately:
 - 85% of all acute care hospitals in the U.S.
 - 60% of all community hospitals in the U.S.
 - 51% of all registered hospitals in the U.S.
- NFP systems are active in the health care M&A market
 - Of the 597 hospital mergers and acquisitions that occurred over the 10 years ending December 31, 2009:
 - 286 or approximately 48% involved NFP buyers
 - 359 or approximately 60% involved NFP sellers

NFP hospital market overview

- M&A outlook
 - Given the current operating environment, the struggles of many community hospitals, and limited access to credit markets, there appears to be a greater appetite for deals
 - Add to this the larger NFP players that still have access to capital, as well as recent private equity backing in the space, there's an indication of greater consolidation on the horizon
 - Some consolidations of hospital sites and specialties offered at specific sites are expected due to:
 - High levels of under-used bed capacity
 - Continuing shift (albeit slowing) of services to ambulatory settings
 - Increasing scrutiny of consumers in comparing the standards and capabilities of hospitals
 - While some of the major national for-profit groups will grow their portfolios (including through acquisitions and joint ventures with not-for-profits), others will consolidate their own portfolios (i.e. sell off unprofitable hospitals)

Key aspects of SFAS 164



Key aspects of SFAS 164

- Purpose and objective
 - Statement of Financial Accounting Standards No. 164 (“SFAS 164”) establishes principles and requirements for NFP mergers and acquisitions, which were specifically scoped out of SFAS 141/141(R)
 - Determines whether a combination is a merger or an acquisition
 - Applies the carryover method of accounting to a merger and the acquisition method of accounting to an acquisition
 - Identifies which entity is the acquirer in an acquisition
 - Described financial statement disclosures for mergers and acquisitions
 - Replaces the use of APB Opinion No. 16, Business Combinations (“APB 16”)
 - Takes into account the unique features of NFP entities and combinations
- Effective date
 - Transactions occurring on or after the beginning of the initial/annual reporting period beginning on or after December 15, 2009
 - i.e. transactions occurring within fiscal year ends of December 15, 2010 or later

Key aspects of SFAS 164 (cont.)

- Scope
 - Includes transactions that both:
 - Result in an NFP entity recognizing another NFP business or NFP activity in its financial statements; and
 - Meet the definition of a merger of NFP entities or an acquisition by an NFP entity
 - Excludes:
 - Joint ventures
 - Acquisitions of assets that are neither a business nor an NFP activity
 - Combinations of entities under common control
 - Transactions that result in control but not consolidation
 - As permitted or required by SOP 94-3 or AICPA Audit and Accounting Guide: Health Care Organizations (“AICPA Health Care Guide”) — such as control resulting from a contract or an affiliation agreement.
 - A for-profit’s acquisition of an NFP entity

Distinguishing between a merger and an acquisition



Distinguishing between a merger and an acquisition

- Merger
 - Governing bodies of two or more NFP entities cede control of those entities to create a new NFP entity
 - Ceded control requires that merging entities not retain shared control of the new entity, but rather, the entity must have a newly formed governing body
 - New entity often is, but need not be, a new legal entity
 - Determining whether a merger occurred requires assessing the characteristics of:
 - The process leading up to the combination
 - The participants of the combination
 - The combined entity
- Acquisition
 - NFP entity obtains control of one or more NFP activities or businesses; and
 - NFP entity initially recognizes the acquiree's assets and liabilities in its financial statements

Distinguishing between a merger and an acquisition (cont.)

The participating entities should consider all characteristics and other pertinent factors (e.g. governance and related control powers, financial capacity, etc.) and, based on the preponderance of the evidence, make a professional judgment of whether a combination is a merger or an acquisition

Merger	Acquisition
<ul style="list-style-type: none">• No one entity dominates the negotiation and process leading up to the formation of the new entity• Creators of the merged entity cease to exist as autonomous entities• Assets are combined, with no cash or assets transferred to owners, members, sponsors or other beneficiaries• No one entity is disproportionately stronger financially than the others• Integrates the bylaws, operating policies and practices of all entities	<ul style="list-style-type: none">• The acquirer often dominates the negotiations and terms of the transaction• Acquirer has a disproportionate board representation<ul style="list-style-type: none">• Acquirer retains more key officers• Acquirer's bylaws, operating policies and practices are substantially unchanged<ul style="list-style-type: none">• Acquirer is financially stronger• Acquiree is in financial distress• Acquirer is substantially larger in terms of revenue, assets or net assets

Accounting for a merger



Accounting for a merger

- Carryover method
 - Combines assets and liabilities of the historical entities at the same historical basis
 - No recognition of additional asset and liabilities such as intangible assets
 - Adjustments occur if one of the entities historically has not followed GAAP
 - Adjustments occur to reflect a consistent method of accounting
 - However, it does not allow for the election of one-time accounting options (e.g. the fair value option) for items that are restricted to the entities' initial acquisition or recognition of them
 - Eliminate the effects of any intra-entity transactions
- Presentation
 - Initial reporting begins with the merger date
 - Report activity from the merger date through the end of the initial reporting period

Accounting for a merger (cont.)

- Disclose information that enables users to evaluate the nature and financial effect of the merger including:
 - Name and description of each merging entity
 - Merger date
 - Primary reason for the merger
 - The opening balance sheet
 - Significant assets and liabilities that GAAP does not require to be recognized (e.g. conditional promises)
 - The nature and amount of significant adjustments to conform accounting policies or eliminate intra-entity balances
 - Public entities need to include pro forma information:
 - if the merger occurred other than at the beginning of the annual reporting period, or
 - if comparative information is shown

Accounting for an acquisition — The acquisition method



Accounting for an acquisition — The acquisition method

- Though similar to SFAS 141(R), the acquisition method for SFAS 164 includes items unique to an NFP entity, including non-recognition of goodwill for particular acquirees
- Acquisition of assets that are neither a business nor an NFP activity are accounted for as an asset acquisition
- Determine the acquirer
 - Health care acquirers follow guidance in chapter 11 of the AICPA Health Care Guide, based on the entity who demonstrates control
 - Voting control and economic interest must be considered
 - In cases where control obtained through contract or affiliation agreement, consolidation is permitted but not required
 - In cases where control is only temporary, consolidation is prohibited
 - Also consider guidance in ARB 51 and possibly other factors described in SFAS 164 (par. A39–A44)

Accounting for an acquisition — The acquisition method (cont.)

- Determine the acquisition date
 - The date that acquirer obtains control
 - Closing date, or
 - A date prior to the closing date if a written agreement provides for control prior to closing
- Measurement period
 - If acquisition accounting is incomplete by the end of the reporting period, the acquiring NFP entity records provisional amounts
 - Adjustments to provisional amounts to reflect new information that, if known on the acquisition date, would have affected the measurement of the amounts must be recorded retrospectively back to the acquisition date
 - Measurement period ends as soon as the acquirer receives information it was seeking about the facts and circumstances as of the acquisition date or learns no additional information is available
 - Measurement period should not exceed one year
- Acquisition costs are expensed as incurred

Accounting for an acquisition — The acquisition method (cont.)

- Identifiable assets acquired, liabilities assumed, and any non-controlling interest are recognized and measured at fair value
- Disclosure information that enable users to evaluate the nature and financial effect of the acquisition include:

- Name and description of the acquiree
- Acquisition date
- Ownership interest
- The primary reason for the acquisition and how the acquirer obtained control
- Qualitative description of the factors that make up goodwill recognized or the separate charge to the statement of activities
- Fair value and type of consideration transferred (cash, contingent consideration, other tangible or intangible assets transferred)
- Details around contingent consideration or indemnification assets including:
 - Amount recognized as of the acquisition date
 - Description of the arrangement and basis of the payment
 - Estimate of range of outcomes (undiscounted)
- The amounts recognized as of the acquisition date of each major class of assets acquired and liabilities assumed.
- Nature and amounts of any contingencies recognized
- The amount of goodwill that is expected to be deductible for income tax purposes, if applicable
- If the acquisition resulted from an inherent contribution, a description of the reasons for the inherent contribution
- Fair value of any non-controlling interest including a description of the valuation technique(s), if applicable
- If the acquirer is a public entity
 - Revenues, performance indicators, changes in net assets attributable to the acquiree since the acquisition date
 - Supplemental pro forma information as though the acquisition occurred at the beginning of the reporting period

Accounting for an acquisition — Recognition



Accounting for an acquisition — Recognition

- Identifiable assets acquired and liabilities assumed
 - Acquired assets and assumed liabilities are recorded at fair value
 - Includes recognition of identifiable intangible assets (e.g., trade names, non-compete agreements, internal use software, licenses/CONs, etc.)
 - An intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion
 - The separability criterion means that an acquired intangible asset is capable of being separated or divided from the acquiree and sold, transferred, licensed, rented, or exchanged, either individually or with a related contract, identifiable asset, or liability
 - An intangible asset that meets the contractual-legal criterion is identifiable even if the asset is not transferable or separable from the acquiree or other rights/obligations

Accounting for an acquisition — Recognition (cont.)

- Exceptions to the recognition principle:
 - No recognition of donor relationships as an identifiable intangible asset
 - No recognition of collections if entity has an accounting policy of not capitalizing collection items
 - Collections are works of art, historical treasures, or similar assets held for public exhibition, education, or research to further public service rather than financial gain
 - Recognition of conditional promises only if conditions are substantially met as of the acquisition date

Accounting for an acquisition — Recognition (cont.)

- Goodwill acquired
 - Goodwill is recorded in acquisition accounting unless the operations of the acquiree are expected to be predominantly supported by contributions or returns on investments (as opposed to revenues and fees in exchange for services provided in a traditional “business”)
 - Goodwill is calculated as:
 - The consideration transferred, plus
 - The fair value of any non-controlling interest in the acquiree, plus
 - The fair value of any previously held equity interest, less
 - The net amount of identifiable assets acquired and liabilities assumed

Accounting for an acquisition — Recognition (cont.)

- Goodwill acquired (cont.)
 - When operations of the acquiree are expected to be predominantly supported by contributions and returns on investments, the amount that would be capitalized as goodwill is expensed as a separate charge to the statement of activities
 - “Predominantly supported” means that contributions and returns on investments are expected to be significantly more than the total of all other sources of revenue
 - Acquirers within the scope of the AICPA Health Care Guide report charge to the statement of activities within the performance indicator
 - For acquisitions with no consideration transferred, the excess of liabilities assumed over assets acquired is recorded as:
 - Goodwill, or
 - Separately charged to the statement of activities when the acquiree’s operations are expected to be predominantly supported from contributions or investment returns
 - Acquirers within the scope of the AICPA Health Care Guide report charge to the statement of activities within the performance indicator

Accounting for an acquisition — Recognition (cont.)

- Contribution received
 - Acquirer records the amount of assets acquired and liabilities assumed in excess of the fair value of consideration transferred, non controlling interest in the acquiree, and previously held equity interest as a contribution within the statement of activities (rather than as a “bargain purchase” or “negative goodwill”)
 - Acquirers within the scope of the AICPA Health Care Guide report contributions received depending on whether the contribution is unrestricted or restricted:
 - Unrestricted — fair value of unrestricted net assets is reported within the performance indicator
 - Temporary or permanently restricted — fair value of restricted net assets is reported outside the performance indicator

Accounting for an acquisition — Recognition (cont.)

	Consideration transferred	No Consideration		Acquiree activities supported by contributions or investment returns
		Assets acquired exceed liabilities assumed	Liabilities assumed exceed assets Acquired	
Consideration transferred, fair value	1,200	-	-	1,200
Non-controlling interest, fair value	-	-	-	-
Previously held equity interest, fair value	-	-	-	-
Total consideration	1,200	-	-	1,200
Assets acquired, fair value	1,200	1,200	1,200	1,200
Liabilities assumed, fair value	(400)	(400)	(1,400)	(400)
Net assets acquired, fair value	800	800	(200)	800
Financial statement reporting				
Goodwill	400	-	200	-
Charge to statement of activity	-	-	-	400
Contribution — Credit to statement of activity	-	800	-	-

Transition guidance



Transition guidance

- Upon adoption
 - Assets and liabilities that arose from mergers or acquisitions whose dates preceded the application of SFAS 164 shall not be adjusted, except for the following balances determined under APB 16 purchase method:
 - Previously recognized goodwill
 - Previously recognized intangible assets
- Previously recognized goodwill
 - An entity that is not predominantly supported by contributions and returns on investments shall:
 - Establish reporting units on the basis of the guidance in SFAS 142, and
 - Subject previously recognized goodwill in each reporting unit to the transitional impairment evaluation required by SFAS 142
 - An impairment loss recognized as a result of a transitional goodwill impairment test shall be recognized as the effect of a change in accounting principle
 - An entity that is predominantly supported by contributions and returns on investments shall write-off previously recognized goodwill by a separate charge in the statement of activities

Transition guidance (cont.)

- Previously recognized intangible assets
 - An entity shall reassess the useful lives of finite-lived intangible assets using SFAS 142 and adjust the remaining amortization periods as necessary
 - An entity shall test indefinite-lived intangible assets for impairment using SFAS 142; any impairment loss shall be recognized as the effect of a change in accounting principle

Transition guidance (cont.)

- Transitional and annual SFAS142 goodwill impairment testing is a two-step process
 - Step 1: Value the reporting unit
 - Estimate the fair value of the reporting unit using the most appropriate methodology given the nature of the reporting unit;
 - Compare fair value of the reporting unit to its carrying value; and
 - If carrying value exceeds fair value, perform Step 2 of the goodwill impairment test
 - Step 2: Calculate the goodwill impairment
 - The fair value of goodwill is determined in the same manner as the amount of goodwill recognized in a business combination under SFAS 141(R), that is:
 - The Step 1 fair value of the reporting unit is allocated to all of the assets and liabilities of that unit; and
 - The excess of the fair value of the reporting unit over the amounts assigned to the net assets represents the fair value of the reporting unit's goodwill
 - The amount by which the carrying amount of goodwill exceeds the fair value is recognized as an impairment loss

Nuances of SFAS 164



Nuances of SFAS 164

- “Contribution received” versus “bargain purchase”
 - An NFP acquirer may acquire another NFP activity or business for an amount less than the fair value of the assets acquired and/or the liabilities assumed, particularly if there is no consideration transferred
 - An NFP acquirer shall recognize the excess value of net assets acquired over consideration transferred (including fair value of non-controlling interest) as a separate credit in the acquirer’s statement of activities as of the acquisition date
 - Under APB 16, value assigned to net assets acquired could not exceed consideration transferred and any such excess was to be allocated to reduce proportionately the values assigned to non-current assets (except long-term investments in marketable securities)

Nuances of SFAS 164 (cont.)

- Treatment of excess purchase price
 - An NFP entity shall apply SFAS 142 in subsequently accounting for goodwill and other intangible assets recognized in an acquisition
 - Introduces the concept of indefinite-lived intangible assets, which are not amortized but tested periodically for impairment
 - Provides guidance on the process for determining goodwill or other finite- and indefinite-lived intangible assets
 - In addition, SFAS 164 requires that the excess purchase price over the assets acquired and liabilities assumed of NFP entities primarily supported by contributions or investment returns is recorded as a separate charge to the statement of activities and not established as goodwill
 - Under APB 17, goodwill and identified intangible assets recorded in a combination were amortized on the basis of estimated useful life, which could not exceed 40 years

Nuances of SFAS 164 (cont.)

- Contingent consideration
 - Contingent consideration is recorded at fair value, regardless of the likelihood of payment, and classified as either an asset or a liability
 - Changes in fair value after the initial measurement but during the measurement period as a result of additional information and circumstances are recorded as a reduction of goodwill or charge to statement of activities (as applicable)
 - Changes in fair value resulting from events after the acquisition date are recorded as a charge in the current statement of activities
 - Under APB 16, contingent consideration was to be recorded when the contingency was resolved and consideration was issued or became issuable

Nuances of SFAS 164 (cont.)

- Defensive assets
 - An intangible asset acquired in a business combination or an asset acquisition that an entity does not intend to actively use but does intend to prevent others from using, is commonly referred to as a "defensive asset"
 - While the asset is not being actively used, it is likely contributing to an increase in the value of other assets owned by the entity
 - Pursuant to SFAS 141(R), an intangible asset must be recognized at fair value in accordance with SFAS 157, regardless of how the entity intends to use that asset
 - See EITF Issue No. 08-7, "Accounting for Defensive Intangible Assets"

Implications for the CFO



Implications for the CFO

- Expect more volatility in financial statements and related performance indicators
- Understand the impact on financial statements and cost reports
- Educating users of financial statements
 - Boards
 - Creditors
 - Rating agencies
 - IRS
- Preparing and training staff
- Working with auditors and valuation consultants
- Additional analysis required related to the transition provisions for not-for-profit entities with existing goodwill and intangible assets in a purchase accounted for under APB Opinion No. 16 related to the transitional impairment tests and useful-life analyses in accordance with SFAS 142

Implications for the CFO (cont.)

- Recognizing importance of pre-transaction due diligence
 - For-profit systems have struggled with determining fair value of acquired and existing assets under SFAS No. 141/141(R)
 - Consequences of overpaying
 - Buyer-specific attributes
 - Importance of valuation assumptions and transaction terms
 - Importance of knowing your target's business, future prospects and projections, operating risks, etc.

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