



Hospital/Healthcare Valuation and ASC 958-805: Not-For-Profit Mergers and Acquisitions

Approximately 58%¹ of hospitals and health systems in the United States operate as not-for-profits, whereby all revenues are utilized in pursuing the organization's objectives as opposed to owner distribution. As the volume of consolidations within the industry continues to accelerate, a thorough understanding of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 958 and valuation issues unique to healthcare are critical. Since tangible assets (in particular the real estate) often make up the bulk of the assets for not-for-profit health systems, this article will primarily focus on valuation issues specific to hospital real estate – though intangibles and equipment will also be touched upon.

There are several important factors that should be considered when it comes to healthcare valuation. This is largely due to the ever-changing regulatory environment, advancements in healthcare technologies and procedures, changing market demands, and political influence.

In recent years, several changes have occurred that significantly affect the way hospitals and other healthcare facilities should be valued.

Some of these changes include the following;

- The implementation of ASC 958-805: Not-for-Profit Mergers and Acquisitions (previously codified as FASB 164)
- Changing market demands and the creation of new building standards and codes by the Joint Commission on Accreditation of Healthcare Organizations (JCAHO) and the American Institute of Architects (AIA)
- The passage of The Patient Protection and Affordable Care Act and the potential impact that this and other current political issues, such as the federal budget crisis, will have on the performance of the healthcare industry

Each of these areas will be discussed in more detail on the following pages.

FASB ASC 958-805

In January of 2010, FASB issued Accounting Standards Update No. 2010-07, which recodified FASB Statement 164 to ASC 958-805. According to FASB the purpose of this statement is to: “Improve the relevance, representational faithfulness, and comparability of the information that a not-for-profit entity provides in its financial reports about a combination with one or more other not-for-profit activities.”

The main provisions of this standard are that it:

1. Determines whether a combination is a merger or an acquisition
2. Applies the carryover method in accounting for a merger
3. Applies the acquisition method in accounting for an acquisition, including determining which of the combining entities is the acquirer
4. Amends ASC 350 (formerly FASB 142): Goodwill and Other Intangible Assets to make it fully applicable to not-for-profit entities

ASC 958-805 essentially makes the financial reporting requirements for for-profit mergers and acquisitions (via ASC 805: Business Combinations) applicable to those of not-for-profit entities. Prior to this statement, the financial reporting requirements for combinations of not-for-profits was much less stringent and complex. Both ASC 805 (formerly FASB 141r) and ASC 958-805 are based on the premise of Fair Value accounting, which is considered to be more detailed, current, and comprehensive than cost-based accounting. Further, Fair Value accounting is reflective of a market value (exit price) and takes into consideration the highest and best use of an asset. This move toward Fair Value accounting has increased the need for qualified and experienced valuation professionals in the financial reporting arena.

According to ASC 958-805, the accounting requirements differ depending on whether a combination of a not-for-profit entity is a merger or an acquisition. As previously mentioned, in the case of a merger, the carryover method is used; and in the case of an acquisition, the acquisition method is used. Each method is briefly discussed in the following paragraphs.

A merger occurs when the governing bodies of the combining entities cede control and, in turn, create a new governing body that will control the newly combined entity. When this is the case, the carryover method of accounting is used. This method involves the combination of the book values of the assets and liabilities of the merging organizations as of the merger date. The main change that this makes in accounting for not-for-profit mergers is that prior to ASC 958-805, the merged entity was required to report their combined operations retroactively rather than from the merger date forward. The requirements of accounting for acquisitions are more complex. Additionally, when an acquisition takes place, it may be difficult to determine which of the combining entities is the acquirer. Therefore, identification of the governing party requires consideration of all aspects of the combination, particularly the ability of one entity to control the selection of the combined entity’s governing board. Once the acquirer is determined, the value of the acquired entity must be determined via the following steps.

1. All assets and liabilities must be inventoried. This may involve searching for additional items of value that were not previously included on the acquiree’s financial statements.
2. The Fair Value of each asset and liability must be determined based on the framework outlined in ASC 820: Fair Value Measurement.
3. If the sum of the Fair Value of the assets is greater than the transaction consideration, the acquirer recognizes contribution income.

3. (CONT) Conversely, if the transaction consideration exceeds the Fair Value of the assets acquired, the accounting differs depending on whether the acquiree's operations are expected to be primarily supported by contributions and return on investment or by revenues in exchange for services provided or goods exchanged. Healthcare facilities fall into the latter category and in this case the excess is recorded as goodwill.

Because ASC 958-805 amends ASC 350 to make it applicable to not-for-profit entities, opening balances for goodwill and intangible assets and annual testing for impairment is now necessary. This is a significant change in the financial reporting requirements of not-for-profits and increases the need for careful valuation of both tangible and intangible assets. In the case of not-for-profit hospitals, intangible assets may not be material. Nevertheless, they should be considered. Example categories of intangible assets common in healthcare are:

- Certificate of Need (CON) and/or License
- Essential documents
- Technology and software
- Noncompete agreements
- Contracts
- Practices and procedures
- Goodwill

It is important that not-for-profit healthcare facilities comply with these recently imposed requirements. Noncompliance can hurt healthcare organizations in a number of ways, including hindering their ability for future mergers and acquisitions (which are becoming increasingly attractive under the current economic and political environment). Additionally, if auditors realize that a not-for-profit is not complying, they can issue a qualified report that could potentially impact the credit rating of the health system and limit the organization's ability to obtain financing (typically through the tax-

UNIQUE REAL ESTATE VALUATION ISSUES

Healthcare organizations typically have substantial tangible assets, including real estate holdings and medical equipment. For financial reporting purposes, both types of tangible assets typically must be valued. When it comes to the valuation of a health system's real estate there are certain distinct characteristics that raise valuation concerns.

Current real property appraisal theory includes consideration of several appraisal approaches, including a cost approach, sales comparison approach, and income capitalization approach. A specific appraisal assignment may use one or more of these valuation approaches based on the definition of value and the quality and quantity of data available for the analysis. When valuing hospitals and other healthcare facilities, the cost approach (estimating the underlying land value plus the depreciated value of the improvements) is often the most applicable approach. This is because hospitals are considered special use properties, designed specifically to provide healthcare services to the community. For special purpose properties, the cost approach is often the most appropriate method. Application of the sales comparison and income capitalization approaches for a hospital would typically reflect the value of the business enterprise, including significant equipment and intangible assets. This is due to the fact that sales of hospitals typically include the entire going-concern, not just the real estate. Therefore, sales of hospitals may be useful for estimating the value of the going-concern, but may not provide a reasonable indication of the underlying real estate value. Likewise with the income capitalization approach, the cash flows generated by a hospital reflect the business of providing healthcare services, not just rent for the real estate. Capitalizing a hospital's cash flow may provide an indication of the going-concern value, but may not provide a reasonable

indication of the underlying real estate value.

For “non-clinical” buildings such as medical office, application of the sales comparison and income capitalization approaches may be appropriate, as these properties are more similar to traditional real property types.

Based on the preceding, when appraising a hospital campus in compliance with ASC 958-805, it is typically most appropriate for the primary real property assets (i.e. main hospital and clinical buildings) to be valued on a cost approach, while the ancillary nonclinical buildings are valued via a sales comparison and/or income capitalization approach.

In the application of the cost approach, it is common for hospital buildings, especially older facilities, to suffer from functional obsolescence. This is due to ever-changing market demands and building standards/codes. Market demands have changed dramatically in recent years. The old “institutional” feel of hospitals is obsolete, and patients now prefer more “hotel-like” amenities, including private rooms with flat-screen televisions, wireless internet access, health clubs and spas, and high-quality food service/restaurants. Building standards and code requirements have changed significantly in the past decade in an effort to meet changing demands, improve patient safety, increase operational efficiency, and reduce costs. The two bodies governing this change are the Joint Commission on Accreditation of Healthcare Organizations (JCAHO) and the American Institute of Architects (AIS). New standards and guidelines in the healthcare industry involve many facility types, including general hospitals, outpatient facilities, and surgical centers. These new guidelines exert substantial pressure on existing hospitals to compete with the latest standards to avoid becoming functionally obsolete. Some of these changes include:

- New AIA guidelines for hospitals that require single patient rooms for most new hospital construction. This requirement is driven by both market and clinical demand, as numerous studies have shown the rates of medical errors and the spread of infection drop dramatically in hospitals with private rooms versus shared rooms.
- Increased minimum size requirements for operating rooms (ORs) in hospitals. For example, general operating rooms are now required to have a minimum clear area of 400 square feet and minimum fixed or wall-mounted cabinets of 20 feet. This requirement is driven by changes in technology, which result in more equipment being utilized in operating room procedures – thereby requiring larger OR spaces.
- As average length of stay decreases, more and more procedures are being done on an outpatient basis. Hospitals are constructing facilities with outpatient centers more frequently to reflect this shift in the industry. Older facilities originally designed for inpatient procedures tend to be obsolete, and the cost of retrofitting these buildings can be prohibitive.

In summary, new guidelines and standards of the JCAHO and AIA are creating a more competitive marketplace in the healthcare industry. The hospitals that offer private patient rooms and larger, more technologically advanced operating rooms experience higher demand, better patient safety, increased operational efficiency, and reduced costs. The value of dated hospitals that have not catered to these changing industry norms is, consequently, negatively affected. In fact, many health systems have embarked upon the process of building replacement facilities for their existing hospitals, often spending hundreds of millions to keep pace with industry changes. With limited alternate use potential for the

hospitals that are replaced, the highest and best use for the old buildings often calls for demolition and redevelopment of the site.

Another consideration in the cost approach is the economic viability of the hospital enterprise. If a separate valuation of the hospital enterprise is completed, it may indicate the value of the entire enterprise (the total assets of the business), is less than the initial value indication for the tangible assets. In this situation, it may be necessary to apply an economic obsolescence adjustment to both the real and personal property, under the theory that there is insufficient cash flow generated by the hospital enterprise to support the underlying value of the tangible assets. Each situation is unique, and the specifics of the transaction must be considered before a final conclusion can be reached. Best practices also suggest that for ASC 958-805 compliance, valuation professionals should be on the same page with both the client and the auditors. Good planning and communication on the front-end can ensure that there are no surprises on the back-end.

CURRENT POLITICAL AND ECONOMIC ISSUES

The current political and economic environment is presently affecting and has the ability to further influence the shape of the healthcare industry going forward. Items such as the passage of The Patient Protection and Affordable Care Act and impending budget crisis have brought healthcare to the forefront of political discussion. Though much uncertainty remains, it is evident that the future structure of the nation's healthcare system will be affected one way or the other.

Several recent reports from financial analysts state that the outlook for not-for-profit hospitals in 2013 is dismal. Fitch Ratings Outlook for 2013 discusses the ongoing pressure on hospital operations due to a weak economy and scheduled decreases in hospital pay under healthcare

reform. During the recession, hospitals and healthcare systems made an effort to reduce expenses and have continued to do so through the slow recovery. However, it is likely that these measures will cease to help deliver stable profits. "Fitch believes 2013 is likely to be the last year of stable performance, as scarcer expense reduction opportunities and looming reimbursement reductions threaten operating performance," the report stated. The report goes on to say that health insurance exchanges created by the healthcare reform bill, which would allow middle- and low-income households to buy subsidized insurance starting in 2014, would benefit hospitals, but development of these exchanges "seems to be behind schedule."

Additionally, a recent Moody's Investor Services outlook on not-for-profit hospitals reports that hospitals will receive lower payments for services from insurers in coming years as Medicare cuts approximately \$300 billion from hospital reimbursements. Beyond these scheduled Medicare cuts and private insurer efforts to temper premium growth, federal deficit reduction measures and state budgetary challenges will all contribute to a decrease in hospital revenue.

These potential challenges are creating a great amount of uncertainty and risk within the industry. Many hospitals will take precautionary measures in an attempt to lessen the fallout. This will likely include an increase in merger and acquisition activity in an effort to create economies of scale and curb costs; this, in turn, will increase the need for not-for-profit healthcare systems to comply with ASC 958-805.

CONCLUSION

As indicated in the preceding discussion, the healthcare industry continues to evolve, and the ever-changing environment is likely to continue for the foreseeable future. New financial reporting standards, distinct real estate valuation considerations, changing market conditions, and risk created by current political and economic circumstances have all affected the industry and will continue to do so. Consequently, the need for valuation professionals who understand the complexities of healthcare and nuances of financial reporting requirements, and who have the expertise to value all asset types (intangible, real estate, and equipment) is critical.

¹According to AHA Hospital Statistics, 2013 Edition.

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