THE IMPACT OF THE AFFORDABLE CARE ACT & TRANSACTION ACCOUNTING ISSUES FOR NOT-FOR-PROFIT HOSPITALS
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The hospital industry has experienced an increase in consolidation in recent years, which has allowed hospitals to lower operating costs through economies of scale, increase service offerings, enhance negotiating power with insurance companies, and compete effectively for managed care business.

Consolidation is largely a reaction to uncertainty in the regulatory environment as well as a favorable financing environment.

A concern of the increased consolidation is the potential creation of monopolies in cities and regions. Some in the industry believe that consolidation has allowed and will allow hospitals to increase prices as the competition in their region dissipates.

A major theme in the hospital industry is uncertainty over the Affordable Care Act (“ACA”) and how key provisions will play out over the next few years.
Implementation of ACA has increased hospital and healthcare center transactions and is expected to continue to do so as hospitals and physician practices feel the impact of the regulations.

In 2010 when ACA began to go into effect the number of hospital and healthcare center transactions increased substantially and has continued since.
Accounting for Not-For-Profit Hospital Transactions

- Not-for-Profit ("NFP") hospitals make up the majority of community hospitals in the United States.

- With the increased level of transactions involving NFP hospitals, the impact of Accounting Standard Codification ("ASC") 958-805 has grown.

- ASC 958-805 was codified in January 2010 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 NFPs." 958-805-10-1

ASC 958-805 (general NFP entities) “provides guidance on a transaction or other event in which a not-for-profit entity that is the reporting entity combines with one or more other NFPs...in a transaction that meets the definition of a merger of not-for-profit entities or an acquisition by a not-for-profit entity.”

The primary guidance provided in the codification of ASC 954-805 includes how to determine whether a transaction is a (i) merger of or (ii) acquisition by a NFP:

- **Merger of NFPs:** “The resulting NFP shall apply the carryover method of accounting, which requires combining the assets and liabilities recognized in the separate financial statements of the merging entities as of the merger date, adjusted as necessary to comply with GAAP (Note: this does not trigger the remeasurement of assets/liabilities at fair value)”

- **Acquisition by a NFP:** “The acquiring NFP shall account the acquisition(s) by applying the acquisition method, which includes
  a) identifying the acquirer,
  b) identifying the acquisition date,
  c) recognizing the identifiable assets acquired (including intangible assets – RubinBrown note), the liabilities assumed, and any non-controlling interest in the acquiree,
  d) recognizing goodwill acquired or a contribution received, including consideration transferred, and
  e) determining what is part of the acquisition transaction”
The primary guidance provided in the codification of ASC 954-805 includes: (Continued)

- Amending ASC 350 (Goodwill and Other Intangible Assets) to make it fully applicable to not-for-profit entities. Specifically, “the term business combination in guidance that links to Topic 805 has the same meaning as a reference to acquisitions by not-for-profit entities”. 350-10-20

Intangible assets recorded to NFP hospitals following transactions include, but are not limited to:

- Favorable or Above-Market Payer Contracts (Managed Care Agreements, Provider Service Agreements, Direct Contracting Customer Lists, and HMO Enrollment lists)
- Trade name
- Assembled workforce
- Medical records
- Non-compete agreements
- Certificates of need
- Proprietary technology/software
- Favorable leasehold interests
- Policies and procedures
Intangible Assets Commonly Recorded in Hospital/Physician Group Transactions

- **Favorable or Above-Market Payer Contracts**
  - A hospital may have contracting power or exclusive contracts with payers and is experiencing above-market profits. The contracts may include Managed Care Agreements, Provider Service Agreements, Direct Contracting Customer Lists, and HMO Enrollment lists. The benefit of the contract may be considered an intangible asset to the buyer.

- **Trade Name**
  - The trade name is the name of the acquired hospital(s). A trade name that adds value to the acquisition may be considered an intangible asset. For example, if a hospital has a strong brand in a region that patients identify positively with, the value of the trade name would generally be considered an intangible asset.
Intangible Assets Commonly Recorded in Hospital/Physician Group Transactions

- Trained and Assembled Workforce
  - A hospital generally has a “workforce in place” at the time of the acquisition. Because the workforce is already in place, the value of the assembled workforce is calculated as an intangible asset.

- Medical Records
  - Medical records that are accurate and readily available are an important asset. The value of the medical records generally would be considered an intangible asset.

- Non-Compete Agreements
  - The seller agrees to not compete with the buyer for a defined period of time after the sale. The agreements add value by preventing a physician from leaving the practice and taking their patients with them.
Certificate of Need/License ("CON")

- A CON is a state-regulated license required in certain states to perform certain medical services in a specified area. The purpose of the CON is to ensure that health providers and services are correctly matched to the needs in a specified area. Because a CON may be expensive and difficult or impossible to obtain, a CON may be considered an intangible asset in the purchase price allocation.

- Number of states with a CON program in place:
  - 36 states currently maintain some form of CON program.
  - 14 states have discontinued their CON programs, but still retain some mechanisms intended to regulate costs and duplication of services.
Certificate of Need by State

State Certificate of Need (CON) Health Laws, 2013

CON law; state approval may be required

CON law repealed or not in effect.

Compiled by NCSL November 2013; based on data from AHPA & State Agencies.
Presented is the asset breakdown of publicly traded hospitals.

Fixed assets and goodwill are generally the largest components of a hospital's assets.

The increase in transactions in the industry has driven goodwill to comprise a significant portion of the balance sheet.

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**Public Hospital Assets**

<table>
<thead>
<tr>
<th>Asset Allocation of Public Hospitals</th>
<th>CYH</th>
<th>HCA</th>
<th>HMA</th>
<th>LPNT</th>
<th>THC</th>
<th>UHS</th>
<th>SSY</th>
<th>Median</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Assets</td>
<td>20.9%</td>
<td>29.4%</td>
<td>69.6%</td>
<td>25.6%</td>
<td>24.1%</td>
<td>17.9%</td>
<td>42.1%</td>
<td>25.6%</td>
<td>32.8%</td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>39.2%</td>
<td>46.0%</td>
<td>19.8%</td>
<td>41.4%</td>
<td>46.9%</td>
<td>41.1%</td>
<td>43.9%</td>
<td>41.4%</td>
<td>39.7%</td>
</tr>
<tr>
<td>Intangible Assets, net</td>
<td>0.6%</td>
<td>n/a</td>
<td>5.8%</td>
<td>1.3%</td>
<td>7.5%</td>
<td>1.1%</td>
<td>4.6%</td>
<td>3.0%</td>
<td>3.5%</td>
</tr>
<tr>
<td>Goodwill</td>
<td>31.1%</td>
<td>19.8%</td>
<td>0.2%</td>
<td>30.4%</td>
<td>18.6%</td>
<td>36.1%</td>
<td>0.7%</td>
<td>19.8%</td>
<td>19.6%</td>
</tr>
<tr>
<td>Other Assets</td>
<td>8.3%</td>
<td>4.8%</td>
<td>4.7%</td>
<td>1.3%</td>
<td>2.9%</td>
<td>3.7%</td>
<td>8.7%</td>
<td>4.7%</td>
<td>4.9%</td>
</tr>
<tr>
<td>Total Assets</td>
<td>100.0%</td>
<td>100.0%</td>
<td>100.0%</td>
<td>100.0%</td>
<td>100.0%</td>
<td>100.0%</td>
<td>100.0%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Capital IQ
We compiled publically available purchase price allocations within the hospital and physician practice industry during 2012 and 2013.

The asset allocation for each transaction is unique based on the characteristics and circumstances of the acquirer and acquiree.

While each transaction is unique and the purchase price allocations may vary greatly across transactions, fixed assets and goodwill generally comprise the majority of the purchase price of a transaction, which is consistent with the general asset breakdown of public hospitals.
Goodwill tends to comprise a large amount of the purchase price allocation as the benefits gained from the acquisition tend to surpass the fair value of the physical assets acquired.

Generally, fixed assets comprise a significant portion of the purchase price allocation as the buildings, land, and equipment purchased tend to be of high value.
Average Allocation - 2013

- Net Working Capital: 7.2%
- Fixed Assets: 32.3%
- Goodwill: 33.4%
- Intangible Assets: 18.7%
- Other Assets: 8.4%
## Allocation of Assets in Acquisitions - 2012

In 2012, the allocation of assets was similar to 2013 with fixed assets and goodwill comprising a significant portion of the purchase price allocation.

<table>
<thead>
<tr>
<th>Seller</th>
<th>Net Working Capital</th>
<th>Fixed Assets</th>
<th>Goodwill</th>
<th>Intangible Assets</th>
<th>Other Assets</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>BIR J.V. LLP</td>
<td>0.0%</td>
<td>7.8%</td>
<td>92.2%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Community Health Partners, Inc. d/b/a Unity Health Center</td>
<td>4.5%</td>
<td>58.8%</td>
<td>32.6%</td>
<td>2.9%</td>
<td>1.2%</td>
<td>100.0%</td>
</tr>
<tr>
<td>East Tennessee Medical Group, P.C.</td>
<td>2.9%</td>
<td>77.0%</td>
<td>0.0%</td>
<td>20.1%</td>
<td>0.0%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Emerus Investment Company II, LLC</td>
<td>0.0%</td>
<td>10.4%</td>
<td>89.6%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>100.0%</td>
</tr>
<tr>
<td>HealthCare Partners Holdings, LLC (HCP)</td>
<td>-4.5%</td>
<td>1.9%</td>
<td>65.4%</td>
<td>35.2%</td>
<td>1.9%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Jewish Hospital and St. Mary’s Healthcare, Inc.</td>
<td>38.1%</td>
<td>59.6%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>2.3%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Marquette General</td>
<td>7.8%</td>
<td>66.8%</td>
<td>15.8%</td>
<td>0.0%</td>
<td>9.7%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Nebraska Heart</td>
<td>5.0%</td>
<td>34.3%</td>
<td>53.0%</td>
<td>7.7%</td>
<td>0.0%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Nine ancillary health care businesses and INTEGRIS Health, Inc.</td>
<td>1.6%</td>
<td>16.7%</td>
<td>28.6%</td>
<td>52.1%</td>
<td>0.9%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Physician practices</td>
<td>-4.8%</td>
<td>24.6%</td>
<td>80.2%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Shawnee Medical Center Clinic, Inc.</td>
<td>38.8%</td>
<td>45.3%</td>
<td>12.2%</td>
<td>3.6%</td>
<td>0.0%</td>
<td>100.0%</td>
</tr>
<tr>
<td>South Hampton Community Hospital</td>
<td>-16.9%</td>
<td>83.9%</td>
<td>32.8%</td>
<td>0.0%</td>
<td>0.2%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Texas Health Ventures Group, LLC</td>
<td>0.0%</td>
<td>43.1%</td>
<td>56.9%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>100.0%</td>
</tr>
<tr>
<td>The Heart Hospital Baylor Denton</td>
<td>0.0%</td>
<td>83.6%</td>
<td>16.4%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>100.0%</td>
</tr>
<tr>
<td>U.S. Healthworks, Inc.</td>
<td>7.5%</td>
<td>5.3%</td>
<td>45.4%</td>
<td>37.9%</td>
<td>3.9%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Valley Hospital Doctors, PLLC</td>
<td>0.0%</td>
<td>0.0%</td>
<td>98.1%</td>
<td>1.9%</td>
<td>0.0%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Various Entities - 1</td>
<td>3.9%</td>
<td>11.2%</td>
<td>83.2%</td>
<td>0.0%</td>
<td>1.7%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Various Entities - 2</td>
<td>-1.6%</td>
<td>9.4%</td>
<td>71.4%</td>
<td>20.8%</td>
<td>0.0%</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Median</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Working Capital</td>
<td>0.8%</td>
<td>4.6%</td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>29.4%</td>
<td>35.5%</td>
</tr>
<tr>
<td>Goodwill</td>
<td>49.2%</td>
<td>48.5%</td>
</tr>
<tr>
<td>Intangible Assets</td>
<td>0.9%</td>
<td>10.1%</td>
</tr>
<tr>
<td>Other Assets</td>
<td>0.0%</td>
<td>1.2%</td>
</tr>
<tr>
<td>Total</td>
<td>100.0%</td>
<td>100.0%</td>
</tr>
</tbody>
</table>
### Average Allocation - 2012

- **Net Working Capital**: 1.2% (4.6%)
- **Fixed Assets**: 35.5%
- **Goodwill**: 48.5%
- **Intangible Assets**: 10.1%
- **Other Assets**: 1.2%
Impact of Intangible Assets and Goodwill on Financial Statements

- While intangible assets are amortized over the estimated useful life of the asset at the time of the acquisition and treated as an expense on the income statement each year, goodwill remains on the acquirer's financial statements until the goodwill is considered “impaired.”

- Goodwill will be considered “impaired” when the carrying value of the acquired company exceeds the fair value of the company.

- When an impairment occurs, goodwill is reduced by the determined amount of the impairment, which is recognized as an expense in that period.

- Goodwill impairments typically require the use of an outside service firm to determine the fair value of the reporting unit that is impaired.

- Both the amortization of intangible assets and the write-off for a goodwill impairment are non-cash expenses and have no impact on the free cash flows of the company.
Use of Funds Obtained in the Sale of a NFP Hospital

- After the sale of a non-for-profit hospital a common issue faced by the hospital’s trustees or board of directors is the proper way to utilize the funds gained in the sale of the hospital.

- The use of funds after the sale of a NFP is generally a very sensitive and political topic within the community due to the substantial amount of funds received.

- Typically states have laws in place to govern where the funds from the sale may be allocated. Generally the funds must be given to a charitable foundation or used to promote the support and promotion of healthcare generally in the affected community.

- In cases where the NFP company being sold has hospitals in different communities, the funds received from the sale may be required to be allocated to each location. The allocation is required to fairly distribute the funds received to each community.
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