

# A&A Update & Valuation Considerations

**SCHFMA Finance & Reimbursement  
Workshop  
November 15, 2011**

**Draffin  
& Tucker, LLP**  
CERTIFIED PUBLIC ACCOUNTANTS

# Agenda

- Goodwill Accounting and Valuation Considerations
- Variable Rate Debt Obligations (VRDO)
- Proposed Lease Accounting Changes

# Goodwill

- Amortization is not allowed – follow FASB 142 (Topic 350)
  - FP & Governmental entities – no change
- Establish reporting units
  - Assign goodwill
  - Annual test for impairment
    - Qualitative evaluation
    - Fair-value-based evaluation

# Goodwill

- Qualitative evaluation
  - Accounting Standards Update No. 2011-08, *Intangibles — Goodwill and Other (Topic 350): Testing Goodwill for Impairment*
  - Whether Events and Circumstances make it “More likely than not” (>50% chance) that goodwill is less than FV
  - Events and Circumstances
    - Macroeconomic conditions
    - Industry and market considerations
    - Cost factors
    - Overall financial performance
    - Other relevant company-specific events

# Goodwill

- Impairment Test – 2 Step Process
  - Step 1 – Determine FV of reporting unit
    - Does book value of reporting unit exceed FV?
      - If Yes, move to step 2
  - Step 2 – Determine implied FV of goodwill
    - a) Assign FV to all recorded and unrecorded assets & liabilities (excluding goodwill)
    - b) Difference in amount calculated in Step 2a and the amount calculated in Step 1 = Implied FV of goodwill

# Goodwill

- Impairment Testing Results –
  - If the implied goodwill is less than the recorded goodwill, then there is impairment
  - The recorded goodwill should then be reduced to equal the implied goodwill estimated above

# Goodwill

- Transitional test with retrospective adjustment (change in accounting principle)
  - Same process as for new goodwill
  - Beginning of implementation year
  - Evaluate again at end of implementation year

# Valuation Approach

- The Cost Approach:
  - What would it cost to purchase the individual items used to operate the Reporting Unit?
- The Market Approach:
  - What was the purchase price for this type of Reporting Unit in the recent past?
- The Income Approach:
  - What is the present value of the net cash flow produced from the Reporting Unit?

# The Income Approach

- Cash flow to equity holders:
  - Estimates the value of Net Equity.
  - Net cash flow after additional capital needs and debt service payments are met.
  - The discount factor used is the Cost of Equity resulting from the Buildup Method.

# The Income Approach

- Cash flow to invested capital:
  - Estimates the value of Total Assets.
  - Net cash flow after additional capital needs but excluding the impact of debt service payments.
  - The discount factor used is the Weighted Average Cost of Capital.

# The Income Approach

- Major assumptions used:
  - Projected income statement in the first year
  - Revenue Growth Rate
  - Expense Growth Rate
  - Additional Capital Needs
  - Terminal Year Amounts
  - Discount Rate

# The Income Approach

- Terminal Year Amounts:
  - The terminal year represents the period when the operations maintain normal growth in perpetuity.
  - The present value of the Terminal Year is obtain in two steps:
    - First, divide the net cash flows by the Discount Rate minus the Growth Rate which equals the Terminal Value.
    - Then, calculate the present value of the Terminal Value.

# The Buildup Method

- Cost of Capital equals the sum of:
  - Risk Free Rate 4.10%
  - Equity Risk Premium 6.70%
  - Industry Risk Premium (Hospital) 3.05%
  - Size Premium (Smallest) 6.36%
  - Cost of Capital for 2010 = 20.21%

# Weighted Average Cost of Capital

- WACC is the sum of weighted debt cost plus weighted capital cost:
  - Weighted Debt Cost – Weight of debt in capital structure times cost of debt
  - Weighted Capital Cost – Weight of capital in capital structure times cost of capital using Buildup Method

# Weighted Average Cost of Capital

- Weight of Debt in Capital Structure:
  - We could use the Long Term Debt to Capitalization Ratio for Health Care Organizations.
    - Ingenix Average of All Sizes (2011) = 37%
- Weight of Capital in Debt Structure:
  - Difference in 100% and Debt Ratio = 63%

# Weighted Average Cost of Capital

- Cost of Debt:
  - Interest Rate Guidelines
    - 2010 Tax Exempt Yields (A) = 5.92%
- Cost of Capital:
  - Buildup Method
    - 2010 Calculation = 20.21%

# Weighted Average Cost of Capital

- Example WACC discount rate:
  - Weighted debt cost
    - $37\% \times 5.92\% = 2.19\%$
  - Weighted capital cost
    - $63\% \times 20.21\% = 12.73\%$
  - WACC =  $14.92\%$

# Cash Flow Project Example

		<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>	<u>Year 6</u>	<u>Year 7</u>	<u>Year 8</u>	<u>Year 9</u>	<u>Year 10</u>	<u>Residual</u>
Revenue		\$ 1,000	\$ 1,050	\$ 1,165	\$ 1,306	\$ 1,456	\$ 1,596	\$ 1,718	\$ 1,823	\$ 1,907	\$ 1,976	\$ 2,035
Gross Profit	90%	900	945	1,049	1,175	1,310	1,436	1,546	1,641	1,716	1,778	1,832
Operating Expenses:												
Maintenance R&D (2)	0.5%	5	5	6	7	7	8	9	9	10	10	10
R&D - Future IP (3)	2.5%	25	26	29	33	36	40	43	46	48	49	51
Trade name advertising (4)	0.5%	5	5	6	7	7	8	9	9	10	10	10
Current customer marketing (5)	3%	27	26	23	18	13	8	4	2	1	-	-
Future customer marketing (6)		18	22	29	40	53	64	73	80	84	89	92
Total marketing	5%	50	53	58	65	73	80	86	91	95	99	102
Total G&A	7%	70	74	82	91	102	112	120	128	133	138	142
Total Operating Expenses	15%	150	158	175	196	218	240	258	274	286	296	305
EBITDA		750	787	874	979	1,092	1,196	1,288	1,367	1,430	1,482	1,527
Depreciation (7)		286	302	337	377	412	451	478	513	540	562	581
Amortization (8)		-	-	-	-	-	-	-	-	-	-	-
EBIT		464	485	537	602	680	745	810	854	890	920	946
Taxes	40%	186	194	215	241	272	298	324	342	356	368	378
Debt Free Net Income		278	291	322	361	408	447	486	512	534	552	568
less: Incremental Working Capital (9)	30%	15	15	35	42	45	42	37	32	25	21	18
add: Depreciation (10)		286	302	337	377	412	451	478	513	540	562	581
less: Capital Expenditures		286	400	450	500	525	541	557	574	591	609	627
Debt Free Cash Flow		263	178	174	196	250	315	370	419	458	484	504
Residual Value (11)												7,200
PV Factor (12)	10%	0.9535	0.8668	0.7880	0.7164	0.6512	0.5920	0.5382	0.4893	0.4448	0.4044	0.4044
PV DFCF		251	154	137	140	163	186	199	205	204	196	2,911
<b>Entity Value</b>		<b>4,746</b>										

# Variable Rate Demand Obligations

- Variable Rate Demand Obligations (VRDO)
  - Short-term obligations (may have long term maturities with short term remarketing periods)
  - "Put" or demand feature
  - Secured by a liquidity facility issued by a financial institution (for example, a standby bond purchase agreement [SBPA], letter of credit [LOC], or line of credit)

# Variable Rate Demand Obligations

- Balance Sheet Classification
  - Current liability unless the following occur:
    - Include a liquidity facility to provide funding should bondholders “put” the bonds and they are not remarketed
      - Must extend beyond one year from the balance sheet date for long-term presentation
      - Must be non-cancelable

# Variable Rate Demand Obligations

- Refinancing considerations
  - Extinguishment criteria
    - Delivery of cash or other financial assets
    - Delivery of goods or services
    - Reacquisition by the debtor of its outstanding debt securities
    - The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor
    - PV of cash flows of new debt is at least 10% different than cash flows on existing debt

# Variable Rate Demand Obligations

- Refinancing considerations
  - Extinguishment criteria met – recognize a gain or loss (deferred and amortized for governmental entities if not redeemed)
    - Include fees paid to modify/extinguish debt in gain/loss calculation as well as original debt issue costs

# Variable Rate Demand Obligations

- Refinancing considerations
  - Considered modified if extinguishment criteria are not met
    - New effective interest rate is determined using the original debt carrying amount and the revised cash flows
    - Fees incurred during the modification are included with remaining unamortized premiums/discounts and amortized to interest expense

# Variable Rate Demand Obligations

- “Put” or demand feature examples

(a) (ii) Tender Option While Project Notes Bear Interest at the Weekly Interest Rate. While the Project Notes bear interest at the Weekly Interest Rate each Holder has the option to tender for purchase, at 100% of the principal amount thereof plus accrued interest to the purchase date (a “Note Purchase Date”), all of the Project Notes (so long as such Project Notes have not previously been selected for redemption) owned by such Holder, or such lesser principal amount (in denominations of \$100,000 or any integral multiple of \$5,000 in excess thereof) as such Holder may specify in writing in accordance with the terms, conditions and limitations hereafter set forth. The purchase price of each such Project Note shall be payable in lawful money of the United States of America and shall be paid in full on the applicable Note Purchase Date.

While the Notes are in the Weekly Interest Rate Mode, Holders have the option to tender their Notes to the Trustee for purchase on a Business Day not prior to the seventh day next succeeding the date notice is given by the Holders. While the Notes are in an Interest Rate Mode other than the Weekly Interest Rate Mode, the Holders have the option to tender their Notes to the Trustee for purchase on any date the interest rate is subject to adjustment (the “Interest Rate Adjustment Date”). Holders are required to deliver the Notes to the Trustee for purchase, and the Notes are deemed to be tendered, upon any conversion to a different Interest Rate Mode. The Notes are also subject to optional and mandatory redemption prior to maturity, as set forth herein. See “THE NOTES.”

# Variable Rate Demand Obligations

- Acceleration clause example

**SECTION 4.01**      **Terms of Redemption of Project Notes.** The Project Notes are subject to redemption prior to stated maturity as follows:

(a)      **Mandatory Redemption Upon Expiration of Letter of Credit.** The Project Notes are subject to mandatory redemption in whole on the Interest Payment Date which next precedes a Letter of Credit Termination Date, at a redemption price of 100% of the outstanding principal amount thereof plus accrued interest to the redemption date unless, at least 60 days prior to any such Interest Payment Date, (a) the bank shall have agreed to an extension or further extension of the letter of Credit Termination Date to a date not earlier than one year from the Letter of Credit Termination Date being extended or (b) pursuant to Section 5.10 hereof, the Company shall have obtained and delivered to the Trustee an Alternate Letter of Credit with a termination date not earlier than one year from the Letter of Credit Termination Date for the Letter of Credit it replaces.

# Variable Rate Demand Obligations

- Letter of credit renewal example

Irrevocable Letter of Credit

No. [REDACTED]

Dated December 30, 2004

Amended December 15, 2010

The Bank of New York Mellon Trust Company, N.A.  
100 Ashford Center North, Suite 520  
Atlanta, Georgia 30338

Ladies and Gentlemen:

You currently hold Letter of Credit No. [REDACTED] (the "Letter of Credit") issued by Fifth Third Bank, an Ohio banking corporation (the "Bank"), in your favor for the account of [REDACTED] (the "Company"). By this Amendment, and at the request of the Applicant, the Bank hereby amends the expiration date of the Letter of Credit to read December 15, 2013 (the "Expiration Date").

The Letter of Credit remains in full force and effect and is not modified in any manner, except as specified in this Amendment. This Amendment shall be attached to the Letter of Credit and shall become a part of the Letter of Credit.

# Lease Accounting

- The Proposed ASU, *Leases*, was issued on August 17, 2010
- Objectives
  - Converge U.S. GAAP and IFRS
  - Address perceived weaknesses in reporting operating leases
    - Ensure that the assets and liabilities from lease contracts are reflected in the statement of financial position

# Lease Accounting

*One of my goals in life is to one day fly on an airplane that appears on the balance sheet of an airline*

*Sir David Tweedie, IASB Chair*

# Lease Accounting

- Scope
  - All leases, including leases of right-of-use assets in a sublease except:
    - Leases to explore for or use minerals, oil, natural gas, and similar non-regenerative resources
    - Leases of biological assets
    - A contract that results in an entity transferring control of the underlying asset and all but a trivial amount of the risks and benefits associated with the underlying asset to another entity

# Lease Accounting

- Current Status
  - Comment period expired on December 15, 2010
  - More than 780 comments on the exposure draft were submitted
    - Most criticized the rules as too complex, potentially costly, and likely to result in unreliable financial reporting
  - IASB & FASB are currently re-deliberating the proposal
  - Boards agreed to re-expose in late 2011

# Lease Accounting

- What is a lease?
  - Contract that conveys the right to **use** a specified asset
  - Contract that conveys the right to **control** a specified asset
    - Direct the use of
    - Receive benefit from the use of
- Lease and non-lease components should be segregated
  - Maintenance contracts, etc.

# Lease Accounting

- Lease Term
  - Noncancelable period plus periods when there is significant economic incentive to extend
    - Bargain renewal options
    - Penalties for non-renewal
    - Significant leasehold improvements
  - Significant change from original proposal

# Lease Accounting

- Lease Payment
  - Base payments plus the following variable payments
    - Payments that depend on an index/rate
    - Payments under residual guarantees
    - Payments that meet a high recognition threshold (reasonably certain)
  - Significant change from original proposal

# Lease Accounting

- Discount Rate
  - Lessee
    - Rate the lessor is charging if available
    - Otherwise incremental borrowing rate

# Lessee Recognition

- Statement of financial position
  - At the date of commencement of a lease, a lessee shall recognize in the a right-of-use asset and a liability to make lease payments.

# Lessee Recognition

- Income statement
  - Interest expense on the liability to make lease payments
  - Amortization of the right-to-use asset
  - Reassessment of changes in the liability to make lease payments due to
    - Contingent rentals
    - Term option penalties and
    - Residual value guarantees
  - Any impairment loss on the right-to-use asset

# Lessee Recognition

- Initial measurement
  - The liability to make lease payments
    - Present value of the lease payments
      - Lessee's incremental borrowing rate
      - Rate the lessor charges the lessee
  - The right-of-use asset
    - Amount of the liability to make lease payments
      - Plus any initial direct costs incurred

# Lessee Recognition

- Subsequent measurement
  - Liability to make lease payments
    - Amortized using the effective interest method
  - Right-of-use asset
    - Amortized cost, subject to the impairment provisions in Topic 350.
      - The amortization period shall be during the period of lease or the useful life of the underlying asset, whichever is shorter.

# Lessee Recognition

- Presentation
  - Statement of Financial Position
    - Liabilities to make lease payments shall be reported separately from other financial liabilities
    - Right-of-use assets shall be reported within property, plant and equipment, separately from assets that the lessee does not lease

# Lessee Recognition

- Presentation
  - Income Statement
    - Amortization of the right-of-use asset as an expense separately from other amortization.
    - Interest expense on the liability to make lease payments separately from other interest.
  - Amortization and interest may be disclosed rather than presented on the face of the income statement

# Lessee Recognition

- Presentation Issues
  - Statement of Cash Flows
    - Cash payments for leases shall be shown as financing activities and shown separately from other financing cash flows.

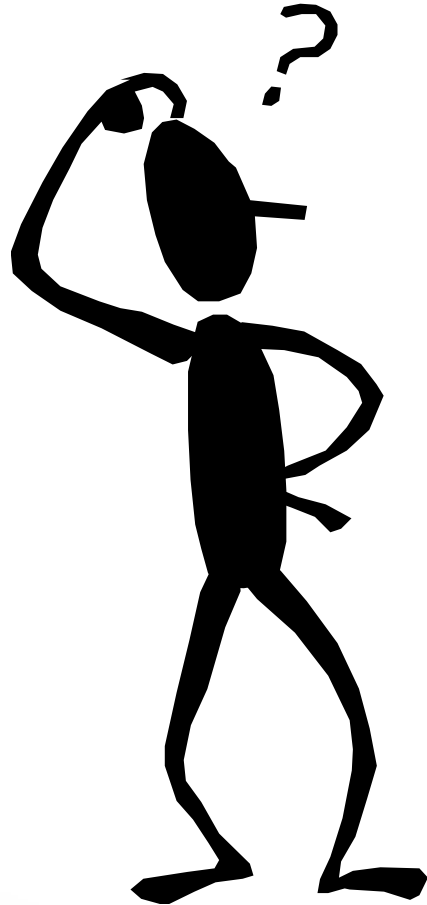
# Short-Term Leases

- Short Term lease are exempt from the right of use asset and liability provisions
  - Short-term leases in the proposed standard are defined as leases that, at the date of commencement of the lease, have a **maximum possible** lease term, including options to renew or extend, of 12 months or less

# Lease Considerations

- Reevaluate lease-buy determination process
- Take inventory of current lease arrangements
  - “Simplified” retrospective application to existing leases
- Review current debt agreements
  - Begin discussions with legal, lenders, or trustees as necessary

# Questions?



# A&A Update & Valuation Considerations

Wes Sternenberg

229-883-7878

[wsternenberg@draffin-tucker.com](mailto:wsternenberg@draffin-tucker.com)