

March/April 2004

commercial lending report



Are the long-term health care industry's risks worth its rewards?

FASB Interpretation No. 46 seeks accountability

Tales your customers' balance sheets may not tell

Tune in to problem borrowers

Simione Macca & Larrow_{LLP}



CERTIFIED PUBLIC ACCOUNTANTS AND BUSINESS ADVISORS

“On Balance, We Offer You More.”

175 Capital Boulevard • Rocky Hill, CT 06067
(860) 529-5600 • (800) 493-5605 • FAX (860) 529-5605

4130 Whitney Ave • Hamden, CT 06518
(203) 281-0540 • (800) 493-5605 • FAX (203) 287-6788

Are the long-term health care industry's risks worth its rewards?

Despite its current unpopularity, the \$100 billion long-term health care (LTHC) industry segment can offer lenders substantial upside potential. But to reap the industry's rewards, you should first learn its quirks. Then your accountant can conduct individualized due diligence to find the most viable prospects.

First, the bad news

A recent American Bankers Association (ABA) survey reports that approximately 75% of bankers have chosen not to take on health care providers as clients. In fact, the ABA survey rates health care entities as the least popular type of client — perceived as even riskier than start-up ventures. Among health care segments, LTHC facilities — such as nursing homes, assisted-living centers and retirement communities — are the least popular.

Overbuilt, improperly managed, over-regulated and under-reimbursed during the last decade, LTHC companies increasingly are unable to service their debt — a fact that has not eluded lenders. In the future, LTHC providers will face ongoing risks, including rising malpractice insurance costs, staffing shortages, government cutbacks and more fraud investigations.

Now, the good news

Demographic trends — specifically, a burgeoning, relatively affluent elderly population — suggest a healthy future demand for LTHC. The segment is actually less risky than some others.

For instance, the demand for LTHC services is largely unaffected by economic downturns, and its government payors are unlikely to default on payments. Most important, though, lenders bold enough to venture into LTHC loans can demand higher interest rates and restrictive terms to offset incremental risks.

Getting a handle on reimbursement

LTHC customers don't usually pay providers for the services themselves. While private individuals fund small portions of LTHC needs, the federal and state governments foot most of the bill for LTHC services.

The federal government chips in on Medicaid, based on a formula that compares the state's average per capita income level with the national average, according to the *Journal of Commercial Lending*. Almost all states pay for a portion of their residents' LTHC via Medicaid.



In 1997, the Balanced Budget Act slashed LTHC providers' reimbursement rates, and many analysts expect cutbacks as the government has returned to deficit spending. Besides causing uncertainty over future government spending, Medicare and Medicaid reimbursements require reams of administrative red tape, licensing and annual operating surveys, all of which increase an LTHC provider's operating costs.

In addition, some government reimbursement policies could contribute to significant unexpected — and unreported — liabilities. To expedite reimbursement, Medicare pays LTHC providers based on interim estimates.

Long after making payments and preparing interim operating statements, the government audits LTHC providers to determine whether they have been underpaid (a hidden asset) or overpaid (a hidden liability). If large and unexpected, overpayments can result in severe cash flow shortages.

Not only is the government cutting back on its reimbursement, but it is also crusading to eradicate fraud and abuse in health care reimbursement. If a Medicare fraud investigation targets an LTHC, it will cost the LTHC ample time and money. If found guilty, the LTHC provider faces steep penalties, including triple damages, additional penalties per false claim, and future exclusion from Medicare and Medicaid programs.

Improving your chance of success

The keys to a successful LTHC operation are stable and competitive occupancy rates, ranging from 90% to 95% for established facilities in most geographic markets. When detected, most other operating deficiencies can be remedied if occupancy is on target, and default often can be averted.

The quality of a facility's services is an obvious precursor to high occupancy rates. Most states perform regulatory inspections that they document in annual operating surveys. To stay on top of an LTHC client, review a

copy of its annual state survey (if applicable) and compare the results to past surveys and those of its competitors.

Overzealous operating forecasts are to blame for many LTHC bankruptcies, so periodically review your LTHC clients' operating forecasts and ask management to reconcile projected and actual performance. LTHC forecasts can quickly become outdated if, for instance, the LTHC continually defers maintenance or new competition enters the marketplace.

Beyond reviewing the numbers, periodic site visits to clients' facilities and even those of their competitors can help ensure forecasts remain on track.

Another common reason LTHC providers fail is unqualified management. Therefore, it's imperative that lenders interview management during their site visits and maintain communication between visits. When speaking with your prospective client's management, note your comfort level with its experience and ability to control costs.

In addition to performing administrative chores, experienced LTHC managers are familiar with seniors' medical, nutritional, safety, transportation, recreation and housing needs. Today's senior expects a broad range of service offerings and seeks a senior care facility that allows him or her to "age in place." As the population ages, the LTHC sector may be worth exploring. **\$**





Beyond the Numbers

FASB Interpretation No. 46 seeks accountability

When Enron, WorldCom and other companies' accounting escapades were uncovered, the domino effect left public markets reeling. We've repeatedly witnessed the financial accounting loopholes and ambiguities that unscrupulous companies can use to artificially boost profits and downplay liabilities. Now the Financial Accounting Standards Board (FASB) is scrambling to pick up the pieces and mend stakeholders' shattered confidence in financial reporting.

Among the onslaught of new, revised or reinterpreted accounting standards is FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (VIEs). It attempts to regain control over the accounting items most defiled by the Enron scandal: special-purpose entities and other off-balance-sheet items. Once FASB irons out some kinks, lenders may be able to use Interpretation No. 46 to uncover fraud before it undoes their customers.

From SPEs to VIEs

Many lenders fear — with good reason — that their customers could be using special-purpose entities (SPEs) and off-balance-sheet items to hide financial unpleasanties. After all, unhealthy companies can use these veiled outside entities to artificially boost revenues or to report phantom gains from worthless assets. These swindles conceal high-risk endeavors and future obligations.

Interpretation No. 46 doesn't prevent companies from using SPEs or other off-balance-sheet items. Rather, FASB issued this interpretation to help financial statement users identify these items,

while offering greater insight into their exposure risk. Here is a sampling of Interpretation No. 46's requirements:

- **Consolidation.** To avoid the negative connotations and preconceived definitions of SPEs, Interpretation No. 46 aims to cover a broader group of entities and coins the phrase "variable interest entities" (or VIEs). Interpretation No. 46's language also includes several other vague new terms, which are likely to cause confusion as accounting professionals scramble to implement this new rule.

Briefly, a VIE is controlled by another entity (or entities) through voting rights or financial interests, similar to a parent-subsidiary relationship. For an entity to fall within the scope of Interpretation No. 46, its "equity at risk" must be insufficient to finance the entity's activities without additional subordinated financial support.

Alternatively, an entity may qualify under Interpretation No. 46 if its equity investors collectively lack the characteristics of a controlling financial interest set forth under this obscure FASB interpretation. Examples of financial interests that constitute variable interests are leases, derivatives, loans and loan guarantees.

To provide more stakeholders with more meaningful information, the FASB has reasoned that the entity that holds a majority of a VIE's variable interests (that is, the "primary beneficiary") should consolidate the VIE into its financial statements.

- **Disclosure.** Interpretation No. 46 requires primary beneficiaries and other entities holding a significant interest in a VIE to disclose its nature, size and activities. Primary beneficiaries' footnotes must also disclose which of its assets are pledged as collateral for the VIE, as well as whether the VIE's creditors have recourse to the primary beneficiary.

In lieu of consolidation, other (nonprimary) significant interest holders must disclose their maximum exposure to loss from their relationship with the VIE.

- **Implementation dates.** FASB postponed implementation of Interpretation No. 46's consolidation requirement until the first reporting period ending after Dec. 15, 2003, for public companies that are the primary beneficiary of a VIE created before Feb. 1, 2003.

The postponement is only valid, however, if the public company hasn't already issued a financial statement in accordance with Interpretation No. 46. In other words, most calendar-year public companies will consolidate VIEs into their Dec. 31, 2003, financial statements.

Private companies have until fiscal years beginning after June 15, 2003, to adopt Interpretation No. 46 for any VIE created before Feb. 1, 2003. Therefore, most calendar-year private companies that are a VIE's primary beneficiary under this condition will consolidate the VIE into their Dec. 31, 2004, financial statements.

For VIEs created after Jan. 31, 2003, consolidation into its primary beneficiary is effective immediately, regardless of whether a company is public or private. In addition, the effective date for nonregistered investment companies that comply with the American Institute of Certified Public Accountants' (AICPA's) guide on investment company audits has been postponed until the AICPA deliberates on this issue.

Implementation of Interpretation No. 46's disclosure requirement is fairly straightforward. Regardless of whether a company is public or private, or whether the company is the primary beneficiary or a significant interest holder, in a

VIE, the interpretation's hefty disclosure requirements start for financial statements issued after Jan. 31, 2003.

Check the fine print

Disclosure requirements are imminent. Lenders should read their customers' footnote disclosures because they may highlight details of formerly clandestine VIEs. In addition to these disclosures, lenders can also benefit from the 2003 consolidations that Interpretation No. 46 requires for public companies and VIEs created after Jan. 31, 2003. For other VIEs, consolidation will first appear in 2004.

If a borrower's financial statements reveal a questionable relationship with another entity — either on the balance sheet or in the footnotes — look into it further. Some VIEs provide lenders with a potential warning sign of impending financial disaster. In fact, upon consolidation, a VIE could increase a customer's debt-to-equity ratio and decrease profitability ratios. If significant, these changes could suddenly put a customer in violation of its loan covenants. **\$**

Up-to-the-minute information

Financial Accounting Standards Board Interpretation No. 46, *Consolidation of Variable Interest Entities*, is extremely complex and requires the assistance of a financial professional accustomed to preparing forecasts, discounted cash flow analyses and fair value estimates. Some practitioners have argued that FASB has provided insufficient time to gather and analyze the information needed to comply with Interpretation No. 46.

In response, FASB posted a proposed clarification and modification of its original interpretation. Odds are, FASB will post additional clarifications and modifications as necessary.

A complete description of this multifaceted interpretation exceeds the scope of this article. To examine the full text of Interpretation No. 46 or check for updates, visit FASB's Web site at www.fasb.org. Or call us to help explore how this new rule affects your customers.

Tales your customers' balance sheets may not tell

Balance sheets give financial statement readers insight into the state of a company's assets and liabilities at a given point in time. As you may have learned the hard way, however, you can't always accept balance sheets at face value because they may exclude some significant future obligations — including pending litigation or IRS investigations. These significant future obligations hide behind the softer sounding term “contingent liabilities.”

Keeping liabilities at bay

If sizable enough, these unrecorded, contingent liabilities can seriously impair a customer's ability to service its bank loans. Unfortunately, you may be the last to discover the distress that contingent liabilities caused a customer — and, by extension, your bank.

Fortunately, your due diligence can proactively identify contingent liabilities and help protect you, even if liabilities have already begun to adversely affect a customer's portfolio. Make sure to:

Read footnote disclosures. If subject to audit or review procedures, your customers' financial statements should disclose contingent liabilities. But finding the requisite information requires review of footnote disclosures. At best, these disclosures may be sketchy; so, if a customer's footnotes indicate a potential contingent liability, ask for additional information.

Also, don't only rely on audits and reviews to provide you with all of a customer's relevant, accurate financial information. Some unscrupulous managers hide or lie about damaging financial information and their accountants may have accepted the information without further investigation. View financial reports with a healthy dose of professional skepticism — just because the footnotes may not mention contingent liabilities, don't assume your customer is free of them.

Interview management and require formal management representations. If you're relying on compiled financial information or financial statements in which the footnotes are otherwise omitted, it's anybody's guess as to whether the company

faces any unrecorded future obligations. In these cases, you may be forced to take management's word for it, underscoring the importance of knowing your customers as well as you do yourself.

It's somewhat surprising how few lenders broach this subject regularly. To protect your portfolio from default, periodically ask prospective and existing customers, “Does your company face any unrecorded or contingent liabilities, such as lawsuits, tax claims or regulatory investigations?” For added protection, consider revising loan agreements to require formal management representations, putting customers into default if you uncover any undisclosed contingent liabilities.

Understand the nuances of your customers' industries. Some unrecorded liabilities result from the nature of the customer's industry, necessitating a lender's thorough understanding of industry billing practices and risk factors. Lenders that understand their customers' industries can foresee potential liabilities and ask pointed questions to assess the customer's susceptibility to any potential contingent or unrecorded liabilities.

Your due diligence can proactively identify contingent liabilities and help protect you, even if liabilities have already begun to adversely affect a customer's portfolio.

For example, health care companies — including long-term health care facilities discussed in “Are the long-term health care industry's risks worth its rewards?” on page 2 — bill Medicare based on periodic estimates to speed up their collection process. At the end of a period, health care providers are subject to Medicare audits that determine whether they have been under- or overpaid.

Significant Medicare underpayments can overwhelm a customer and blindside an unsuspecting lender. A lender familiar with this industry's nuances could inquire about the historic accuracy and sophistication of a health care customer's billing systems. 💰

Tune in to problem borrowers

Ideally, your customers would never get to the point where they need an “intervention.” All of their numbers would add up, all of their businesses would be successful — everything would be harmonious and no monitoring of portfolios would be necessary. Unfortunately, reality is more dissonant.

When managing problem borrowers, start by focusing on cash flow and the entity’s short-term survival. Only after you and your accountant have finished that examination should you focus on the borrower’s long-term survival prospects. If all goes well, everyone concerned will be in tune.



Identifying the problem

Zeroing in on snags a loan may have hit is relatively simple because the process is guided by practical experience. In contrast, identifying a potentially problem borrower can require a great deal of time and effort.

To ferret out troubled borrowers, lenders should focus on cash flow. Let’s say a company has goods in inventory that can be sold at 50% of their cost. Selling these goods would produce a loss, but if the company can’t meet its payroll or other operating costs, the decision to sell the goods would generate

much-needed cash. Under the circumstances, selling the goods might be a wise decision.

Or, consider a company that has a work in progress that’s 80% complete. For little or no additional expenditure, the company could sell the production and realize significant revenues. In this case, finishing the production might not make sense, regardless of the profit and loss issues.

Working toward a solution

The first step in a crisis management and turnaround program should be to conduct a detailed cash flow analysis and create a reporting and monitoring system. This system may exist outside the entity’s traditional information reporting system.

Analyzing cash flow establishes a hierarchy that can then be used to determine the most effective use of limited resources. For example, the purchase of goods expected to generate revenues that are two to three times the cost would have a higher priority than a lease payment on a seldom-used machine that produces a small revenue stream.

Once the entity’s immediate cash flow needs have been identified and addressed, the focus can shift to issues of long-term profitability. It’s critical to determine the root of the cash flow problem. If the borrower’s credibility is in question, or if there are conflicts of interest that may impair his or her judgment, additional concerns arise. One key indicator of a problem borrower is a lifestyle beyond what can be supported by the entity’s cash flow.

Dealing with a problem borrower can complicate cash flow issues, because they may not only be dishonest with you, they may also be lying to themselves by refusing to acknowledge cash flow problems and insisting prosperity is imminent. Problem borrowers also may misreport collateral, misrepresent sales and expenses, or hide expenditures.

A lender should work with a financial professional who has experience in improving the borrower’s financial situation, which may not necessarily mean reducing outstanding loans or advance rates on collateral. 💰

How Simone Macca & Larrow, LLP Can Help You...

- Loan investigation services
- Collateral monitoring
- Troubled loan reviews
- Pre-loan surveys
- Operational review
- Financial studies with operating ratios by industry

...and Your Customers

- Profit enhancement services
- Due diligence and consultation in merger & acquisition efforts
- Valuation for use in stockholders buy-sell agreements, sale of business and estate planning
- Business succession planning
- Employee stock ownership plans
- Accounting personnel searches
- Vendor negotiations
- Financing searches for non-bankable companies
- Management retreat facilitation
- Audit, accounting and tax services

**For more information, call
Carmen Macca or Richard Simone
Toll-free at 1-800-493-5605**



Carmen J. Macca, CPA, MST

Carmen is managing partner of Simone Macca & Larrow LLP and services a diverse commercial client base as well. He directs all lender services for the firm, including pre-loan surveys, collateral monitoring, operational reviews and lender seminars. Carmen assists lenders with borrowing-base reporting compliance and evaluation of customer management and accounting systems. Additionally, he assists companies in developing business plans, obtaining financing, preparing financial projections and with profit enhancement strategies. Carmen is a graduate of Bentley College and has a Master's Degree in taxation.



Richard C. Simone, CPA

Dick is partner-in-charge of Simone Macca & Larrow, LLP's Hamden office. He has over 30 years' experience in public accounting, with emphasis in real estate, construction, non-profit and medical practice. He handles individual, corporate and estate tax matters, and business consulting for closely-held companies. Dick served with the U.S. General Accounting Office in Washington, D.C. after graduating from Providence College.



Julianne J. Gillespie, CPA

Julie is the firm's audit partner with extensive experience in accounting, auditing, consulting and tax services within several industries, including manufacturing, real estate, architecture, engineering, insurance and printing. In addition, Julie has assisted her clients with financial reporting, cost control, systems, business planning, mergers and acquisitions, financing, cash flow analysis, and tax planning and projections. She assists with negotiating, structuring, monitoring and calculations of compliance ratios. Julie is a graduate of the University of Connecticut and has over 15 years experience as a CPA.

Simone Macca & Larrow_{LLP}



CERTIFIED PUBLIC ACCOUNTANTS AND BUSINESS ADVISORS

175 Capital Boulevard
Rocky Hill, CT 06067

PRSTD STD
U.S. POSTAGE
PAID
Permit No. 352
Rocky Hill, CT

ADDRESS SERVICE REQUESTED