Fraud Prevention, Internal Controls & Ethics
NAHC-HHFMA
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Michael Gavagni, CPA, MSA, MSAT

Patrick Reynolds, CPA, CVA
is an audit Partner at Simione Macca & Larrow LLP.

Pat earned his Bachelor of Science degree in Accounting from the University of Connecticut.

Pat is a Certified Public Accountant licensed in the State of Connecticut, and a Certified Valuation Analyst with over twenty-five years of experience in providing auditing and accounting services to clients in a wide variety of industries.

He has performed audits in accordance with the Federal and State Single Audit Acts, the HUD Audit Guide for governmental entities, non-profit organizations, home health agencies, hospices, hospitals, nursing homes, and a health center for the City of Hartford.

Pat has provided consulting services for numerous home care agencies and non-profit organizations including working as a Chief Financial Officer, and preparing valuations and budgets.

Pat is a member of the Connecticut Society of Certified Public Accountants and the American Institute of Certified Public Accountants.
Michael Gavagni, CPA, MSA, MSAT

- Michael Gavagni, CPA, MSA, MSAT is a Partner at Simione Macca & Larrow LLP.
- Michael started his career with the Hartford office of Deloitte & Touche LLP, providing audit and business advisory services to both public and private companies.
- This experience includes reviewing and assessing control environments under the Sarbanes-Oxley Act of 2002.
- Michael earned his Bachelor of Science degree in Accounting and Masters of Science in Accounting from Quinnipiac University, and his Masters of Science in Taxation from the University of Hartford.
- He sits on the Quinnipiac University Accounting advisory board, and is the Vice President of the board of a Connecticut not for profit organization.
- In addition, Michael became an adjunct teacher at Quinnipiac University in the fall of 2013.

Fraud facts

- Each company loses an estimated 5% of revenues each year to fraud
  - translates to a potential projected global fraud loss of nearly $3.7 trillion
- Median duration 18 months
Fraud cases we know

- Enron
- WorldCom
- Bernie Madoff-$50 billion Ponzi scheme
  - https://www.youtube.com/watch?v=cEhySte3D08
- ZZZZ Best Carpet Cleaning Co.
- HealthSouth

ZZZZ Best Carpet Cleaning Co.

- Created more than 10,000 phony documents to steal more than $100 million
- 86% of revenue was fake at this company
- After jail time, was convicted on two other unrelated fraud charges
  - https://www.youtube.com/watch?v=CdS16pWSKoE
HealthSouth

- Richard Scrushy-Founder, Chairman, CEO
- Corporate accounting scandal surfaced in 2002 after he sold $100 million of stock days before reporting a large loss
- Accused of falsely reporting exaggerated earnings to meet shareholder expectations
- Fraud spanned 7 years, and inflated earnings $1.4 billion, more than 10% of company assets
- At one point the corporate tax bill was more than the current earnings
- FBI efforts unsuccessful; however, sued by investors and ordered to pay $1.8 billion

Fraud in the news

- June 18, 2015-largest ever healthcare fraud takedown
- Those involved charged for billing Medicare and Medicaid for medically unnecessary treatments, or treatments never provided
- A total of 243 individuals were charged including 46 doctors, nurses and other licensed medical professionals for a total of $712 million in fraudulent billing
- Over 44 of the defendants were charged with fraud related to the Medicare prescription drug benefit program, also known as Part D
- Miami, FL; Texas; Los Angeles, CA; Detroit, MI; Tampa, Fl Brooklyn NY; New Orleans, LA
Fraud Prevention

- What is the largest deterrent for fraud?

What is it?

- In order to prevent, we must understand!
- Fraud is defined as
  - intentional perversion of truth in order to induce another to part with something of value or to surrender a legal right
  - wrongful or criminal deception intended to result in financial or personal gain
  - a person or thing intended to deceive others, typically by unjustifiably claiming or being credited with accomplishments or qualities
What counts as Fraud?

- **Internal fraud**
  - Misuse of cash
    - Most precious asset
    - Most safeguarded asset
  - Misuse of company physical assets
    - Office supplies and equipment
  - Misuse of intangible assets
    - Customer lists, donor lists, internal secrets

- **External fraud**
  - Vendor abuse
    - Double billing, overcharging
  - Board of Directors
    - Excessive compensation, sweetheart deals, insider information
  - Other
    - Data breach with bank or other data
What counts as Fraud?

- Stealing company money
  - Not only physical theft?
    - Over reporting on expense reports
    - Mileage abuse
      - Using mileage assistant software saved one client 15% or $67,500
    - Time clock abuse
    - Personal use of company assets

Common Health Care Fraud

- Billing for services not provided
- Misrepresentation of dates of service
- Kickbacks
What may lead to Fraud?

- Rationalization
- Opportunity
- Pressure

What about trust?

- But we trust them
- They are an asset to our organization
- We could not be where we are without them

- TRUST is not only an asset, but a LIABILITY
Who can be a fraudster?

- Manager
- Receptionist
- Janitor
- Owner
- Customer
- Vendor
- General public
- Father
- Mother
- Sister
- Brother
- ANYONE!

2014 Global Fraud Study

- Performed by the Association of Certified Fraud Examiners
- Study performed on over 1,400 occupational fraudsters
- More than 100 countries included
- 48% in the United States with median loss of 100K
Position of a Fraudster

**Position**
The majority of occupational frauds were committed by staff at the employee or managerial level.

- **42%** Employee
- **36%** Manager
- **19%** Owner/Executive

**Median Loss by Position**
The higher the fraudster's level of authority, the greater losses tended to be.

- **$75,000** Employee
- **$130,000** Manager
- **$500,000** Owner/Executive

Source: ACFE's 2014 Global Fraud Study: www.acfe.com/rttn

Department of a Fraudster

**Department**
77% of all occupational frauds originated in one of seven organizational departments: accounting, operations, sales, executive/upper management, customer service, purchasing and finance.

- **17.4%** Accounting
- **22.9%** Operations
- **15.3%** Sales
- **11.6%** Executive/Upper Management
- **7.7%** Customer Service
- **7.2%** Purchasing
- **5.2%** Finance
- **4.2%** All Other Departments

Source: ACFE's 2014 Global Fraud Study: www.acfe.com/rttn
Gender of a Fraudster

- 67% of fraudsters are male
- 33% of fraudsters are female

MEDIAN LOSS BY GENDER
Losses attributed to males were 123% higher than losses caused by females.

Source: ACFE's 2014 Global Fraud Study: www.acfe.com/rttn

Age of a Fraudster

52% of fraudsters were between 31 and 45 years old, but older fraudsters tended to cause larger losses.

Source: ACFE's 2014 Global Fraud Study: www.acfe.com/rttn
Tenure of a Fraudster

Median Loss by Tenure
The longer a fraudster had worked for a company, the more harm he or she was likely to cause.

- $< 1,000 (11.1%)
- $100,000 (11.1%)
- $200,000 (11.1%)
- $220,000 (11.1%)

Source: ACFE's 2014 Global Fraud Study: www.acfe.com/rttn

What type of fraud was committed?

Source: ACFE's 2014 Global Fraud Study: www.acfe.com/rttn
Anti-fraud Controls in place based upon number of employees

How was the fraud caught?
How effective are controls?
(based upon duration of fraud)

<table>
<thead>
<tr>
<th>Control</th>
<th>Percent of Cases</th>
<th>Control in Place</th>
<th>Control Not in Place</th>
<th>Percent Reduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Surprise Audits</td>
<td>33.2%</td>
<td>12 months</td>
<td>24 months</td>
<td>50.0%</td>
</tr>
<tr>
<td>Proactive Data Monitoring/Analysis</td>
<td>34.8%</td>
<td>12 months</td>
<td>24 months</td>
<td>50.0%</td>
</tr>
<tr>
<td>Dedicated Fraud Department, Function or Team</td>
<td>36.9%</td>
<td>12 months</td>
<td>24 months</td>
<td>50.0%</td>
</tr>
<tr>
<td>Anti-Fraud Policy</td>
<td>45.4%</td>
<td>12 months</td>
<td>24 months</td>
<td>50.0%</td>
</tr>
<tr>
<td>Fraud Training for Employees</td>
<td>47.8%</td>
<td>12 months</td>
<td>24 months</td>
<td>50.0%</td>
</tr>
<tr>
<td>Hotline</td>
<td>54.1%</td>
<td>12 months</td>
<td>24 months</td>
<td>50.0%</td>
</tr>
<tr>
<td>Formal Fraud Risk Assessments</td>
<td>33.5%</td>
<td>12 months</td>
<td>23 months</td>
<td>47.8%</td>
</tr>
<tr>
<td>Management Review</td>
<td>62.6%</td>
<td>13 months</td>
<td>24 months</td>
<td>45.8%</td>
</tr>
<tr>
<td>Independent Audit Committee</td>
<td>62.0%</td>
<td>14 months</td>
<td>24 months</td>
<td>41.7%</td>
</tr>
<tr>
<td>Internal Audit Department</td>
<td>70.6%</td>
<td>14 months</td>
<td>24 months</td>
<td>41.7%</td>
</tr>
<tr>
<td>Job Rotation/Mandatory Vacation</td>
<td>19.9%</td>
<td>12 months</td>
<td>20 months</td>
<td>40.0%</td>
</tr>
<tr>
<td>Fraud Training for Managers/Executives</td>
<td>47.8%</td>
<td>13 months</td>
<td>21 months</td>
<td>38.1%</td>
</tr>
<tr>
<td>External Audit of ICDFR</td>
<td>65.2%</td>
<td>15 months</td>
<td>24 months</td>
<td>37.5%</td>
</tr>
<tr>
<td>Management Certification of F/S</td>
<td>70.0%</td>
<td>15 months</td>
<td>24 months</td>
<td>37.5%</td>
</tr>
<tr>
<td>Rewards for Whistleblowers</td>
<td>10.5%</td>
<td>12 months</td>
<td>18 months</td>
<td>33.3%</td>
</tr>
<tr>
<td>Code of Conduct</td>
<td>77.4%</td>
<td>16 months</td>
<td>24 months</td>
<td>33.3%</td>
</tr>
<tr>
<td>External Audit of F/S</td>
<td>61.4%</td>
<td>18 months</td>
<td>24 months</td>
<td>25.0%</td>
</tr>
<tr>
<td>Employee Support Programs</td>
<td>52.4%</td>
<td>14 months</td>
<td>18 months</td>
<td>22.2%</td>
</tr>
</tbody>
</table>

Source: ACFE’s 2014 Global Fraud Study: www.acfe.com/rttn

U.S. Frequency of controls with fraud occurrence

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<thead>
<tr>
<th>Control</th>
<th>Percent of Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>Code of Conduct</td>
<td>72.8%</td>
</tr>
<tr>
<td>External Audit of Financial Statements</td>
<td>72.5%</td>
</tr>
<tr>
<td>Employee Support Programs</td>
<td>65.0%</td>
</tr>
<tr>
<td>Management Certification of Financial Statements</td>
<td>63.4%</td>
</tr>
<tr>
<td>External Audit of Internal Controls over Financial Reporting</td>
<td>59.2%</td>
</tr>
<tr>
<td>Internal Audit Department</td>
<td>58.8%</td>
</tr>
<tr>
<td>Management Review</td>
<td>55.5%</td>
</tr>
<tr>
<td>Independent Audit Committee</td>
<td>53.3%</td>
</tr>
<tr>
<td>Hotline</td>
<td>51.5%</td>
</tr>
<tr>
<td>Fraud Training for Managers/Executives</td>
<td>50.3%</td>
</tr>
<tr>
<td>Fraud Training for Employees</td>
<td>48.4%</td>
</tr>
<tr>
<td>Anti-Fraud Policy</td>
<td>42.0%</td>
</tr>
<tr>
<td>Proactive Data Monitoring/Analysis</td>
<td>36.1%</td>
</tr>
<tr>
<td>Dedicated Fraud Department, Function or Team</td>
<td>34.6%</td>
</tr>
<tr>
<td>Formal Fraud Risk Assessments</td>
<td>34.5%</td>
</tr>
<tr>
<td>Surprise Audits</td>
<td>28.7%</td>
</tr>
<tr>
<td>Job Rotation/Mandatory Vacation</td>
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<tr>
<td>Rewards for Whistleblowers</td>
<td>12.0%</td>
</tr>
</tbody>
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Source: ACFE’s 2014 Global Fraud Study: www.acfe.com/rttn
How effective are controls? (based upon $ savings)

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<tr>
<td>Proactive Data Monitoring/Analysis</td>
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<td>$70,000</td>
<td>$180,000</td>
<td>59.7%</td>
</tr>
<tr>
<td>Employee Support Programs</td>
<td>52.4%</td>
<td>$90,000</td>
<td>$200,000</td>
<td>55.0%</td>
</tr>
<tr>
<td>Management Review</td>
<td>62.6%</td>
<td>$100,000</td>
<td>$200,000</td>
<td>51.9%</td>
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<td>Code of Conduct</td>
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<td>$100,000</td>
<td>$200,000</td>
<td>50.0%</td>
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<tr>
<td>Internal Audit Department</td>
<td>70.6%</td>
<td>$100,000</td>
<td>$180,000</td>
<td>44.4%</td>
</tr>
<tr>
<td>Formal Fraud Risk Assessments</td>
<td>33.5%</td>
<td>$94,000</td>
<td>$168,000</td>
<td>44.0%</td>
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<tr>
<td>Surprise Audits</td>
<td>33.2%</td>
<td>$93,000</td>
<td>$164,000</td>
<td>43.3%</td>
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<td>External Audit of ICoPR</td>
<td>65.2%</td>
<td>$103,000</td>
<td>$180,000</td>
<td>42.8%</td>
</tr>
<tr>
<td>Fraud Training for Managers/Executives</td>
<td>47.5%</td>
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<td>Hotline</td>
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<td>Dedicated Fraud Department, Function or Team</td>
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<tr>
<td>Anti-Fraud Policy</td>
<td>45.6%</td>
<td>$100,000</td>
<td>$155,000</td>
<td>35.5%</td>
</tr>
<tr>
<td>Management Certification of F/S</td>
<td>70.2%</td>
<td>$120,000</td>
<td>$194,000</td>
<td>34.0%</td>
</tr>
<tr>
<td>Job Rotation/Mandatory Vacation</td>
<td>19.0%</td>
<td>$100,000</td>
<td>$150,000</td>
<td>33.3%</td>
</tr>
<tr>
<td>External Audit of F/S</td>
<td>81.4%</td>
<td>$125,000</td>
<td>$185,000</td>
<td>32.8%</td>
</tr>
<tr>
<td>Rewards for Whistleblowers</td>
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Source: ACFE’s 2014 Global Fraud Study: www.acfe.com/rttn

Top 7 effective controls compared to top 18 controls in place

- Proactive data monitoring & analysis - #13
- Employee support programs - #3
- Management review #7
- Code of conduct #1
- Internal audit #6
- Formal fraud assessment #15
- Surprise audits #16
What about collusion?

- Nontraditional controls are necessary
  - Don’t be predictable
  - Ask your auditors if they do the same thing every year- “but you always ask for 5 or items over 25K”
- Surprise audits
- Be alert for a cozy department
- Job rotation & cross training
  - Including nontraditional cross training
What can you do?

- Fraud schemes that occurred at victim organizations that had implemented any of several common anti-fraud controls were
  - Significantly less costly
  - Detected much more quickly

Anti-fraud Controls

- External audit is not focused on discovering fraud
- Hotline=common sense
- Why don’t we reward whistleblowers?
  - IRS does
  - FBI does
Tips

- Organizations with hotlines were much more likely to catch fraud by a tip.
  - 41% less costly events
  - detected frauds 50% more quickly
- Tips are consistently and by far the most common detection method.
- Over 40% of all cases were detected by a tip — more than twice the rate of any other detection method.
- Employees accounted for nearly half of all tips that led to the discovery of fraud.

Corporate Tone

IF YOU COULD JUST ADD THAT TOP SIDE ENTRY THAT WOULD BE GREAT
Corporate Tone

- Find the right answer, not just the answer that you want
- Management estimates are estimates
  - Need to have a reasonable basis

Remember the Triangle

- Opportunity
  - Lack of controls and oversight
- Rationalization
  - No code of ethics
  - Everyone is doing it
  - I deserve _____
- Pressure
  - Internal management
  - External circumstances
The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.

The primary factor that distinguishes fraud from error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.

**Fraud is an intentional act** that results in a material misstatement in financial statements that are the subject of an audit.

Two types of misstatements are relevant to the auditor's consideration of fraud—misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets.

Due professional care requires the auditor to exercise professional skepticism

Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence

The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present

Professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred
Discussion with Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud

- During the planning phase of the audit, members of the audit team should discuss the potential for material misstatement due to fraud.
- The audit team should discuss the potential for material misstatement due to fraud.
- Management could perpetrate and conceal fraudulent financial reporting.
- Assets of the entity could be misappropriated.
- An emphasis on the importance of maintaining the proper state of mind throughout the audit regarding the potential for material misstatement due to fraud.

Making Inquiries of Management and Others Within the Entity About the Risks of Fraud

- The auditor should inquire of management about:
  - Whether management has knowledge of any fraud or suspected fraud affecting the entity.
  - Management's understanding about the risks of fraud in the entity.
  - Whether the entity has established controls to mitigate specific fraud risks the entity has identified, or that otherwise help to prevent, deter, and detect fraud.
  - Whether management monitors programs and controls.
Analytical Procedures

- Analytical procedures need to be performed in planning the audit with an objective of identifying the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have financial statement and audit planning implications.
- The auditor also should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that may indicate a material misstatement due to fraudulent financial reporting.

A Consideration of the Risk of Management Override of Controls

- Even if specific risks of material misstatement due to fraud are not identified by the auditor, there is a possibility that management override of controls could occur.
- Management is in a unique position to perpetrate fraud because of its ability to directly or indirectly manipulate accounting records and prepare fraudulent financial statements by overriding established controls that otherwise appear to be operating effectively.
- Examining journal entries and other adjustments for evidence of possible material misstatement due to fraud.
Evaluating the risks of material misstatement due to fraud at/near date of the auditor's report.

- At or near the completion of fieldwork, the auditor should evaluate whether the accumulated results of auditing procedures and other observations affect the assessment of the risks of material misstatement due to fraud made earlier in the audit.
- This evaluation primarily is a qualitative matter based on the auditor's judgment.
- Such an evaluation may provide further insight about the risks of material misstatement due to fraud and whether there is a need to perform additional or different audit procedures.

Responding to misstatements that may be the result of fraud

- When audit test results identify misstatements in the financial statements, the auditor should consider whether such misstatements may be indicative of fraud.
- That determination affects the auditor's evaluation of materiality and the related responses necessary as a result of that evaluation.
- Attempt to obtain additional audit evidence to determine whether material fraud has occurred or is likely to have occurred, and, if so, its effect on the financial statements and the auditor's report thereon.
- Discuss the matter and the approach for further investigation with an appropriate level of management that is at least one level above those involved, and with senior management and those charged with governance.
- If appropriate, suggest that the client consult with legal counsel.
Communicating About Possible Fraud to Management, Those Charged With Governance, and Others

- Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management.
- This is appropriate even if the matter might be considered inconsequential, such as a minor defalcation by an employee at a low level in the entity's organization.
- Fraud involving senior management and fraud that causes a material misstatement of the financial statements should be reported directly to those charged with governance.

The Understanding of Internal Control

- There are five interrelated components of internal control.
  1. Control environment
  2. Risk assessment
  3. Information and communication
  4. Monitoring
  5. Control activities
Control Environment

- The auditor should obtain an understanding of the control environment.
- The auditor should evaluate whether management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior.
- Integrity of management or the owner/manager often plays a significant role in establishing a strong control environment.
- The auditor should also evaluate whether the strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control and whether those other components are not undermined by deficiencies in the control environment.

Risk Assessment

- The auditor should obtain an understanding of whether the entity has a process for:
  - Identifying business risks relevant to financial reporting objectives.
  - Estimating the significance of the risks.
  - Assessing the likelihood of their occurrence.
  - Deciding about actions to address those risks.
Information and Communication

The auditor should obtain an understanding of the information system, including the related business processes relevant to financial reporting, including the following areas:

- The classes of transactions in the entity's operations that are significant to the financial statements
- The procedures within both IT and manual systems by which those transactions are initiated, authorized, recorded, processed, corrected as necessary, transferred to the general ledger, and reported in the financial statements

Information and Communication (continued)

- The related accounting records supporting information and specific accounts in the financial statements that are used to initiate, authorize, record, process, and report transactions
- How the information system captures events and conditions, other than transactions, that are significant to the financial statements
- The financial reporting process used to prepare the entity’s financial statements, including significant accounting estimates and disclosures
- Controls surrounding journal entries, including nonstandard journal entries used to record nonrecurring, unusual transactions, or adjustments
Information and Communication
(continued)

- The auditor should obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including:
  - communications between management and those charged with governance and
  - external communications, such as those with regulatory authorities

Monitoring

- The auditor should obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls
Control Activities

- The auditor should obtain an understanding of control activities relevant to the audit.
- An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them.
- However, the auditor should obtain an understanding of the process of reconciling detailed records to the general ledger for material account balances.

Extent of the auditor's understanding of Internal Controls

- The overriding criterion for the understanding of internal control is that it be sufficient to assess the risk of material misstatement of the financial statements due to error or fraud and to design the nature, timing, and extent of further audit procedures.
- Obtaining an understanding that is sufficient to assess the risks of material misstatement necessitates that the auditor to develop a fairly thorough and robust knowledge of the components of internal control.
- The auditor should identify and assess the risks of material misstatement throughout the process of obtaining an understanding of the entity and its environment, including the relevant controls that relate to the risks.
How are the results of the auditor’s understanding of internal controls used?

- The understanding of internal control needs to be sufficient to assess the risks of material misstatement and to design the nature, timing, and extent of further audit procedures. Specifically, the understanding is used to:
  - Identify types of potential material misstatements
  - Consider factors that affect the risks of material misstatement
  - Design tests of controls, when applicable, and substantive procedures

Understanding the Entity and Its Environment

- The auditor should obtain an understanding of the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks
- Obtaining a solid in-depth understanding of the client's business and how it operates is fundamental to both audit efficiency and effectiveness
- Understanding the business is the key to knowing what the risks are and where to look to see if the risks have resulted in a material misstatement of the financial statement
Understanding the Entity and Its Environment

- The auditor's understanding of the entity also assists in:
  - Establishing planning materiality and evaluating whether such judgments remain appropriate throughout the audit
  - Evaluating whether certain observed conditions, such as unusual or unexpected relationships from preliminary analytical procedures, do not make business sense and indicate possible risk considerations
  - Considering fraud risk factors, for example, the existence of significant or complex related-party transactions
  - Evaluating the appropriateness and sufficiency of audit evidence

The Nature of the Entity

- The auditor should obtain an understanding of the nature of the entity relevant to the audit
- The auditor should also obtain an understanding of:
  - The entity’s operations, its ownership and governance
  - The control environment regarding management’s attitude and ethical values
  - Whether the entity demonstrates a commitment to integrity and ethical values
- The understanding of the nature of the entity helps the auditor to understand the classes of transactions, account balances, and disclosures that would be expected in the financial statements
Ethical Values

- The auditor needs to evaluate the following:
  - whether management and those charged with governance have created and maintained a culture of honesty and ethical behavior
  - whether the entity has a culture that emphasizes the importance of integrity and ethical behavior
  - whether the entity demonstrates a commitment to integrity and ethical values

Ethical Values (continued)

- The auditor can perform the following procedures to determine the entity’s ethical values:
  - Review of general policy statements on ethical values.
  - Inquiry of other personnel regarding communication received on ethical values.
  - Discussion with human resources regarding actions taken on ethics violations.
  - Review of written communications issued to employees; for example, employee acknowledgement forms signed upon hiring regarding ethical behavior or code of conduct.
Conclusion

- When obtaining an understanding of the entity and its environment, including its internal control, auditors need to evaluate whether fraud risk factors are present.
- The auditor should identify and assess the risks of material misstatement due to fraud at the assertion level for classes of transactions, account balances, and disclosures.
- The auditor assesses identified fraud risks, taking into account an evaluation of the entity's antifraud programs and internal controls.
- The auditor considers whether the entity's antifraud programs and internal controls mitigate the identified risks of material misstatement due to fraud.
- Generally, the manner in which the auditor responds to fraud risks depends on (a) the nature and significance of the identified risks and (b) the programs and controls that address the risks.

Questions?
Contact Info

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National Association for Home Care & Hospice
CPA Summer Camp
Tax Update

J. Cameron Weldon, CPA
Principal

Objectives

- Understand the current federal tax landscape
- Summarize current business tax provisions not extended for 2015.
- Understand benefits and common issues with flow through entities.
- Recognize tax savings strategies for home care & hospice companies.
Current Tax Rates

• Maximum corporate tax rate – 35%
• Maximum individual tax rate
  – 39.6%, right?
• Capital gains and qualified dividend tax rate
  – 15%-20%, right?
• Net investment income tax
• Medicare surtax
• Itemized deduction phase-out
• Personal & dependent exemption phase-out
• Self-Employment Tax

Maximum Individual Tax Rate

• Adjusted gross income threshold for 39.6% tax rate:
  – Single - $406,750
  – Married Filing Joint - $457,600
• Adjusted gross income threshold for 20% capital gain tax rate:
  – Single - $406,750
  – Married Filing Joint - $457,600
Net Investment Income Tax

• 3.8% tax on net investment income
• Net investment income:
  – Interest
  – Dividends
  – Capital gains (net of capital losses)
  – Rent & royalty
  – Passive business

Net Investment Income Tax

• Adjusted gross income threshold for NIIT:
  – Single - $200,000
  – Married Filing Joint - $250,000
• Strategy to minimize NIIT:
  – Donate appreciated stock
  – Harvest capital losses
  – Maintain active status in business
  – Municipal bonds
  – Installment sale
Medicare Surtax

- 0.9% Medicare tax on wages and self-employment income
- In addition to 1.45% (2.9% for SE) Medicare tax
- Adjusted gross income threshold for Medicare surtax:
  - Single - $200,000
  - Married Filing Joint - $250,000

Itemized Deduction Phaseout

- 3% of AGI in excess of a threshold
- Limited to offsetting no more than 80% of total itemized deductions
- AGI phaseout threshold
  - Married Filing Joint - $305,050
  - Single - $254,200
- Medical expenses, investment interest, casualty losses, gambling losses excluded
Exemption Phaseout

- Personal & dependent exemption phases out over the following ranges of AGI:
  - Married filing joint - $305,050-427,550
  - Single - $254,200-376,700

Self Employment Tax

- 12.4% Social Security tax on first $117,000
- 2.9% Medicare tax, no threshold
- Tax against ordinary business income, including:
  - Sole proprietor (Schedule C)
  - Partnership (active participation)
- Income reduced by health insurance premiums
- Half of SE tax deductible
Tax provisions not currently enacted for 2015

Work Opportunity Tax Credit

- Targeted group – certified with a state workforce agency
- 25% or 40% of $6,000 of first year wages if worked at least 120 hours or 400 hours, respectively
- Credit against income tax for individuals and corporations.
- Requires addback to taxable income for credit amount
- Credit on payroll tax return for exempt organizations
Research & Development Credit

- Percentage of qualified research expenditures:
  - Salaries
  - Supplies
  - Contract labor
- Full credit requires an addback to taxable income
- Can elect reduced credit (no addback required)

Bonus Depreciation

- First year depreciation of 50% cost basis of original use property
- MACRS recovery period of 20 years or less
- Take first year MACRS depreciation on remaining basis
- Qualified Leasehold Improvement – 15 year property (interior improvements, 3rd party lease)
- Expired 12/31/14
Section 179 Deduction

• 2014 limits and deduction
  – Assets placed in service - $2,000,000
  – Maximum 179 deduction - $500,000

• 2015 limits and deduction
  – Assets placed in service - $200,000
  – Maximum 179 deduction - $25,000
Benefits of S Corporation

• C Corporation – double taxation
  – Income taxed by corporation (35%)
  – Dividends tax to shareholder (15%/20% + NIIT)
• S Corporation – one level of tax
  – Income taxed at the shareholder level
  – Distributions can be tax free to the shareholder

Who can be an S corp?

• Limited to 100 shareholders
• Individuals only as shareholder
• One class of stock
• Income and distributions must be proportionate to ownership
• File Form 2553 to elect to be treated as S corp
Who can be an S corp?

- C corporation
- Limited Liability Company
  - But beware!
  - S corporation require income allocation and distribution be proportionate to ownership
  - S corporation requires only one class of stock
  - LLC operating agreements could violate one or both

Built in Gain

- Entity taxed as a C corp elects to be treated as S corporation
- Value business at time of conversion
- Holding period – 10 years
- Subject to 35% tax
- After 10 years – no BIG tax
Reasonable Compensation

• Ordinary income allocated is not subject to self-employment tax (FICA & Medicare)
• Must take reasonable compensation
• IRC provides no definition on reasonable compensation
• Look to market for standard salary

Partnerships
Why use a partnership?

• Flexibility
• Multiple classes of units
• Can elect to be C or S corporation
• Allocations and distributions follow operating agreement
• Liabilities provide tax basis
• Partners aren’t required to take salary

What’s the catch?

• Income allocated to active partner subject to SE tax
• Complexity can increase compliance and consulting costs
Tax Savings Opportunities

Work Opportunity Tax Credit

- Very beneficial for organizations with regular hiring practices of targeted groups
- Many states offer a version of the WOTC
- Be sure the certification is filed with the state workforce agency
- Many firms available to outsource this task
- Track 2015 hires in case the credit is extended
Capitalization Policy

- De minimis safe harbor
- Amount paid to acquire tangible property may be deducted if not exceeding certain threshold
- Up to $5,000 if:
  - Applicable financial statement (i.e. Audit)
  - Written accounting procedure stating the capitalization threshold

Capitalization Policy

- Up to $500 if no applicable financial statement
- Must use for book and tax and apply to all eligible property
- Must include delivery, installation, etc. if on same invoice
Retirement Plan

- Individual Retirement Accounts (IRA)
- Simplified Employee Pension (SEP Plan)
- SIMPLE IRA Plan
- Profit sharing plan
- 401(k) Plan
- Cash balance plan
- Defined benefit plan

Contact Information:

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Planning & Modeling - Working with Lean Margins & Trimming Your Cost

Pre-Conference – CPA Summer Camp
June 28, 2015

Future Path for Hospice & Home Care?
Objectives

• Brief overview of the evolving healthcare delivery system and why it is causing lean margins and cost trimming.

• Hospice & Home Care strategies
  – Development of new or alternative revenue sources
  – Improvements in operations efficiencies
    • Technology
    • Leveraged resources
  – Developing a collaborative partnership

• Modeling to assist with financial planning

• Q&A
Bi-Partisan Proposal: IMPACT Act of 2014

- Introduced March 18, 2014, and passed by Congress on September 26, 2014 called, “Improving Medicare Post-Acute Care Transformation” (IMPACT) Act of 2014
  - Standardized patient assessment metrics across PAC providers
  - Required reporting of Standardized Patient Assessment Data and Quality Measures.
  - Public reporting of new metrics and develop reports to provider
  - New quality metrics including: skin integrity, medication reconciliation, major falls, accurate communication during care transitions.
  - New efficiency measures: total beneficiary costs, discharge to community rate and hospitalization rate.
  - Studies of alternative payment models including site-neutral payment, etc.
Final IMPACT Act: Reporting Requirements

• Post Acute Care (PAC) Providers covered by law: SNFs, IRFs, LTCHs and HHAs

• PAC Providers to report:
  1. Standardized patient assessment data & quality measures
  2. Resource use & other measures

Reporting begins
• 10/1/2016 for SNFs
• 1/1/2017 for HHAs

IMPACT Act: Phasing-in use of the measures

• Phase I: Measure is defined and reporting required
• Phase II: Confidential feedback to PAC provider on measures (at least quarterly)
  – One year after Phase I
• Phase III: Public Reporting of Measures
  – Two years after Phase I
  – PAC providers can review and submit corrections
IMPACT Act: Alternative Payment Models

- Four years following implementation of the data collection, MedPAC charged with studying and submitting recommendations to Congress regarding a PAC prospective payment system
  - **Payment to be based on:**
    - Individual patient characteristics not site of service
    - Clinical appropriateness and Medicare beneficiary outcomes
    - Standardized patient assessment data
    - Incenting further clinical integration (i.e., coordination around a single condition or procedure -- *episodic payment*)
    - Recommendations for Medicare FFS rules that should be changed (e.g., 3-day hospital stay)
    - Impact proposed payment will have on total Medicare beneficiary cost of care, access and choice of setting

Medicare 2015 Updates

- SGR (Doc) Fix – 1% reduction in the market basket starting in 2018
- Congress proposing to “transform Medicaid” by converting to block grants
- Patient co-pay for HH
- Reform Hospice payment system sooner
- Increased payment recovery (Medical Review) for long stay Hospice patients
Trends in Home Health

- Continued “deflation” eroding “bottom lines”
- Increasing partnerships among large HH providers and Hospitals
- Heightened regulatory/compliance issues
- ACA health insurance requirements
- Increased need for shared medical records
- Implementation of “Star Rating” system on quality scores
- Overall aging work force

Trends in Hospice

- Potential emergence of new reimbursement system in 2015 to be effective 2016
- Reduced revenue and margins
- Increasing denials based on lack of medical necessity
- Increasing partnerships among large HH providers and Hospitals
- Heightened regulatory/compliance issues
- ACA health insurance requirements
- ACO development
- Future development of “Star Rating” system on quality scores (after HH launch)
- Overall aging work force
- Increasing worker comp rates and premiums
The Foundation: Value-Based Payment

Value Based Payment: “a reform initiative whereby health care providers will receive payment for service based on their performance or the potential outcomes of the service”

Tying payment to performance is perhaps the most significant aspect of health care reform.

*The de facto definition of “value” in health care reform is the intersection of lower cost and improved quality.*

Providers who can lower costs and deliver quality will be measured as “value-based providers”

Chronic Conditions Drive Medicare Spending*

* Source: MedPAC March 2013 Report to Congress Figure 1-5
What do you see as Opportunities?

Considerations for Future Improvements in Operational Efficiencies...

Opportunities??

Operational Efficiencies...

- Geographic reach, network of offices, remote based staff.
- Technology: tele-health mentoring, smart phone apps, communication devices – electronic health record
  - Investments $$$
  - Support relations
- Staffing/Labor choices... what part of your cost structure is Labor?
  - Compensation choices... full time, part time, pool of labors
  - Benefit choices
  - Travel reimbursement
- Leverage resources
  - Back office functions: billing, payroll, human resources, training
  - On-Call
  - Centralized Admissions
  - Accreditation
  - Credentialing
Potential Partners

• Have you defined your organizational philosophy around service diversification?
  – Have you decided to diversify your service offerings yourself or through a strategic relationship with other providers?
  – Have you discussed this potential at a management or board level?
• Has your organization prepared itself to enter into some form of affiliation with other service providers?
  – Have you defined which business lines might make sense to build organically vs. partner with another provider?

Potential Partners (continued)

• Have you identified other providers in your market who have complementary service offerings?
  – ACOs, PACE, Behavioral Health MCOs,
  – Hospitals and Health Systems
  – Physician Networks, Rural Health Clinics
  – Other In-Home care providers (Hospice, Home Health, Non-Certified Home Care)
  – Social service organizations case management roles??
  – Other community based entities: pharmacies, clinics, bankers, attorneys, estate planners, case managers/organizers
  – Senior living organizations
    • CCRCs
    • Independent Living Facilities
    • Assisted Living Facilities
    • Skilled Care Facilities
### Preparing for Change...

Key strategies for health care providers:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
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<tbody>
<tr>
<td>1.</td>
<td><strong>Bend the cost curve</strong> – lower costs and increase effectiveness</td>
</tr>
<tr>
<td>2.</td>
<td><strong>Understand and capitalize on strengths</strong> – Create an understanding of existing patient care delivery patterns; Identify and implement best practices and strategies by diagnoses</td>
</tr>
<tr>
<td>3.</td>
<td><strong>Use technology better</strong> – Develop electronic health exchange, monitoring tools and communication vehicles</td>
</tr>
<tr>
<td>4.</td>
<td><strong>Focus on patient, not process</strong> – Determine practices for patient-centered care and patient engagement approaches</td>
</tr>
<tr>
<td>5.</td>
<td><strong>Connect Quality to Value</strong> – Define a financially savvy path transitioning to value based/gain-sharing payments</td>
</tr>
<tr>
<td>6.</td>
<td><strong>Build new relationships</strong> – Develop relationships at the organizational level, not just referral level</td>
</tr>
</tbody>
</table>

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**Internal**

Assessment/Budgeting/Forecasting/Dashboards/Modeling
Ask Yourself:  
*How Far Do You Want to Get In?*

- What is your current business strategy?
- What is your level of diversification?
- Do you have capacity to grow or expand?
- Can you partner or affiliate with others?
- Do you have energy to take it all on?
- Do you have a budget/forecast?
- Should you have a budget/forecast?
- Do you have a dashboard?
- Do you have a model?

*Are you prepared to embrace RISK?*

---

**Why budget?**

A budget is a financial plan of future costs and revenues for a specific period in the future
- To compare budgeted revenues with actual revenues
- To compare budgeted costs with actuals costs
- To help in controlling costs
- To plan for the future
- It is for a particular period of time – ST/LT
- It is a tool for accountability and management
Budget

• Long term
  – 5-10 years
  – Usually top level management
• Short term
  – 1-2 years
• Current Budget
  – Months & weeks
  – Current results vs budgeted
• Types of budgets
  – Revenue budget (HH/Hospice)
  – Labor budget (SN, HHA, Contract Labor)
  – Inventory/Supplies budget (DME, medical supplies)
  – G & A budget
  – Marketing budget
  – Mileage budget

Forecast?

A forecast is an estimate of what will actually be achieved.
• Generally limited to major revenue and expense line items
• Usually updated at regular intervals, maybe monthly or quarterly
• Can be used for changes to your operations within the Short-term (such as staffing, inventory, marketing)
• No variance analysis as there is in a budget
• It is for a particular period of time – ST/LT
• It is a tool for accountability and management
Why dashboards?

Visualization tool with selected data that displays particular indicators of a process or business metric at a specific point in time.
- Provides useful and timely data to assist in management’s ability to impact patient care
- Provides high level view of information in a simple format
- With large number of reports available to a user, this reduces the number of reports needed to achieve the same info.

Different Dashboards for different users

Financial Dashboards
- Census/Admits (MC, MD, PI)/Visits/By location (Is one location doing better or worse than the other?)
- Case mix/Actual visits per episode/Revenue per episode/Therapy utilization/
- Hospice # of days/Average Length of Stays
- Days to bill a RAP/EOE
- Referrals/conversion rates

Director/Clinical Dashboards
- Census/Admits (MC, MD, PI)/Visits/By location (Is one location doing better or worse than the other?)
- Case mix/Planned visits per episode/Actual visits per episode/Revenue per episode/Therapy utilization/Hospice # of days
- Patient Outcomes
- Patient Satisfaction surveys
- Employee productivity
- Notes outstanding
Strategic Financial Planning

- An integrated process that facilitates long-range financial planning and decision making
- Assists in exploring how various options will influence financial performance and overall success

A Change in How We Plan

“It is better to be roughly right than precisely wrong.”

- John Maynard Keynes
Even though less accurate, critical to cover long term

Lower Accuracy

Higher Accuracy

Long term strategic planning

Short term planning

Budgets

Short Term Horizon

Long Term Horizon

5 Steps to Strategic Success

1. Establish the Baseline
2. Set Financial Targets
3. Evaluate Capital Capacity
4. Evaluate Strategies
5. Solve for Gaps
Establish Financial Targets Upfront

- Establish Goals Upfront
- Short Term and Long Term

Set Targets

Chart the Future

- Use Targets to Plan
- Understand Direction

- If Targets not met, agree on solutions
- Re-evaluate targets

Revisit Outcomes

Evaluate Strategies

- Determine Strategic Needs
- Profile Strategy
  - Quantify Performance Drivers
- Measure Impact of Strategies
  - Individually
  - In Aggregate
  - Sensitivity Analysis
### Adjustment to Average Visits/Episode

#### ABC Home Health

**2015 Budget**

<table>
<thead>
<tr>
<th>REVENUE AND EXPENSE ASSUMPTIONS</th>
<th>2015 Budget</th>
<th>Expense</th>
<th>2015</th>
<th>Expense</th>
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<tr>
<td>Average Daily Census</td>
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<td>LPH A (% of Episode)</td>
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<td>Avg Daily Episode, Total of LPH A</td>
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</table>

**New Payor Contract Scenarios**

- Average Payment Per Visit: No New Contract
- Number of Annual Visits: No New Contract
- Net Revenue Less Direct Cost: No New Contract

### Adj to Average Visits/Episode + Addition of FTE

#### ABC Home Health

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### Modeling the Impacts of Future Medicare Reimbursement Changes

**5 YEAR PROJECTION**

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<tr>
<th>MEDICARE PPS RATE CHANGES</th>
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<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
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**MEDICARE OTHER REIMBURSEMENT IMPACTS**

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<tr>
<th>ICD-10</th>
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<tr>
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### Copayment Assumptions

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Questions?

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OVERVIEW OF TODAY’S DISCUSSION

- Background

- Private Company Council
  - What is it?
  - What is it doing?

- Leases

- Wrap-Up
PERCEIVED WEAKNESSES OF U.S. GAAP FOR PRIVATE COMPANIES

- Complexity
- Focus on Public & Larger Entities
- Increased Emphasis on Fair Value
- Ever-Changing Rules
- Cost / Benefit to Users
- Irrelevant & Confusing
- Private Companies

BACKGROUND

- Recommendations for future of private company standard setting
  - AICPA Blue Ribbon Panel on Standard Setting for Private Companies
  - Financial Accounting Foundation (FAF)
  - National Association of State Boards of Accountancy (NASBA)
PRIVATE COMPANY COUNCIL (PCC)

- Established by FAF in May 2012
- Advises FASB on modifications to GAAP for private companies
- FASB must endorse change

INITIAL PROJECTS

- Topic 805, *Business Combinations*
  - ASU 2014-18, *Accounting for Identifiable Intangible Assets in a Business Combination*
  - ASU 2014-02, *Accounting for Goodwill*
- Topic 810, *Consolidation*
  - ASU 2014-07, *Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements*
- Topic 815, *Derivatives and Hedging*
  - ASU 2014-03, *Accounting for Certain Receive-Variable, Pay-Fix Interest Rate Swaps - Simplified Hedge Accounting Approach*
Initial Projects (Cont’d)


- ASU 2013-12, Definition of a Public Business Entity

Private Company Decision-Making Framework

  - FASB & PCC will use Guide in determining when accounting alternatives should be considered for private companies
  - Guide discusses five areas in which accounting & reporting guidance might differ for private & public companies: recognition & measurement, disclosures, display, effective date & transition method
In December 2013, FASB issued ASU 2013-12 which established the new definition of public business entity.

New definition will be used to identify which entities will not be eligible to use private company exceptions & alternatives issued by FASB. These include:

- Private companies are entities that are not public business entities, NFPs or EBPs.

Not-for-profit entities (NFPs) & employee benefit plans (EBPs) are excluded from the definition of public business entity.

Public business entity is an entity that meets any of the following criteria:

- It is required by the SEC to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in filing).

- It is required by the Securities Exchange Act of 1934 (Act), as amended, or rules or regulations promulgated under Act, to file or furnish financial statements with a regulatory agency other than the SEC.

- It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
ASU 2013-12: DEFINITION OF A PUBLIC BUSINESS ENTITY (CONT'D)

- Public business entity is entity that meets any of following criteria
  - It has issued, or is conduit bond obligor for, securities that are traded, listed or quoted on exchange or over-the-counter market
  - It has one or more securities that are not subject to contractual restrictions on transfer, & it is required by law, contract or regulation to prepare U.S. GAAP financial statements (including footnotes) & make them publicly available on periodic basis (for example, interim or annual periods) – entity must meet both of these conditions to meet this criterion

ASU 2014-02: INTANGIBLES—GOODWILL AND OTHER (TOPIC 350): ACCOUNTING FOR GOODWILL

- ASU 2014-02, issued in January 2014, provides alternative to private companies for accounting for goodwill subsequent to business combination

- Two main provisions of ASU
  - Amortization
  - Simplified impairment model
Amortization
- Goodwill would be amortized straight-line over 10 years or shorter period if company can demonstrate that another useful life is more appropriate

Simplified Impairment Model
- Private companies would only be required to test goodwill for impairment upon occurrence of triggering event that indicates fair value of entity (or reporting unit, if elected) may be less than its carrying value
- Goodwill impairment testing can be performed at entity level or reporting unit level, based on accounting policy election upon adoption of ASU
- Impairment loss, if any, would be recognized for excess of entity’s (or reporting unit’s) carrying amount over its fair value – not to exceed goodwill carrying amount

Effective for annual periods beginning after December 15, 2014, & interim periods thereafter, early adoption is permitted

Applied prospectively to all goodwill existing at beginning of period of adoption & to all new goodwill generated in business combinations after effective date

Early application is permitted for any interim and annual financial statements that have not yet been made available for issuance
ASU 2014-03: DERIVATIVES AND HEDGING: ACCOUNTING FOR CERTAIN RECEIVE-VARIABLE, PAY-FIXED INTEREST RATE SWAPS – SIMPLIFIED HEDGE ACCOUNTING APPROACH

➢ ASU 2014-03, issued in January 2014, provides private companies (except financial institutions) alternative to accounting for interest rate swaps entered into to economically convert variable-rate debt to fixed-rate debt

➢ Three main provisions of ASU
   • Practical expedient to apply hedge accounting
   • Measurement (settlement value versus fair value)
   • Hedge documentation

Practical Expedient to Apply Hedge Accounting

➢ Private companies, other than financial institutions, would qualify for hedge accounting for certain interest rate swaps that are entered into for purpose of economically converting variable-rate debt to fixed-rate debt

➢ For qualifying swaps, company would be able to assume no ineffectiveness

➢ Under this approach, income statement charge for interest expense would be similar to amount that would result if company had directly entered into fixed-rate debt instead of variable-rate debt & interest rate swap
Measurement (Settlement versus Fair Value)

- Private companies following simplified hedge accounting approach will have option to measure swap at settlement value instead of fair value
  - Primary difference between settlement value & fair value is that nonperformance risk is not considered in determining settlement value

Hedge Documentation

- Private companies following simplified hedge accounting approach will have until issuance of their financial statements to complete their hedge documentation; as opposed to contemporaneous documentation requirement under current U.S. GAAP

Effective for first annual period beginning after December 15, 2014, & interim periods thereafter, with early adoption permitted

Private companies have option to apply using modified retrospective approach or full retrospective approach, as elected on swap-by-swap basis

Early application is permitted for any interim and annual financial statements that have not yet been made available for issuance
ASU 2014-07: APPLYING VARIABLE INTEREST ENTITY GUIDANCE TO COMMON CONTROL LEASING ARRANGEMENTS

- Allows private companies to elect alternative which exempts them from applying variable interest entity (VIE) guidance to lessor entities under common control when certain criteria are met.

- FASB issued final standard in March 2014.

- Final standard is effective for annual financial statements beginning after December 15, 2014, & interim periods thereafter, with early adoption permitted.

- Standard requires full retrospective application.

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ASU 2014-07: APPLYING VARIABLE INTEREST ENTITY GUIDANCE TO COMMON CONTROL LEASING ARRANGEMENTS (CONT'D)

- Private company lessee can elect alternative & not apply VIE guidance to lessor entity when four criteria are met:
  - Private company lessee & lessor entity are under common control.
  - Private company lessee has leasing arrangement with lessor entity.
  - Substantially all activity between the private company lessee & the lessor legal entity are related to leasing activities (including supporting leasing activities) between those two entities.
  - If the private company lessee explicitly guarantees or provides collateral for any obligation of the lessor legal entity related to the asset leased by the private company, then the principal amount of the obligation at inception of such guarantee or collateral arrangement does not exceed the value of the asset leased by the private company from the lessor legal entity. Leased asset sufficiently collateralizes debt of lessor company at inception.
ASU 2014-07: APPLYING VARIABLE INTEREST ENTITY GUIDANCE TO COMMON CONTROL LEASING ARRANGEMENTS (CONT'D)

- If alternative is elected, more robust disclosures are required about the leasing arrangement & any potential liabilities the private company is & could be exposed to due to relationship.
- Election of this alternative is an accounting policy election applicable to all leasing arrangements that meet requirements for applying this approach.

ASU 2014-18: ACCOUNTING FOR IDENTIFIABLE INTANGIBLE ASSETS IN A BUSINESS COMBINATION

- Provides simplified accounting by recognizing fewer intangible assets in a business combination.
- Private companies can limit customer-related intangibles (CRIs) it recognizes separately to those that are capable of being sold or licensed independently from the other assets of the business.
- Private companies also wouldn’t separately recognize noncompetition agreements.
ASU 2014-18: ACCOUNTING FOR IDENTIFIABLE INTANGIBLE ASSETS IN A BUSINESS COMBINATION

- Companies that elect the new intangible asset alternative will be required to elect the goodwill accounting alternative in ASU 2014-02

- Companies that elect the goodwill accounting alternative would not be required to elect the intangible assets accounting alternative

The decision to adopt the alternative must be made when the first qualifying transaction occurs in fiscal years beginning after December 15, 2015

- If such transaction occurs in the first fiscal year beginning after December 15, 2015, adoption of alternative will be effective for that fiscal year’s annual financial reporting and all interim and annual periods thereafter

- If such transaction occurs in fiscal years beginning after December 15, 2016, adoption of alternative will be effective in the interim period that includes the date of that first qualifying transaction and subsequent interim and annual periods
ASU 2014-18: ACCOUNTING FOR IDENTIFIABLE INTANGIBLE ASSETS IN A BUSINESS COMBINATION

- A company that elects the alternative must apply it to all future qualifying transactions
- Early application is permitted for any interim and annual financial statements that have not yet been made available for issuance

LEASES – WHERE DO THINGS STAND?

- After two exposure drafts and intense re-deliberations, FASB is finally getting closer to wrapping up their leases project and expects to issue a final standard in 2015.
- After their May 2013 ED on leases, FASB received over 600 comment letters; most of which criticized the proposal and raised significant concerns over the increased cost and complexity that would result.
  // Based on this feedback, it was clear to FASB that changes needed to be made, so they went back to the drawing board and during 2014 re-deliberated many of the key concepts in the proposal.
  // During these re-deliberations, FASB settled on a revised model that is much simpler than the one proposed in the May 2013 ED, and that will be less costly to implement.
There is only one substantive difference between existing lessee accounting and the revised model:
- All leases greater than one year will be recognized on the balance sheet.

This accomplishes the primary objective of the lease project, which is to put all leases on the balance sheet.

For income and expense recognition, FASB and IASB have gone in separate directions and it doesn’t look like convergence will be achieved.

Lessor model is substantially the same as the current model.
LEASES – WHERE DO THINGS STAND?

Type A
- Balance Sheet
- Income Statement
- Cash Flow Statement
- Right-of-use asset
- Lease liability
- Amortization expense
- Interest expense
- Cash paid for principal & interest payments

Type B
- Right-of-use asset
- Lease liability
- Single lease expense on straight-line basis
- Cash paid for lease payments

Recognition and Measurement Exemption

For leases with a term of 12 months or less

No longer based on maximum possible term, now aligned with definition of lease term
WRAP UP

- What questions do you have?

- Thanks!