by Stephen D. Harrell, CPA and Kathryn M. Fletcher, CPA

Lease Accounting Changes - What Healthcare Providers Need to Know

Like many other industries, the healthcare industry has been plagued by the current woes of the U.S. economy. In addition, equipment used in healthcare, such as CT scanners, x-ray machines, etc., can be very costly, and the technology can change rapidly. Individuals in management positions within the healthcare industry must make decisions on a daily basis to remain competitive in the ever-changing technological market, while also staying within the financial constraints of their respective organization. Due to these pressures and the fact that healthcare facilities often have limited available cash, financing arrangements such as equipment leases may be more feasible than purchasing the equipment.

CURRENT ACCOUNTING STANDARDS

Current generally accepted accounting principles require lessees to classify and record leases as either capital or operating. Capital leases are recorded as if the lessee borrowed funds to purchase the leased property, and the lessee therefore recognizes an asset and a liability. Operating leases are treated as the rental of property and the consideration paid is recorded as a period expense. In order for a lease to qualify as a capital lease, it must meet one of the following four criteria: ownership transfers at the end of the lease term; the lease contains a bargain purchase option; the lease term is at least 75 percent of the property's estimated economic life or the present value of the minimum lease payments is at least 90 percent of the property's fair value. If none of the four criteria are met, the lease is classified as operating.

TAKEAWAYS

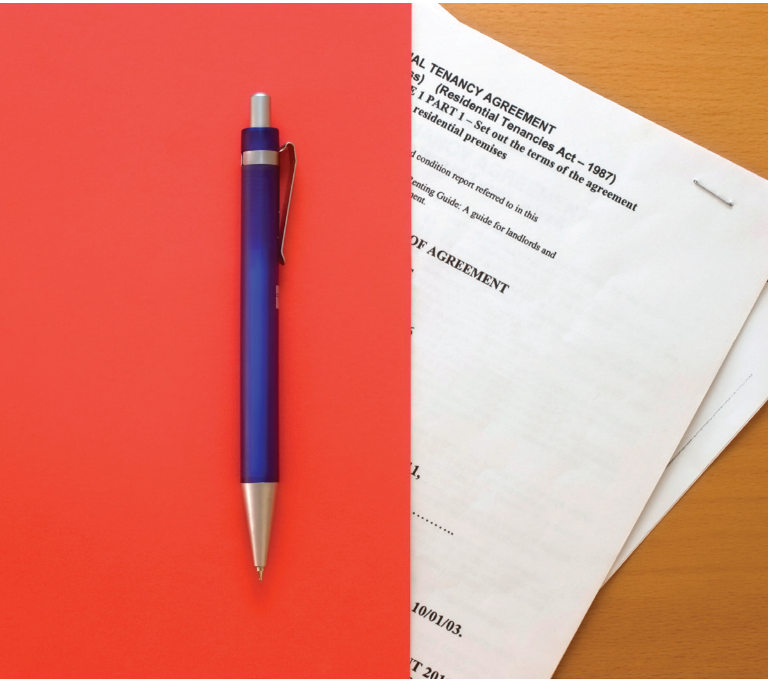
- Financing arrangements such as equipment leases may be more feasible than purchasing the equipment.
- The current lease standard exposure draft is a right-of-use model.
- Healthcare entities should be proactive in preparing for expected exposure draft changes.

EXPECTED FUTURE ACCOUNTING STANDARDS

Under the lease standard exposure draft (ED) issued in August 2010 by the FASB and IASB, lessees will be required to recognize an asset and a liability for substantially all leases, with the exception of certain short-term leases. This approach is a right-of-use model in which a lessee would recognize an asset, representing its right to use an underlying asset, and a liability, representing its obligation to make lease payments during the lease term.

Under the original ED approach, the asset and liability would be recognized at the present value of the lease payments. The asset would presumably be amortized using the straight line method and the liability would be subsequently accounted for using the effective interest method. This approach results in a front-loading of the total lease expense since the amount of interest expense recognized is highest at the beginning of the lease.

As of May 15, 2012, the FASB and IASB have discussed other alternative approaches for amortizing the right-of-use asset. The approaches under consideration utilize factors such as the present value of economic benefits or the impact of the time value of money,



and asset consumption discount rates including discounting the expected residual value. Another approach being considered is to treat the asset and liability as a unit and adjust both to the present value of the remaining lease payments. These alternative approaches have different effects on total expense, ranging from varying total expense during the lease term to a constant straight-line amortization.

PROS AND CONS

Current lease accounting models have often been criticized for their lack of reporting consistency as well as the omission of relevant data in financial reporting. Proponents of the new lease accounting models suggest that reporting would be more consistent by eliminating the subjectivity related to the current capital versus operating reporting option. Proponents also suggest that the new lease accounting model would promote more accurate and transparent reporting of the rights and obligations related to the right-of-use assets.

Opponents of the proposed lease accounting changes state that the additional reporting requirements noted above will be time consuming and burdensome for healthcare entities' accounting personnel. These opponents also point out the potential negative aspect associated with debt covenants and the restrictions many place on incurring additional debt. If debt covenants are not structured to permit additional debt in the form of lease agreements, the availability of alternative funding or the ability to amend current loan documents will need to be considered.

Finally, opponents of the original ED point out the negative effect on the entities' total expenses during the earlier periods of the lease term. As noted above, the FASB and IASB are considering other approaches that may address this front loading of expenses. However, opponents suggest that the amortization approaches currently being considered include subjective measures which may lead to inconsistent reporting.

HOW HEALTHCARE ENTITIES CAN PREPARE FOR CHANGES

While a revised exposure draft is not expected to be issued until the second half of 2012, healthcare entities should be proactive in preparing for the expected changes. Management should review current and potential future debt arrangements for covenant issues, and if applicable, begin pursuing amendment or waiver options to ensure the availability of financing opportunities when the proposed changes are implemented. Management should also review and summarize all current leases to understand their expiration dates and potential term negotiability. Finally, consideration should be given to the expected changes when structuring new lease arrangements to ensure the arrangements are economically advantageous for the entity.

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