Hospitals— Controlling Costs Through Outsourcing

Proposed changes in accounting rules could encourage more hospitals to switch to rental textiles

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By Stanley S. Fishbein

Healthcare organizations, and hospitals in particular, are trying to cope with a tsunami of financial challenges as the industry undergoes transformational changes brought on by the Patient Protection & Affordable Care Act. Cuts in Medicaid and Medicare reimbursements have hurt revenue, which has been further reduced by the federal sequester and lower state funding. Hospitals are self-inflicting more revenue pain, as they work to bring down re-admissions to avoid new penalties. Meanwhile, patient demand for services has softened as patients are paying more attention to their out-of-pocket costs. During the first half of this year, Fitch rating analysts downgraded eleven health systems or hospitals and said the outlook was negative for another 15.

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Given these developments, hospital executives are under mounting financial pressure to find ways to boost revenue, conserve cash and cut costs, while trying to improve the quality of healthcare services and patient outcomes. In addition to streamlining inefficient processes, other actions healthcare providers are taking include outsourcing of medical and nonmedical services, creating joint ventures, affiliations and mergers with other hospitals and healthcare groups, terminating employees and cutting, cutting, cutting!

WHY LEASE EQUIPMENT?

Most companies, including healthcare organizations and textile services companies, lease equipment because leasing conserves cash and provides a low-cost way to stay current with technological changes. Leasing is also a flexible financial tool used to maximize tax benefits and accomplish financial reporting objectives, while achieving a desirable economic result. As a testament to leasing's popularity, much of the $725 billion of equipment (in all sectors of the economy—not just laundry) that will be financed in the U.S. this year will be leased.

A lease is a contract whereby the owner of an asset (lessor) conveys to another party (lessee) the *right to use* the asset for a period of time (term) in return for a periodic payment. Absent a renewal or purchase option, the asset must be returned to the lessor at the end of the lease term.

CURRENT LEASE CLASSIFICATION AND TREATMENT

How a lease is classified for accounting and tax purposes will affect a lessees' financial profile and bottom-line result. The key question in classifying a lease is whether or not the lease documentation results in a true usage agreement (a true lease, aka, a rental agreement) or a sales contract. Criteria used to make this determination for accounting purposes is very specific, while less so for income-tax purposes.

Accounting: Since 1976, the classification of a lease by companies using generally accepted accounting principles (GAAP), has been governed by the criteria contained in the Statement of Financial Accounting Standards No. 13 (SFAS 13). Lease classification is important because it will affect the lessee's balance sheet ratios and EBITDA, which may impact a lessee's compliance with its bank covenants.

If the lease is determined to be a sales contract (capital lease) the lessee's accounting classification and treatment will be the same as if the lessee acquired the asset with a loan. The asset and corresponding liability will be on-balance sheet and the lessee will deduct asset depreciation as well as the interest implicit in the lease payments in its income statement.

If the lease is determined to be a usage agreement (operating lease), the leased asset and corresponding liability will not be on the lessee's balance sheet. Instead, the minimum lease payments for the next five years plus a lump sum for subsequent years will be disclosed in the footnotes to the lessee's financial statements. The lessee will deduct the lease payments as an operating expense in its income statement.

Tax: Lease classification is based upon the determination of which party to the lease has the risks and rewards of asset ownership. Since the Internal Revenue Service (IRS) hasn't issued specific guidelines, one must rely upon interpretations of the internal revenue code by IRS and the courts.

If the lease is considered to be a sales contract (nontax lease), the lessee is deemed to be the owner of the asset and is entitled to the tax benefits (depreciation and any investment tax credit). The lessee will deduct depreciation and the interest implicit in the lease payments on its income tax return.

If the lease is considered a true usage agreement (tax lease), the lessor is deemed to be the owner of the asset and is entitled to the tax benefits. The lessor will take into consideration the after-tax value of its tax benefits when setting the lessee's lease payments, making the tax lease the type of lease with the lowest monthly payment. The lessee will deduct the lease payments on its tax return.

Statement of Financial Accounting Standards No. 13 (SFAS 13):

Capital lease classification is required if ***any one*** of the following criteria is met:

- There is an automatic transfer of title to the lessee at the end of the lease term.
- The lease contains a bargain-purchase option.
- The lease term is equal to or greater than 75% of the asset's economic useful life.
- The present value of minimum lease payments is equal to or greater than 90% of the asset's fair market value.

PROPOSED NEW LEASE ACCOUNTING RULES

As part of a global effort to establish uniform corporate financial-accounting standards, the Financial Accounting Standards Board (FASB) in conjunction with the International Accounting Standards Board (IASB) has proposed a new set of rules that would transform lease accounting for all public, private and not-for-profit entities currently subject to SFAS 13 under GAAP financial reporting. The proposed rules would NOT apply to most small companies, since these companies use the income tax method when preparing financial statements as well as income tax returns.

The proposed rules are intended to improve transparency and better inform financial statement readers by requiring lessees to put all leased assets and associated liabilities on the balance sheet, with the exception of short-term leases (not greater than 12-months including any options to extend). However, the proposed rules are complex and the transition will be more difficult for companies that have heavily utilized operating leases.

For leases of assets other than real property (for example, equipment, aircraft, cars, trucks), a lessee would classify the lease as a Type A lease and would do the following:

1. Recognize on its balance sheet a "*right-of-use asset*" and liability, initially measured at the present value of the lease payments, and
2. Recognize on its income statement the unwinding of the discount on the lease liability as interest separately from the amortization of the right-of-use asset.

For most leases of property (land and/or a building or part of a building), a lessee would classify the lease as a Type B lease and would do the following:

1. Recognize a right-of-use asset and a lease liability, initially measured at the present value of lease payments

2. Recognize a single lease cost, combining the unwinding of the discount on the lease liability with the amortization of the right-of-use asset, on a straight-line basis.

The good news for the textile services industry and its customers is that the proposed lease accounting rules will NOT apply to goods or services provided under a lease when the supplier has the right to substitute assets—for example, fungible assets, such as linen and uniforms. So hospitals may seek to convert laundry service contracts to textile rental agreements to improve liquidity and financial ratios by moving textile assets (i.e., customer-owned goods [COG]) off-balance sheet.

It took the FASB and IASB four years to issue its first exposure draft of the proposed rules in 2010. After receiving heavy criticism for creating unintended consequences, primarily in the real estate industry, the accounting boards issued a revised version in May 2013. As a result, the latest version addresses many of these concerns and keeps most real property leases off-balance sheet by creating a rule as to "whether or not the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset."

The accounting board's plan is to consider all public feedback and resume deliberations in the fourth quarter this year. While the proposed rules are not final and no adoption date has been set, it's important to note that the rules, as currently proposed, do not allow the grandfathering of existing leases. Therefore, lessees will be required to re-classify existing leases (using the new classifications and terminology) and include these changes in the prior period when preparing financial statements with prior-period comparisons.

The good news for lessees is that the income tax treatment of leases will not be affected by the lease-accounting proposal and the many benefits of leasing equipment will remain intact, such as improving cash flow, preserving capital, obtaining flexible financial solutions and avoiding equipment obsolescence.

FUNDING FOR CAPITAL PROJECTS

Healthcare executives are searching for and finding ways to fund capital projects. They are using government grants to implement electronic medical records and energy efficiency measures and using low-cost loans and leases to upgrade equipment. While hospitals have traditionally been big users of true (operating) leases to obtain medical and IT equipment, a more recent trend has been to use capital leases and loans given historically low interest rates (now starting to increase), and perhaps more importantly, to avoid the herculean task and cost of reclassifying a multitude of operating leases, assuming the proposed new lease-accounting rules are adopted.

True leases should regain their prominence in the healthcare industry after the proposed lease accounting rules are either abandoned by the accounting boards, or become effective, for two primary reasons. First, because true leases enhance liquidity when revenue generated from the use of medical equipment exceeds lease payments; second, because true leases provide highly desirable end-of-term flexibility and cost savings when dealing with old, and perhaps obsolete, medical and IT equipment.

HEALTHCARE LAUNDRY SERVICES

Hospitals' outsourcing of laundry services, the No.1 outsourced service by hospitals, is expected to increase as hospitals continue to cut costs and increase revenues by converting floor space from costly support services to revenue-generating healthcare services. Hospitals' outsourcing of healthcare services, another trend that is expected to grow, is creating new customers for laundry services, such as clinics, imaging and surgery centers. As mentioned above, hospitals may seek to convert laundry service contracts to textile rental agreements to improve liquidity and financial ratios by moving COG textile assets off-balance sheet.

To meet this increasing demand, textile services companies are expanding existing laundry facilities, building new plants and acquiring equipment. Forward-looking textile services companies are now replacing aging equipment with new smarter technology machines to reduce downtime and maintenance costs and increase production and revenue. Increasing top as well as bottom-line results when upgrading to new equipment makes leasing an attractive cash-management tool. Working with a lease-financing expert who also understands your business, and the laundry process, will greatly reduce the time and effort you and your accountant need to make to obtain the best equipment lease for your company.

The Chinese ideogram for crises consists of two characters signifying danger and opportunity. The tumultuous transformation of the healthcare industry is a golden opportunity for companies in textile services, and equipment leasing can help you capture the gold! TS

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