IMPLEMENTING THE NEW LEASE STANDARD: THE VITALS FOR HEALTHCARE

What are Embedded Leases?

Healthcare entities often have service arrangements which include a physical asset (e.g., a medical device) and/or other goods (e.g., medical consumables) and services. These service arrangements must be scrutinized to determine whether the physical asset is indeed being leased under the new standard. These arrangements containing a leased asset within an overarching service contract are referred to as an "embedded lease." An embedded lease likely exists if the arrangement contains an identified physical asset that is indeed controlled by the customer.

In some cases, the existence of embedded leases may be easily overlooked. In other cases, entities must make difficult decisions about whether the service arrangement contains a lease.

The new lease accounting standard (ASC 842) will have a significant impact on most healthcare companies, given the historical high volume of operating leases now required to be shown on the balance sheet. Hospital systems and other providers have large amounts of leased real estate and medical equipment, like CT scanners and MRI machines. Biotech companies, medical equipment manufacturers, and healthcare facilities will all, to a greater or lesser degree, be affected by the new standard.

The Basics

What does the new leasing standard do?

Under prior guidance, leases were classified as either (1) capital leases, which were capitalized on the balance sheet, or (2) operating leases, which were expensed and appeared only as disclosures in the notes to the financial statements.

Many companies worked to structure their leases as operating so they were off balance sheet. Fewer capital leases meant fewer liabilities viewed as debt; less debt improved leverage and made the company more attractive to banks and other lenders. Cash-strapped companies with high debt were especially eager to keep lease obligations off the balance sheet.

To increase transparency and eliminate incentive for off-balance-sheet strategies, the FASB issued ASU 842. Now all leases — with a few exceptions, like those less than 12 months — will be on the balance sheet. The benefits of structuring leases as operating leases mostly disappear. Leasing decisions will be made for primarily business reasons rather than accounting purposes.

As opposed to lessees, lessors don't face as big a change to their accounting. They'll generally continue to classify leases as sales-type, direct financing or operating. Our discussion therefore focuses on issues for the lessee.

When is the standard effective?

ASC 842 is already in effect for public calendar year-end companies. For private companies, it is effective for calendar years beginning January 1, 2020.

The Vitals For Healthcare Companies

Many calendar year-end public healthcare companies found the adoption (aka Day 1) and planning for operationalization (Day 2) of the new standard to be longer and costlier than expected, given the complexity and volume of operating leases, including embedded operating leases. Simply identifying and inventorying all leases proved a greater challenge than anticipated.

Also, some entities underestimated the time and effort required to understand and adopt the new standard because it is principles-based and no longer contains clear rules, thus requiring subjective judgment.

Most simply did not devote enough internal resources, or enlist the help of external resources and/or technology solutions soon enough. Due to high lease volume, the effort to abstract and validate data proved overwhelming. Many companies rightly selected a technology solution but struggled with the brute-force effort to obtain and digest data to put in it. To be clear: This was not a system problem, but rather a data issue.

Overall, healthcare companies struggled with fundamental problems that can be avoided with proper planning and assistance. Unfortunately, these struggles left many companies scrambling for Day 1 compliance while tabling Day 2 operational optimization.

Key Areas of Focus For Healthcare Companies

The following recommendations address areas of focus for healthcare companies as they seek to adopt and operationalize the new standard.

Achieve buy-in internally by involving key internal stakeholders early.

Adopting the new standard requires engagement and support from key stakeholders across the company.

Key internal stakeholders must be made aware of the new guidance, so they can better understand how it will impact them. Such stakeholders outside of the accounting and finance area may include real estate, procurement, internal counsel and IT personnel. All will need to be educated on the new standard and their own importance to the overall success of adoption and post compliance.

Some key internal stakeholders will have little contact with the accounting and finance department or experience in adopting new accounting standards. Thus, some may deem the project a low priority without a better understanding of the overall impact and scale it may require. Achieving buy-in from top management to ensure cooperation across the business prior to project commencement is essential.

Note: Complexity of a project can easily double, or triple when there's an increased number of locations and key internal stakeholders in a highly decentralized company.

Involve external stakeholders: They have an important role throughout the project.

A healthcare company will have numerous external stakeholders that should be involved during the project, including lenders, service providers and auditors.

Lenders: Depending on a healthcare company's capital structure, many having debt will need to discuss with their lenders what impact, if any, the standard may have on their debt covenants. Many lenders are familiar with the new standard and are working to understand potential impacts on their lending arrangements. Taking a proactive approach is generally appreciated by lenders; failing to do so could result in potential covenant failures in the future when lenders surely will not be so accommodating.

***Service providers*:** Enlisting the help and having an arrangement with a service provider can greatly assist in assessing whether an embedded lease exists. In general, both parties to the arrangement should look at it similarly (i.e. the arrangement is, or isn't, a distinct physical asset controlled by the customer). Consider involvement by landlords and equipment vendors as well when evaluating subjectivity or ambiguity in a lease contract.

External auditors: They should be involved throughout the initial adoption process to avoid challenges and rework. Auditors can be particularly helpful when companies are drafting policies to help develop agreed-upon rules upfront. Additionally, involving auditors in making subjective judgments among varying material outcomes should be welcomed by both parties.

Inventory all leases: Search and identify a comprehensive and complete list of existing and new leases.

For many healthcare companies, simply identifying all leases will prove to be a challenge. It will be especially difficult in highly decentralized hospital systems with multiple locations and complex service arrangements.

First, healthcare companies should start to inventory existing operating leases by working backwards from their latest five years and thereafter commitments and contingency footnote support and known operating leases. Second, companies should develop and leverage lease questionnaires that both seek to uncover unknown leases and validate known leases by decentralized locations and accounting. Last, in conjunction with procurement staff, service providers should be identified in which physical assets may be being conveyed as part of the arrangement, thus creating the potential for an embedded lease.

Companies should strongly consider having a repository to store electronic copies of leases as they are identified and inventoried. Having easy access to lease documents will become crucial in performing data abstraction and validation.

Healthcare companies should not expect employees in the field to fully understand the new standard. Employees will benefit from additional resources and protocols when attempting to identify and interpret leases in accordance with new corporate policy.

Solve the data problem: Perform data abstraction and validation by individual lease, identifying ALL pertinent data and aggregate lease data in a highly uniform and structured format ready for a technology solution.

For many companies, abstracting and validating key lease information has proven to be very difficult. Furthermore, companies should strongly consider **all** data elements that may be necessary for proper accounting with their chosen technology solution in mind.

Healthcare companies should not underestimate the resourcing and expertise necessary to abstract and validate lease data. Companies should be careful to think about what format and data elements will ultimately be required for their chosen technology solution. Analyzing and extracting lease data one time for the right information and data elements will mitigate the need to revisit and reexamine leases for additional data elements, which will be very time consuming and costly.

Abstracting and validating data may well be the most labor-intensive and time-consuming activity as companies work to adopt the new standard. Companies should strongly consider budgeting time per lease and then double it!

Choose a technology solution wisely: Not all lease technology solutions are created equally — each has its advantages and disadvantages.

Overall, healthcare companies with a high volume of leases will need a strong technology solution, of which there is not a shortage. The majority of the available lease technologies are cloud based and will work with most ERP systems.

Some lease technology companies have been in business for many years. Others have been established more recently for helping companies adopt the new standard. Historically, some focused on real estate leases, others on equipment leases. Now most accommodate both.

The new standard gives companies the opportunity to rationalize a lease technology solution by automating processes and mitigating manual effort through automation, built-in workflow and inherent controls. Generally, there is a strong case for achieving ROI within one to two years.

Structuring of pricing for implementation and on-going subscription costs can vary significantly by solution. Generally, most are priced based on volume of leases or lease portfolio value, or a combination of both. Healthcare companies with a high volume of leases should be especially wary of low cost and unproven solutions.

When selecting a technology solution, healthcare companies should prioritize and consider the following:

- A strong reputation in the marketplace with proven healthcare company qualifications
- A trusted implementation partner and their ability to execute
- A simple user interface that is easy to navigate and use
- A solution that provides automation, built-in workflow and inherent controls—and preferably with SOC reports
- A solution with robust and customizable reporting abilities

- A solution that was predominantly built with equipment leases in mind (given high volume of equipment leases in healthcare)

Note: Lease technology solutions discussed above focus on leases by a lessee and not the lessor. Some of the solutions will allow and account for sublease income but are specifically designed to accommodate lessor accounting.

Plan for Day 2 operationalization: A technology solution will go a long way to ease lease accounting under the new standard; however, necessary change management involving people and process cannot be ignored to maintain compliance post adoption.

Many companies that fell behind in their implementation plans for Day 1 adoption were forced to forgo efforts to further operationalize for Day 2 optimization. Some have potentially risked on-going compliance as a result.

Getting a healthcare company to Day 1 adoption is not the end of a leasing project. A well-thought-out project plan and implementation partner will drive a Day 2 focus that will mitigate risk and lower on-going costs of compliance.

Starting up a leasing Center of Excellence (COE) within the company to focus on Day 2 is considered a best practice. A properly established COE might perform the following:

- Ongoing employee training and resource for questions and field support
- Maintain a single source repository of lease data and arrangements
- Continually monitor policy compliance and necessary controls
- Maintain the lease technology solution, including administration
- Act as a conduit to lease experts and auditors
- Generate monthly/quarterly/annual lease reporting and ad hoc reporting

Conclusion

The new lease accounting standard will have a significant impact on most healthcare companies given the historical high volume of operating leases now required to be shown on the balance sheet.

Healthcare companies will struggle and risk compliance if they fail to adequately plan, involve the right partners and technology solutions and generally underestimate the overall effort. However, with proper foresight a prepared healthcare company can successfully:

- ***Achieve buy-in internally***
- ***Involve external stakeholders***
- ***Inventory ALL leases***
- ***Solve the data problem***
- ***Choose a technology solution wisely***
- ***Plan for Day 2 operationalization***