Proposed Lease Accounting Rules Will Change our Business
Focus on Healthcare
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This is the sixth of a six part series on how the proposed lease accounting rules will impact six major market segments in the leasing industry. This segment will focus on ***healthcare***. The municipal, IT/office equipment, vehicles, large ticket market segments and construction/material handling/agriculture equipment were covered previously although readers from those segments should read on as I include new information regarding recent Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) joint decisions in the lessee and lessor summaries below. They are at the point in the project where they have completed virtually all their deliberations so the summaries are a good representation of their final proposed rule.

Summary of the proposed *rules*:
Note: Most of what was proposed in the Exposure Draft (ED) issued by the FASB/IASB boards has changed as they addressed most of the negative aspects that the industry and the ELFA pointed out in comment letters. ***It should be noted that the FASB/IASB have decided to re-expose the proposed rules in the first quarter of 2012.*** *This is great news as it gives us and our customers another chance to comment. We know what the new exposure draft will include (see summary below for lessee and lessor accounting and timing). There are 3 major issues remaining that I see that the industry hopes the FASB/IASB will change and they are – retain straight line P&L rent expense as per current GAAP for operating leases as currently defined, retain some form of leveraged lease accounting and improve the proposed profit recognition for sales-type leases. I hope readers will send in comment letters to the new exposure draft when issued as there is power in the number of comment letters. If you don't comment don't complain about the results.*

Lessee:

Where we are now is that all operating leases will be capitalized as an asset (the right of use (ROU) of the leased asset) and a liability (capitalized lease obligation) measured by the present value of the ***estimated*** lease payments based on the definition of the term of lease (virtually unchanged versus current GAAP). Minimum lease payments to be capitalized will include interim rent payments, contractual payments, bargain or compelling renewal payments, estimated payments under residual guarantees (the amount by which the residual guarantee is in the money) and estimated contingent rent payments, as explained below, occurring during the estimated lease term. Variable payments based on usage like cost per use or excess mileage charges will only be considered a minimum lease payment if they are considered to be "disguised' minimum lease payments (where the contractual rents are below market and the contingent rents are sure to occur and make up the difference). Variable payments based on interest rates (floating rate leases) or an index like CPI are to be included as a minimum lease payment using the spot rate to estimate future payments. As the spot rate changes for floating rate leases or when the rent changes based on changes in CPI, the new spot rate is used to recalculate and book the adjustment of future rents. If the lease payment includes service/executory cost elements as in a bundled full service lease, the lessee and lessor must separate the executory (service) costs from the lease payment, but if the lessee has no observable market information to estimate the breakdown it would have to capitalize the whole bundled payment. It should be noted that the definition of a lease will change with more leases considered service contracts. This could be important for this segment as if the transaction is considered a service contract it will not be capitalized by the customer. The lessee will consider the lease term to be the contractual lease term plus renewals where the lessee has a “significant economic incentive” to exercise the options (in other words, the definition is very much the same as current GAAP). Purchase options will be ignored unless they are bargains (in which case the lease is considered a loan/capital lease). Lessees will use their incremental borrowing rate or the implicit rate in the lease, if known, to calculate the PV of the payments to determine the amount to capitalize. Lessees have to review and adjust estimated variable payments, estimated residual guarantee payments and the lease term estimate (as in if the lessee decides to renew the lease or decides that a bargain renewal will not be exercised) whenever they report financial results and use the original incremental borrowing rate to calculate any adjustment. However, if the estimated lease term changes the incremental borrowing rate will also have to be changed to reflect the revised term. Leases of 12 month terms or less and have no renewal options can be accounted for under the current operating lease method if so elected. The P&L lease cost will be comprised of straight line amortization of the ROU asset and imputed interest on the liability. This front ends lease costs for lessees. Lessees will be required to provide more extensive disclosures compared to current GAAP.

It should be noted that the definition of a lease

Lessor:

Lessor accounting has been decided with 2 proposed methods for equipment lessors. Short term leases, where the term including possible renewals is 12 months or less can still use the current GAAP operating lease method. All other equipment leases will be accounted for much like current GAAP direct finance leases. This is good news compared to what was proposed under the ED and, thankfully, compared to current GAAP where many leases in this segment were operating leases for the lessor. They call the new lessor accounting method the “receivable and residual” (R&R) method. Under this method a PV receivable and a “plugged’ residual would be recorded and the leased asset is removed from the lessor’s balance sheet. The residual asset is accreted over the term so that the sum of the finance income on the lease rents as collected and the residual accretion will be the same as the amortization of unearned income under current direct finance lease accounting. The rate used to discount the rents and accrete the residual would be the implicit rate in the lease. Lessors are also required to estimate lease payments in the same manner as lessees. In leases with bundled lease payments lessors must bifurcate the payment and account for the lease portion using the R&R method and account for the service portion as revenue when the payment is due for services rendered (basically the cash basis).

Sales-type lease accounting for gross profits of manufacturers/dealers will be allowed for all but short term leases, but the portion of the gross profit related to the residual must be deferred until the asset is sold or released. This is good news as more leases will be subject to sales-type gross profit recognition but the downside is the deferral of the portion of the gross profit associated with the residual.

Leveraged lease accounting is a US-only issue (not a product offered in the healthcare segment) and will be eliminated with no grandfathering of existing deals. The Boards will not allow the "MISF" yield or a tax affected yield to be used for revenue recognition for tax leases.

For real estate lessors there are 3 methods. For leases of a whole building use the R&R method as above. For those lessors who qualify as investment companies use investment property accounting which is like the current operating lease accounting but where the residual asset is adjusted to its fair value (up or down as the values fluctuate). For all other real estate leases use the current operating lease method.

Timing and Transition:

They will issue a new exposure draft in the first quarter of 2012 with a 120 day comment period. I urge all readers to submit a comment letter. They will read the comment letters and re-deliberate and make adjustments if they see fit. This means it will not be until the last quarter of 2012 that they will issue the new lease accounting rules. The transition date is likely to be 2016 when lessees and lessors have to convert all existing leases and begin accounting under the new rules.

The lessee transition will be as follows:

1) For all capital leases no adjustment will be required. This is good news because it simplifies transition.
2) For operating leases the lessee will record a liability equal to the present value of the remaining payments using the lessee's incremental borrowing rate at the transition date. The right to use asset value recorded will be the present value of the remaining payments adjusted based on the ratio of remaining rents to total rents from inception with the difference charged to equity and deferred tax assets. This added complexity is an attempt to lessen the impact of the front loaded leases cost pattern that results from the ROU accounting method.
3) Lessees will have the option of using the full retrospective method where each lease is recorded at inception. This will lessen the impact of the front loaded lease cost pattern but will result in a larger charge to equity and deferred tax assets.

The lessor transition will be as follows:

1) For all existing direct finance and sales-type leases no adjustment is necessary.
2) For all operating leases and leveraged leases the R&R method is used at the earliest period presented in the financials treating the remaining term as the lease term. They do not provide details regarding existing leases that have a manufacturer or dealer profit but although it will be difficult to calculate, presumably some portion of the remaining

gross profit will be recognized and the portion associated with the residual will be deferred.

3) Lessors will have the option of sing the full retrospective method where each lease is booked at inception. I see little benefit to electing this option.

Focus on the healthcare business segment

In my opinion the overall impact to the industry will not be great.

Impact to Lessees:

The healthcare market is broad and many of the product offerings are loans. Those that are leases are generally of high tech equipment like MRIs and CT scanners with good residuals and attractive tax benefits (100% bonus MACRS) so the resent values (capitalized amounts) are significantly less than cost.

- Doctor and dentist financings are generally start up financings and are loans. For any equipment acquisitions for doctors and dentists, the liberal tax write offs under section 179 would favor CSA or $1 dollar out transactions.
- In the hospital business segment there have been a great deal of acquisition financings which are loans. Hospitals do use FMV leases to acquire imaging equipment and the capitalized amounts should be low enough to keep the lease product popular. The bigger the PV benefit, the lower the amount capitalized. Stand alone imaging centers have traditionally used the FMV product as well to acquire high tech imaging equipment.
- The traditional reasons for leasing (raising capital, low financing cost, fixed rates, level payments, transfer of tax benefits, managing equipment needs, transfer of residual risk, convenience and service) will continue to exist. The off-balance sheet accounting reason for leasing will be reduced but not eliminated as long as the amount capitalized is less than the cost of the equipment.
- Dollar out leases will be treated the same as under current GAAP capital lease accounting – the lease will be capitalized at 100% of the asset's price.
- Synthetic leases may become a more popular product for lessees that can use the tax benefits as the capitalized amount will be low compared to the equipment cost.
- The municipal tax exempt lease product where the lessee is a municipal hospital will remain popular (as it will be unchanged) as the Government Accounting Standards Board (GASB) has not taken up a lease accounting change project as of this writing.

Examples of the probable impact by product are as follows:

Lease Type	Terms	Lessee Capitalized Amount	Commentary
FMV "true" leases – "rated" credits	Cost = $1,000,000 Term = 60 months Rent = $14,332 in advance	$809,220 (81% of equipment cost) assuming a	• Pricing assumes 100% bonus MACRS • Low PV/amount capitalized

FMV "true" leases – "lesser" credits	Residual assumed = 20% Pretax implicit rate = 2% Cost = $1,000,000 Term = 60 months Rent = $15,349 in advance Residual assumed = 20% Pretax implicit rate = 4.0%	lessee incremental borrowing rate of 2.5% $826,383 (83% of equipment cost) assuming a lessee incremental borrowing rate of 4.5%	makes the product attractive
Dollar out	Cost = $100,000 Term = 60 months Rent = $1,879 in advance, Purchase Option = $1 Implicit rate 5%	$100,000 = cost of equipment	• Same result as current capital lease accounting
Synthetic lease	Cost = $100,000 Term = 60 months Rent = $1,440 in advance Month 60 PO/RVG = 30% Implicit rate = 5%	$76,624 (77% of cost)	• Purchase option and residual guarantee ignored except to the extent that the residual guarantee is "in the money" • Low PV capitalized makes the product attractive
Dollar out to a municipal owned hospital (under section 103)	Cost = $100,000 Term = 60 months Rent = $1,749 in advance Purchase Option = $1 Implicit rate 2.0%	$0	• Municipalities use government accounting (GASB) which still recognizes operating lease treatment for dollar out leases with non-appropriation clauses
Muni financing to a not for profit 501c3 hospital with $1 purchase option	Cost = $100,000 Term = 60 months Rent = $1,749 in advance Purchase Option = $1 Implicit rate 2.0%	$100,000	• Same result as current capital lease accounting • To achieve some accounting benefit the transaction may be structured as a synthetic lease

- The impact of front ending of lessee P&L lease costs will not be too severe given that lease terms are not long in this industry segment. Typical lease terms range from 5 to 7 years. The P&L cost pattern will be front ended and will not be called rent expense. Rent expense will be replaced by straight line amortization of the ROU asset and imputed interest on the lease obligation. The front ended pattern will cause lessees to book deferred tax assets as book expenses reported will exceed the tax deductions for rent in the early years of the lease. The front ended pattern is a timing difference that will turn around in the second half of the lease term. The front ending effect will be lower the shorter the lease term as illustrated in the table below.

The Effect of Front Ending Lease Costs	
Lease Term	**First Year Increase in Lease Cost – proposed rules vs. current GAAP**
3 Years	7%
5 Years	11%
7 Years	16%

- Lessees that receive operating lease cost reimbursement from Medicare/Medicaid will still only get cost reimbursement for rent paid when the new rules take effect. With the front ending of lease costs as proposed it will mean that reported lease costs in the early years of the lease term will be more than costs reimbursed, although this is a temporary difference as the costs reimbursed in the last half of the lease will be higher than reported lease costs.   Cost reimbursement rules do not allow for reimbursement of the ROU asset amortization and the imputed interest on the lease obligation.

Impact to Lessors:

- There will be no more operating lease accounting for FMV leases for lessors except for short term leases. This is great news as the earnings pattern under the R&R method is more representative of the economics of the lease. The earnings pattern under an R&R lease without a sales-type gross profit creates a constant yield versus the declining lease investment.
- Synthetic leases will be classified as R&R method leases. A PV lease receivable and plugged residual will be booked. The residual guarantee is not considered a minimum lease payment as per current GAAP (not the best outcome as you can't "securitize" a residual and get off balance sheet treatment as a residual is not considered a financial asset). There will be no need to buy residual insurance for accounting purposes as synthetic leases will not be treated as operating leases.
- For manufacturers/captives sales-type lease profit will be recognized up-front for ***all*** but short term leases. Gains on sale will be recognized based on the portion of the value of the right of use transferred in the lease, with the balance (the residual portion) deferred. The value of the right of use is the PV of the rents so if the rents PV to 79% of fair value of the leased asset, then 79% of the gross profit will be recognized. The gross profit attributed to the residual will be deferred and recognized when the asset is sold or re-leased. I think that this is good news for this segment as many leases are operating leases and current GAAP does not allow sales-type gross profit recognition for operating leases. The residuals in this segment are so high that buying residual insurance to get

sales-type lease treatment under current GAAP is too costly, but now residual insure will not be needed.

Conclusion – things are not so bad!

This market segment seems to be faring pretty well as many of the transactions are debt products. The high tech FMV leases should have capitalized present values that are low enough compared to the equipment cost to remain attractive. Lessors of the high tech FMV leases should be happy as the operating lease accounting method will be replaced by the R&R method with a more rational revenue pattern. Also all leases will be sales type leases but with the portion of the gross profit related to the residual deferred. This is good news for captives in this segment where the equipment has high residuals but may not be so great for those lessors with low residual equipment. It would be nice to get the FASB/IASB to retain straight line rent expense for lessees for what are now operating leases. This can only be achieved if enough comment letters are sent in with well thought out reasoning.

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