The Latest FASB Lease Accounting Rules

How Reagent Placement Agreements are Affected and What to Do About It

CASE STUDY

Fifth Third Bank

Overview: The Latest Updates

The latest updates to lease accounting rules in FASB ASC 842 have major ramifications for healthcare organizations. Most importantly, the bulk of embedded leases within agreements for assets such as lab equipment and medical supplies now needs to be identified and recorded on balance sheets in a specific manner. Failure to do this will result in material financial misstatements.

Full ASC 842 compliance typically requires identifying leases that once went largely unscrutinized. Under the previous guidance of ASC 840, operating leases and service contracts followed similar accounting rules, meaning that organizations did not always have to determine if a given agreement incorporated a lease. Now, virtually all operating leases must be recorded with corresponding assets and liabilities.

This white paper examines what the ASC 842 rule changes require at a high level, in the form of how embedded leases in typical reagent rentals and similar agreements are affected. You will come away with clear steps and workflows for bringing lease agreements into compliance, as well as guidance on how lease agreements can be optimized going forward by efficiently tracking the equipment.

Essential steps to mitigating the risk of potentially significant misstatements:

1. Scrutinize all reagent and supply agreements for any embedded leases that fall under ASC 842 provisions.
2. If a lease exists, separate lease and non-lease components and classify each lease component as operating or finance.
3. Set up scalable processes for tracking assets and accompanying leases across your locations.

Embedded Leases, Reagent Rentals, and ASC 842, explained

Business agreements in healthcare commonly contain embedded leases, even if the assets in question are provided without an explicitly stated cost. For example, a hospital may partner with a medical device company to receive lab equipment at no stated cost, while being subject to a minimum purchase agreement for the consumables used with that equipment.

Under FASB ASC 842, these lease components must be recorded on the balance sheet as a capital expense rather than an operating one. The new setup puts pressure on both the healthcare facility and the medical equipment supplier.

The facility may eventually experience a capital shortfall, due to how its budget now classifies its reagent agreements as capital expenses.

Meanwhile, you're dealing with the complications of identifying lease and non-lease components in the agreement from your equipment supplier and determining if they need to be separated or can be left unseparated per the practical expedient of ASC 842.

To add to the overall complexity, embedded leases can also be hidden within agreements that are not explicitly labeled as leases. Some agreements which weren't previously considered leases are now labeled as such. For example, an equipment supplier provides lab equipment for "free" under the condition that 5,000 units of consumable supplies are purchased each month. This will likely be classified as a lease and need to be recognized as such.

Plus, if the consumables used with the equipment are part of the lease agreement, their cost will go on the balance sheet as equipment cost (debt). When they expire, they become a loss on the balance sheet.

Use Case

A lease agreement is made for a blood analyzer for 60 months. The blood analyzer is free with 25,000 blood test strips per month. It turns out that the hospital only uses 5,000 strips per month, but they continue to receive 25,000 strips each month. The cost of the 25,000 strips per month goes on the balance sheet as equipment cost (debt). When those test strips expire, it is placed on the balance sheet as a loss.

PRO TIP: Ask the vendor for the cash price and buy the consumable supplies separately as needed. Lease the blood analyzer as an operating lease (non-debt liability) and then buy supplies separately as needed.

With these implications for reagent rentals and other common embedded lease situations in mind, let's look at what can be done to streamline the process starting with finding an answer to a seemingly simple question: What is a lease?

Step 1: Determining What is and isn't a Lease

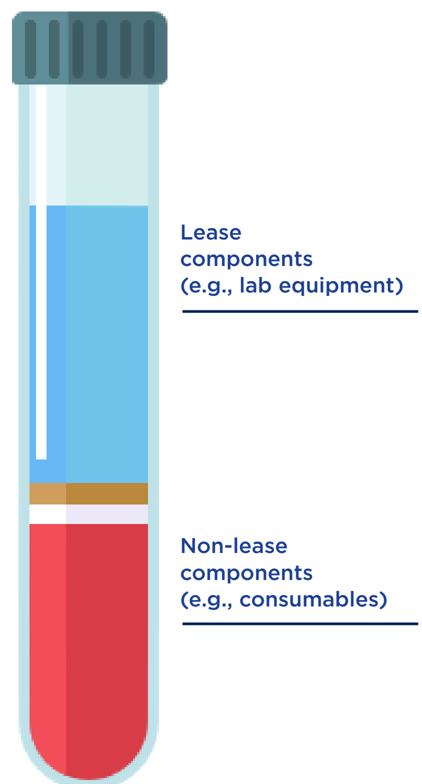
There are two major considerations when deciding if something in an agreement needs to be classified as a lease for ASC 842 compliance:

- Is there an explicitly or implicitly identified asset in the contract? (e.g. lab equipment)
- Does the customer have the right to "obtain substantially all" of the economic benefits of using the asset throughout the designated term of use?

An identified asset will be physically distinct (e.g. a piece of medical equipment or an IT system), as the scope of ASC 842 excludes leases of intangible assets, biologicals, inventory, and anything under construction. For an agreement to contain an embedded lease, the supplier must also not have the right to substantive substitution, which would allow it to fulfill its contractual obligation with an alternative asset throughout the period of use and at economic benefit to itself.

The right-of-use requirements are slightly more complex than in the past. The term "substantially all" does not have an ASC 842-defined meaning, but 90% is a commonly followed threshold. It is also important to consider how much control the customer has in directing the use of the asset and whether the supplier can change the operating instructions at any juncture.

Step 2: Separating the Lease and Non-lease Components



Once an embedded lease is identified, it needs to be broken down into its lease and non-lease components. To reuse the reagent rental example from earlier, a lease might exist for the lab equipment but not for the consumables that go with it. Both components will require allocations of the consideration provided to them.

The process for doing so can be complex, since many healthcare products have uncertain or highly variable prices. The necessary pricing information might have to be requested from the supplier/lessor who may be reluctant to comply. Or, in lieu of that, it can be approximated using residual estimation.

It may be possible to combine the lease and non-lease components of an embedded lease as one. Doing so can eliminate some accounting complexity but will result in a large liability on the balance sheet, which can be risky. Combined or not, each lease must also be classified as an operating or capital lease and presented in the respective format.

Step 3: Optimizing and Tracking Leases

With a traditional lessor, healthcare facilities can find themselves in confusing lease agreements with evergreen clauses, hidden fees and other money traps. This hides the true cost of the lease agreement, which may increase by 25% or more.

By contrast, LaSalle Solutions, the leasing division of Fifth Third Bank, offers full transparency into lease agreements. We also provide options for refreshing your equipment on a regular basis, plus complete visibility into your leased equipment portfolio with the LAMP platform. LAMP is our industry-leading cloud-based platform which brings all your equipment information together in one place while providing tools for reporting and planning. This way, healthcare organizations get the most value from leases while also tracking upcoming end-of-lease dates and other information throughout the entire lifecycle.

Our programs are designed for customers to achieve a 0% to negative effective interest rate. This means our customers are paying less than actual equipment cost without any unbudgeted fees at any point during the lease. You end up with get the best cost of usage and extra cash to direct toward other needs!

Conclusion

Although the updated FASB rules significantly alter how leases are recognized and accounted for, they do not change the value of leasing depreciating assets. Leasing is still the most cost-effective way to procure critical equipment and infrastructure for healthcare operations. It is much easier to manage with support from a proven partner and a sophisticated technical platform.

Fully complying with the updated FASB rules requires help from the right partner. With decades of healthcare experience, Fifth Third can provide you with the guidance and tools needed for a successful transition.

To learn more about our leasing services and LAMP, contact Jdrake@elasalle.com.

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