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Fitch Rtgs: New Lease Accounting Won't Affect Not-Fo--Profit Hospital Rtgs

Fitch Ratings-New York-22 August 2019: The Financial Accounting Standards Board's new accounting standard for operating leases is not expected to have an effect on the vast majority of Fitch-rated not-for-profit hospital and health system ratings, says Fitch Ratings, because Fitch currently includes operating leases in its debt-equivalent calculations.

Pursuant to the new standard, which took effect Dec. 15, 2018, operating leases must be reported on the balance sheet as an asset and a liability, consistent with the current treatment of capital leases. Under the old standard, operating leases, such as hospital equipment and building leases, were considered an operational expense and were only recorded as such under the income statement, while absent on the balance sheet. In contrast, capital leases were recorded as an asset with the related debt captured under debt or other liabilities on the balance sheet. This resulted in what Fitch believes was an understatement of liabilities on the balance sheet.

Early on in January 2018, Fitch incorporated operating leases as a debt-equivalent liability in our assessment of leverage profiles with the publication of the revised U.S. Not-For-Profit Hospitals and Health Systems Rating Criteria. Under the criteria, Fitch uses a 5.0x multiple to capitalize annual operating lease charges to create a debt-equivalent figure to capture the effect the new lease accounting standard will have on Fitch-rated hospitals and health systems. This figure is included in Fitch's core leverage metrics and is currently used to evaluate total long-term liabilities and leverage. For the most part, our use of the 5.0x multiple compares similarly or conservatively to the new standard, based on a sampling of unaudited financial statements of hospitals and health systems in recent interim periods.

The accounting change was implemented in order to align the treatment of operating and capital leases and improve financial reporting transparency and disclosure. As hospitals and health systems typically lease facilities as a cost effective strategy rather than purchasing these facilities themselves, the change in lease accounting is expected to have a significant effect on the long-term debt profiles of these organizations, especially for large health care systems with multiple leased facilities across numerous states.

Fitch's treatment of operating leases incorporates all operating leases in our debt-equivalent calculation, inclusive of short-term leases. As such, our initial analysis indicates that the Fitch-calculated figure is fairing more conservatively compared with expected debt-equivalents reported under the new standard, although there may be exceptions as additional rated entities report on the accounting change.

Reported leverage medians of Fitch-rated hospitals and health care systems based on the new standard are expected to generally remain unchanged or possibly even slightly improve over the Fitch-estimated figure, assuming all other factors remain constant, given permitted exclusions of short-term operating leases under the new standard. Hospitals and health systems are likely to have more information and disclosures in their 2019 audits that will shed more light on the calculation of operating leases and discount rates used in estimations.