BECKER'S
HOSPITAL REVIEW

Getting real about relifing: An opportunity to add millions back to hospitals' bottom line

"That's the way we've always done it." More than ever, this phrase raises a red flag to hospital and health system leadership. In a $3 trillion industry experiencing substantial regulatory, financial, clinical and technological shifts, "the way we've always done it" cannot hold water.

Today's hospital and health system financial leaders should assess some accounting and financial reporting functions that were handed down from their predecessors. One specific function to examine is the rate of depreciation for a hospital's fixed assets. For many hospitals and health systems, the calculated useful lives of assets no longer reflect reality. This can affect bond financing, capex expense and insurable values, to name a few.

By reassessing the depreciation of assets through a process known as "relifing," organizations can incur savings averaging $2 million for an individual hospital to $50 million for a hospital system. To understand relifing and how hospitals may mistakenly approach facility lives today, *Becker's Hospital Review* caught up with two experts from Chicago-based Principle Valuation LLC, a member of Prism Healthcare Partners.

What is asset life?

Asset life refers to the periodic depreciation expense of hospitals' fixed assets, such as the buildings or equipment. Relifing occurs when executives review the estimated useful lives of fixed assets and adjust the assets' lives based on their actual use.

In the broader field of accounting, relifing is often overlooked, and fixed asset accounting is rarely taught. Instead, many finance professionals learn this technique on the job. "Depreciation and fixed assets are kind of orphan areas of accounting," says John Holmes of Principle Valuation. "CFOs may look at these areas only when the organization needs to borrow money, but in reality, regular review can yield significant financial benefit."

How does relifing affect hospitals' bottom line?

Relifing itself does not increase an organization's cash reserves or improve a hospital's operating processes. Depreciation is a non-cash item, but if hospitals write off assets quicker than they should, it negatively affects their ability to borrow and their fair market value. "You will end up paying more for your money than you should have to and receive less than the entities are truly worth in a sale or merger," says Mr. Holmes.

Rapidly writing off buildings or equipment creates a gap between long-term bonds and the assets supporting them, which are effectively being amortized in 23 to 25 years. This increases the

debt-to-equity ratio. The costs of over-depreciated assets vary. "In some cases we have seen the bottom line impacted by $2 million to $3 million a year. In other cases, for health systems, it's as high as $50 million a year," says Timothy H. Baker, managing partner of Principle Valuation.

Relifing has a similar effect as an annuity, since the adjusted useful lives will maintain the ongoing reduced depreciation expense for the remaining life of the asset while it is owned. The new lives also provide a lower depreciation for future construction projects.

"Updating a useful life estimate to reflect longer utilization results in both an immediate and long-term positive financial result," says Mr. Holmes. Additionally, it better facilitates achieving the age-old accounting concept of matching revenue with expense.

Compared to years past, now is the time for nonprofit hospitals in particular to reexamine their fixed assets and, if appropriate, revise those lives. There are several reasons for the urgency.

Why relifing and why now?

Despite policy change, many hospitals have over-depreciated their assets for years.

"Back in the late '60s and early '70s, Medicare included depreciation as a cost when it started to reimburse hospitals on an actual cost basis," says Mr. Holmes. "It was in hospitals' best interest to write off assets. They sought the shortest possible useful lives for assets to receive their Medicare payment as quickly as possible."

Medicare fully eliminated depreciation payments in 2001 after phasing them out for 10 years. "But in many hospital accounting departments, things continue to function as 'the way we've always done it,' or pre-2001," says Mr. Baker.

Hospitals and health system accounting teams have typically assigned asset lives based on recommendations in the American Hospital Association's publication, "Estimated Useful Lives of Depreciable Hospital Assets." The AHA has published and updated this resource for some 50 years. The guidelines were initially drafted to maximize depreciation, but that need has grown obsolete since Medicare no longer reimburses for depreciation. The actual expected useful life of an asset should be used.

Furthermore, the AHA's published asset life recommendations are only an estimate for hospitals. "The AHA specifically says these are guidelines, they're not written in stone," says Mr. Baker. "There can and should be adjustments." Mr. Baker and Mr. Holmes helped spearhead a national study of hospital buildings and equipment, initiated in 2000, based on more than 400 hospitals. They found most healthcare organizations use their assets longer than the suggested lives published by the AHA. Annual depreciation using AHA lives is often half as much of the useful lives identified in other studies, which are arguably more realistic.

For example, if a hospital assigns a 40-year life to building structural components and 20 years for building service components (such as electricity, plumbing and HVAC), the hospital will effectively write off the entire property in less than 23 to 25 years. However, there is substantial evidence of hospital buildings lasting longer than 40 or 50 years. In fact, some hospital buildings are 100 or more years old, highlighting the disconnect between actual useful lives and the significantly shorter lives used when depreciation was reimbursed.

It is in healthcare organizations' best interest to reassess their assets' useful lives and determine whether the depreciation of their assets reflects actual usage. ■