

Free is not Free

## Loan of Equipment and Purchase of Related Disposables

Current Vendor Sales & Marketing Approach

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Capital Administrator, Johns Hopkins

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# **John Sdanowich – *Capital Administrator Johns Hopkins Healthcare System***

## **Professional Profile**

John Sdanowich has been with the Johns Hopkins Health System for the past 20-years, 12 of those years as the Capital Administrator, responsible for the financing and negotiations of all health system medical equipment and contracts. Currently working establish a Contracts Administration function for the JHHS, brining together the recent acquisitions and standardizing the contract and negotiation functions.

His focus is the Technology, life-cycle-management and obsolescence risk of the medical equipment. John's approach includes reviewing the changes in vendor's medical equipment, evaluating products at the factory and with senior management in research and development.

John is the Co-Chairman of the RFID committee, tasked with finding a real time location solution for tracking equipment, patients and employees, which will be installed in two new clinical towers scheduled to open April 2012.

John has also worked in the Department of Emergency Medicine as the Assistant Administrator and as a Management Engineer, working on the re-engineering of the Johns Hopkins Hospital. The main focus of the restructuring was in the departments of Surgery and Medicine.

John has published: a White Paper, "Life-Cycle Financing For Capital Investments", "Strategies to Maximize your Capital Dollars", in Medical Imaging/MedAssets.Com Forum, and "How to Create a Capital Process to Maximize Investments", in Biomedical Instrumentation & Technology.

# Willie Foerstner – CEO, Princeton Management Advisory and Consulting, L.L.C

## Professional Profile

Willie Foerstner is a senior healthcare executive with 33 years of sales and management experience in the United States, Europe and Asia. He has over 22 years of healthcare financing experience with 10 years devoted to providing corporate finance solutions and technology asset management to the healthcare sector. His professional business experience includes: Financial services, sales and marketing and strategic asset planning. He has successfully implemented technology asset management program in major academic/research institutions and cutting edge healthcare systems such as Johns Hopkins Hospital and Health Systems. The solutions focused on the total cost of ownership that included capital equipment, service and finance.

**Vice President, CG Commercial Healthcare Finance Irvine, California.** CG Commercial Healthcare Finance is a leading healthcare commercial financial services organization that provides the capability to finance the entire spectrum of your requirements for your health system. That would include Aircraft, Infrastructure, Networking, IT, EMR systems, CT, MRI, PET, Furniture, complete facility build outs, Co-gen, and all the others needs your facilities might require.

**Senior Advisor and Equity Partner, SBF Healthcare Pvt. Ltd., Bangalore, India.** SBF Healthcare is a leading healthcare manufacturer that has developed a new SPMF Therapeutic System that induces cellular regeneration and / or degeneration processes and methods of treatment based on such processes. Based on the indication of the disease type the following diseases may be treated: cancer, osteoarthritis and neuro degenerative disease. He has prepared to company for an M&A.

**Held various positions at Siemens during his 28-year tenure.** They included V.P Corporate Finance at Siemens Financial Services, Inc., V.P. Structured Finance at Siemens Medical Solutions, Inc. and other general management positions. During his tenure at Siemens he developed and successfully implemented technology asset management programs at major academic, research institutions and cutting edge healthcare systems.

# Discussion of Program – Free is not Free

- Overview *Free is not Free*
  - *Current Vendor Sales & Marketing Approach*
- Overview *Zero APR is not Zero IRR*
  - *Current Finance Sales & Marketing Approach*
- Healthcare Market Overview
- FASB Overview
- Finance solutions required from your Financier

# Synopsis of the program Free is not Free

- With the advent of the current economic healthcare climate many vendors have devolved programs that encompassed nothing more than alternative financing arrangements for the equipment.
- This session will bring awareness to other healthcare institutions on what type of sales, marketing and finance programs that are being promoted to our system.
- We will clearly describe how these programs could impact your health system from a legal, credit rating, accounting and the fraud and abuse statute.
- You must demand that there is full transparency to every transaction that includes fixed terms and pricing. You must also understand what's included in the purchase price and life-cycle of the equipment.
- There is no such thing as 0 percent financing! Or just pay for the disposables and the equipment is free. One must be very cautious small leaks can sink big ships.
- The Devil is in the Detail” – This is why all deals have to be unbundled.



Just buy the disposables and get the  
equipment for free!

It's our new sales promotion!

OR

It's our Business model!

# Discussion of Program - Disposable Leases

- **In the proposed agreements the vendor places a piece of equipment in the hospital at no charge and the hospital purchases the related disposals. The vendor retains ownership and in many cases performs the service.**
  - The vendors don't provide a transparent view of the transaction or separate equipment and disposable costs
    - In many cases we have a letter from the company's CFO stating that there is no embedded cost for the equipment or service within the disposable
  - Many of the agreements are indefinite and could continue forever as long as the hospital is purchasing disposables
  - Most of the equipment are long term assets
  - Often the cost of the disposable is presented to be the same whether you purchase, rent, or enter into the loaner agreement

# Compliance

Re: Loan of Equipment

## Agreements

Dear John,

We are responding to your concerns about certain loan of equipment agreements whereby a medical device equipment manufacturer consigns, leases or gives a Hopkins affiliated entity a piece of medical equipment in return for the Hopkins entity's promise to purchase, at "marked up" prices, certain disposables needed to operate the equipment. Based on our research, and the advice of outside counsel, this type of structure does not violate Federal Anti-kickback laws as long as any discount the Hopkins entity receives is reported by the Hopkins entity on their Medicare cost report. The discounted amount reported on the Medicare cost report should reflect either: a) the difference between the fair market value of the equipment and the disposables subtracted by the amount the Hopkins entity actually paid for the equipment and the disposables; or, b) if the medical device equipment manufacturer is unwilling or unable to provide the fair market value of the equipment and the disposables, the discount submitted on the cost report should reflect a reasonable figure based on available information. The chart below is illustrative:

# Compliance

EQUIPMENT AGREEMENT							
	Equipment Cost	Disposable's Cost	Term	# of Disposables per year	Total Cost	Total Discount Amount	Per Year Discount
Equipment Purchase Cost without purchase of disposables	\$25.00	\$1.00 each	2 Years	20	\$65.00	n/a	n/a
Equipment Purchase Cost with purchase of "marked up" disposables	\$0.00	\$1.25 each	2 Years	20	\$50.00	\$15.00	\$7.50

# Discussion of Program – Functional Issues

- Revenue
  - Potential for overbilling because of an upcharge on the disposable
- Accounting
  - As per accounting department, accounting would make a journal entry separating the equipment cost from the disposable cost using the amount calculated from the Disposable Lease Calculation
- Legal
  - Fraud and Abuse
  - Discounts are permissible as long as properly disclosed

# Federal Statute Section 42 U.S.C 1320a-7b(b)(3)(a)

Medicare Compliance. The no charge rental of the Blowers is provided to Customer as a “discount or other reduction in price,” on the purchase of the Blankets, under 42 U.S.C. §1320a-7b(b)(3)(A). Customer is responsible for disclosing such discount to reimbursing agencies (including Medicare and Medicaid) and other entities in accordance with all applicable laws and regulations, including, without limitation, 42 C.F.R. §1001.952(h). For purposes of making such reports, we suggest that \$25 per month per Blower be allocated to the value of the no-charge rental and that the same amount be deducted as a discount off the aggregate amount paid for all Blankets purchased during the corresponding period.

# Equipment

- Blanket Warmers
- Cardiac Ablation System
- Humidifiers
- Surgical Shaver Systems
- Cutting and Coagulation Equipment
- Solution Warmers
- Cerebral Monitors
- Endoscopic Aspirator for Brain Tumors

# Form for Leases, Rentals, and Disposable Lease Agreements

- The Johns Hopkins Health System requires that all alternative financing methodologies be completely transparent. All of the associated costs must be completely unbundled. The vendor is required to disclose but is not limited to these items:
- Cost of the underlying equipment
  - List
  - JHHS discount
- Cost of the disposables
  - List
  - Discount
- Embedded cost of the equipment portion of the disposable
- Service cost embedded in the disposable
- Copy of service agreement or statement of what is covered
- Interest rate
- Agreement term in months
- Disposable purchase requirements
- Life-Cycle of the underlying equipment
  - Life of the equipment
  - Any future generations or upgrades

# Disposable Lease Analysis form---FIN116

Shaded Sections are input sections:

## Disposable Lease Calculations

Annual Disposables	120.00
Agreement Term	5.00
Disposable for Term	600.00
Price per Disposable	\$ 69.00
Agreement Term Disposable Price	\$ 41,400.00
Equipment Value	\$ 19,000.00
Total Agreement Value	\$ 60,400.00

## Information For Accounting

% of Equipment to value to Agreement Value	31.46%
Dollar Value of Equipment per unit	\$ 30.56
Purchased out of? (MDC or Department)	MDC
MDC Item number	P300629005 P300630005 P300631005 P300632005

Notes:

### Disposable Usage Program Agreement

Requesting 2 pieces of equipment valued at \$9,500/each

Program	Wrap Cost		
	Device Cost	Over 36 Mo.	Total Cost
DUP Program	\$ 5,500	\$ 6,920	\$ 12,420

### DUP

Warranty during entire period

3 year contract necessary

Must order 5 disposables per month minimum (\$77 each or \$345 for 5 pack)

Generator placed at no charge if minimums kept

### Disposable list price is \$77 each

\$345 for pack of 5 (69 each)

**Monthly Payment \$ 152.78**

### Projected usage is 120-144/ yr

**Price per unit \$ 30.56**  
(if 5 per month per unit)

### ECRI price is \$327.75

Purchasing to negotiate pricing

# Disposable Lease Analysis form---FIN116

## JOHNS HOPKINS HOSPITAL Loan of Equipment and Purchase of Related Disposables Evaluation Form

FUNCTIONAL UNIT: JHH Respiratory  
 LEASE DOCUMENT: XYZ System  
 LEASED FROM: Internal - For Accounting Only

INPUT SECTION	
Prime rate + 1=	5.50%
Term =	36
Payment=	305.60
Value of Equipment=	19,000.00
Estimated Life in Years=	5
Lease Term in Years=	3

- The Attached is:
- Consignment with Disposables  
 A Operating Lease  
 A Capital Lease

- 1.) IS THERE A TRANSFER OF OWNERSHIP AT THE END OF THE LEASE ?
- 2.) DOES THE LEASE CONTAIN AN OPTION TO BUY THE PROPERTY AT A BARGAIN PRICE ?
- 3.) IS THE LEASE TERM EQUAL TO OR GREATER THAN 75% OF THE ESTIMATED ECONOMIC LIFE OF THE LEASED PROPERTY ?
- 4.) DOES THE PRESENT VALUE OF RENTAL AND OTHER MINIMUM LEASE PAYMENTS EQUAL OR EXCEED 90% OF THE FAIR VALUE OF THE LEASED PROPERTY ?

YES	NO
	X
	X
	X
	X

PV OF LEASE PAYMENTS	\$10,120.58
VALUE OF NEW EQUIPMENT	\$ 19,000.00
% OF PAYMENTS TO VALUE	53.27%
LEASE TERM IN YEARS	3
ESTIMATED LIFE IN YEARS	5
% OF LIFE DURING LEASE	60.00%

- RECOMMEND:
- Purchase Some or All of Equipment Outright  
 Sign Agreement As Attached  
 Submit to the Capital and Contingency Committee For Disposition  
 Do Not Acquire This Equipment  
 Recommend that Further Review be completed before Final Decision

COMMENTS:

\_\_\_\_\_  
 John G. Sdanowich  
 Capital Administrator

\_\_\_\_\_  
 Date:

# Last Words

- Do your homework
- Don't just take a physicians word that this is needed
- Understand the equipment and the life-Cycle
- The Devil is in the Details
- What Makes sense?
- Would you do something like this with your own money?
- Remember the dollars you save may be funding your salary

# Zero is not Zero - APR is not the IRR

- What would you like the rate to be?

Program	Term	Equipment Price	Rate	%	Residual Value	Payment	Buy Down
Simple Math	60	\$1,000,000	0.00%	0.00%	\$0	\$16,666.67	
Buy Down	60	\$900,412	10.00%	20.00%	\$180,082	\$16,666.67	\$99,588
Buy Down no RV	60	\$790,960	10.00%	0.00%	\$0	\$16,666.67	\$209,040
Interest Buy Down	60	\$1,000,000	6.54%	20.00%	\$200,000	\$16,666.67	\$87,482
RV Adjustment	60	\$1,000,000	10.00%	34.39%	\$343,936	\$16,666.67	\$143,936

Actual Transaction FMV	60	\$1,000,000	10.00%	20.00%	\$200,000	\$18,510.05
Actual Transaction Capital	60	\$1,000,000	10.00%	0.00%	\$0	\$21,071.45

Rate Buy Down	60	\$1,000,000	6.54%	20.00%	\$200,000	\$16,666.67
Rate Buy Down	60	\$912,518	10.00%	20.00%	\$200,000	\$16,666.67
Rate Buy Down		\$87,482				

# Healthcare Market Overview

Healthcare spending increases for IT & “EMR”

# Market Overview

- Dramatic changes to capital spending have been evident over the last 3 years. Economic conditions have driven capital spending freezes and scale back on spending for many organizations. This session will begin by providing a brief summary of the current economic pressures and challenges facing healthcare providers and suppliers.
- I will address how each is advising customers to manage through this unprecedented time of change and economic turmoil.
- The overview will allow organizations to understand how to best align and segment the message about the economy to capital equipment, clinical and financial stakeholders. Finally, various alternative funding sources will be identified that will help to address some of the pent up capital demand.

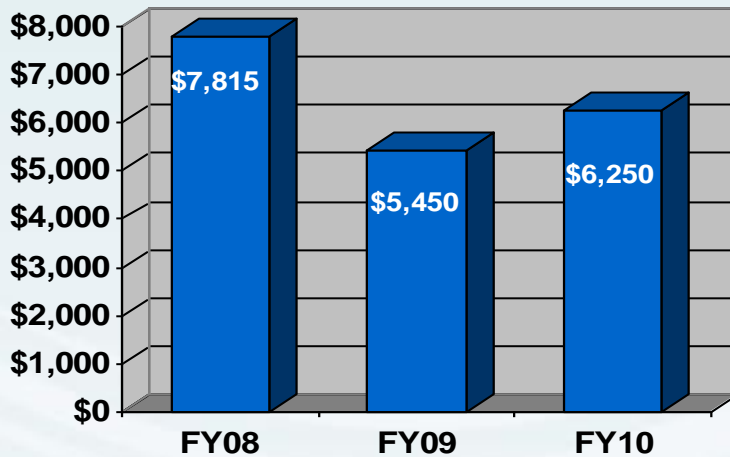
# Major topics for review

- Supplier collaboration for technology road mapping (lifecycle management)
- Understand capital equipment acquisition strategies that must include non-obsolescence protection
- Exploration of pending FASB (FAS 13) “Accounting for Leases” reporting change - FASB and IASB Propose Significant Changes to Lease Accounting
- Sources of funding for capital initiatives

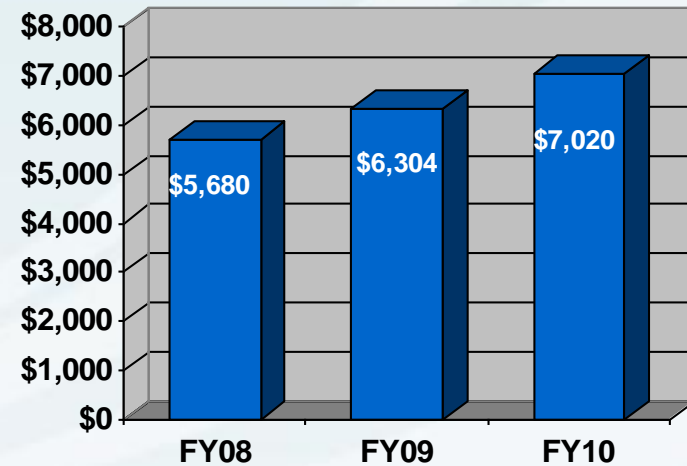
# Review of Market Overview – Spending

## Healthcare Spend 2008 – 2010

**Total U.S. Medical Device Sales  
Non-Clinical  
(\$ Millions)**

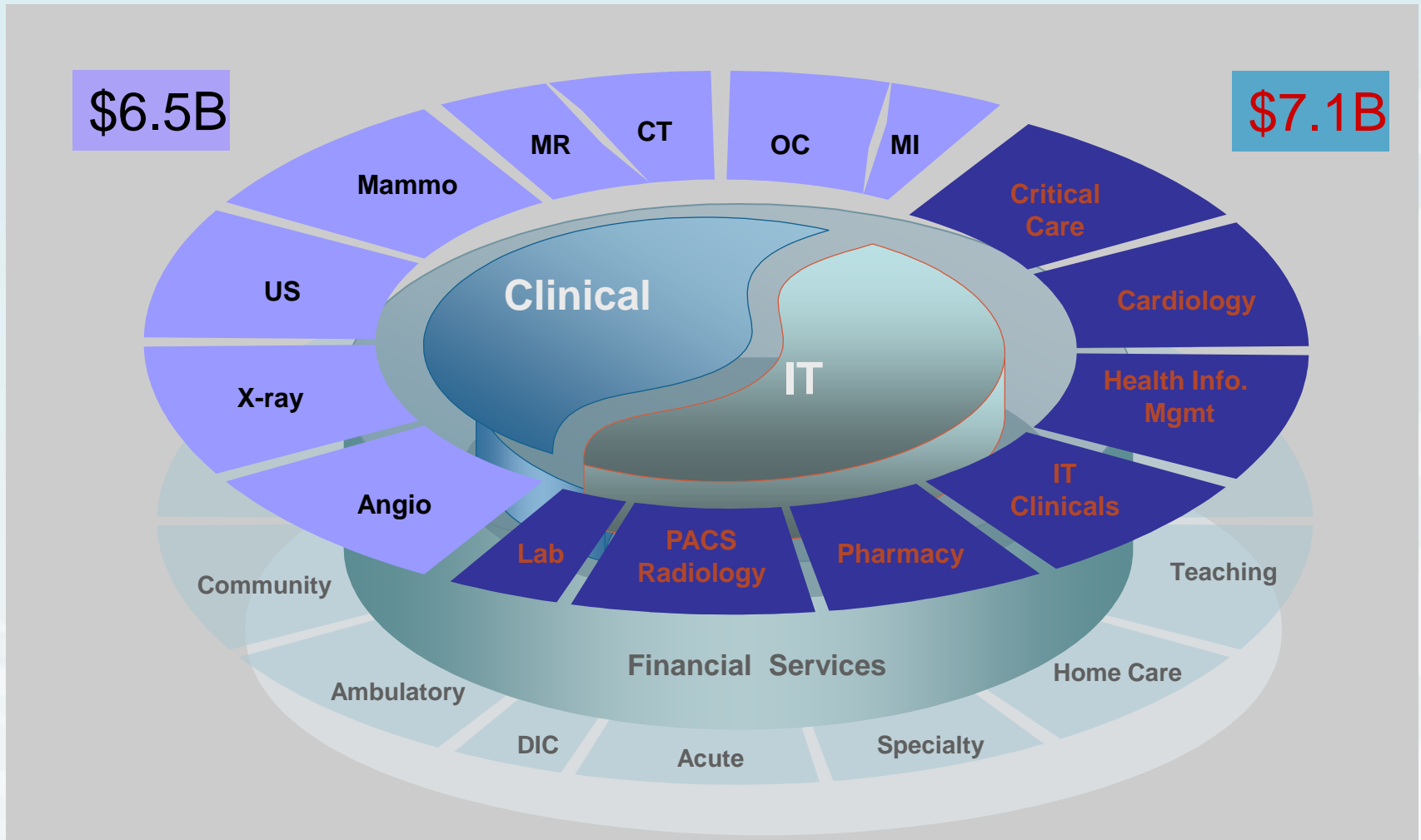


**Total U.S. Medical IT Sales  
Clinical  
(\$ Millions)**

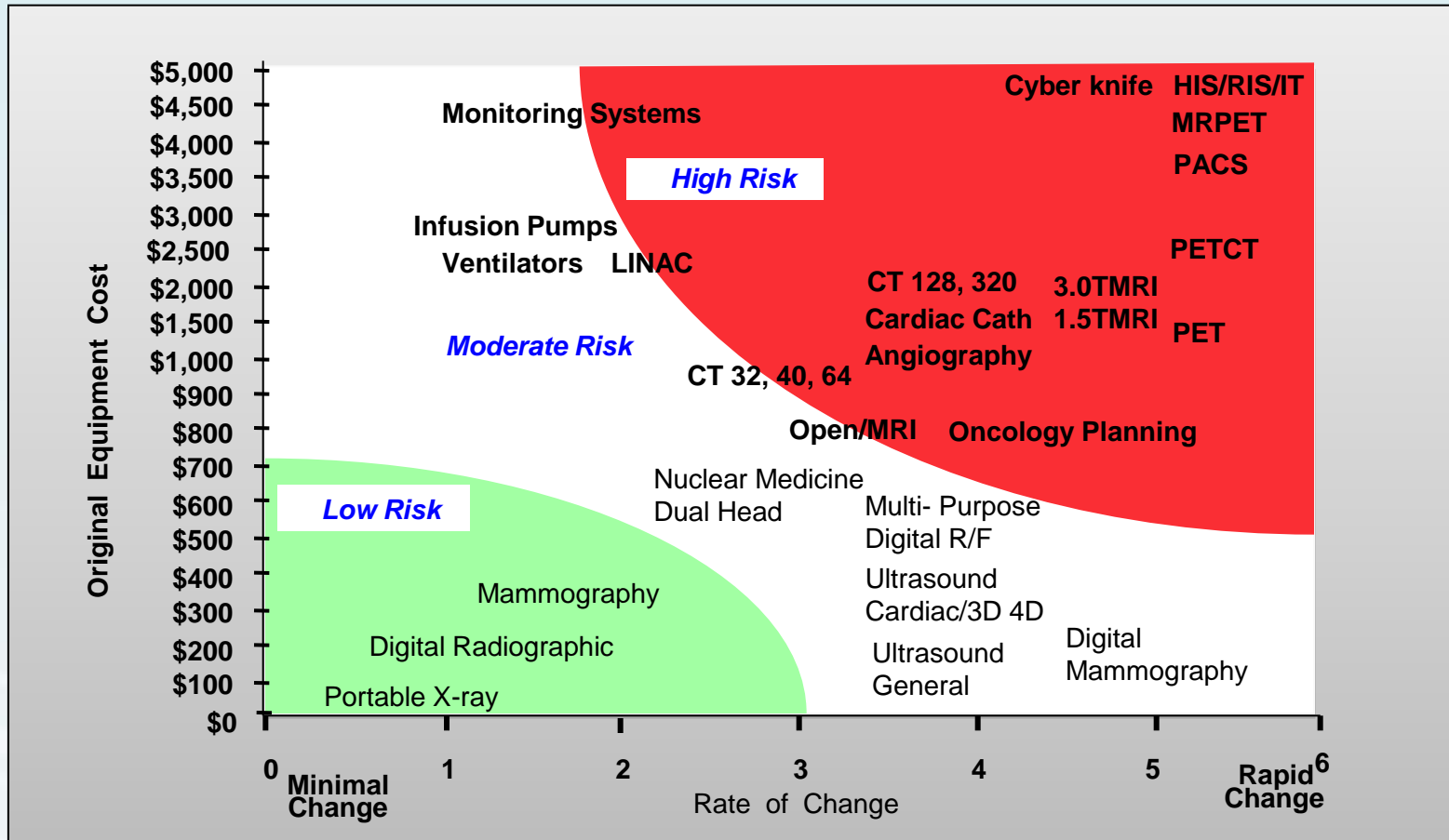


PWC 2010

# Managing Funding Solutions for a complex medical market!



# Which technology is changing the most? Where is the greatest risk of obsolescence?

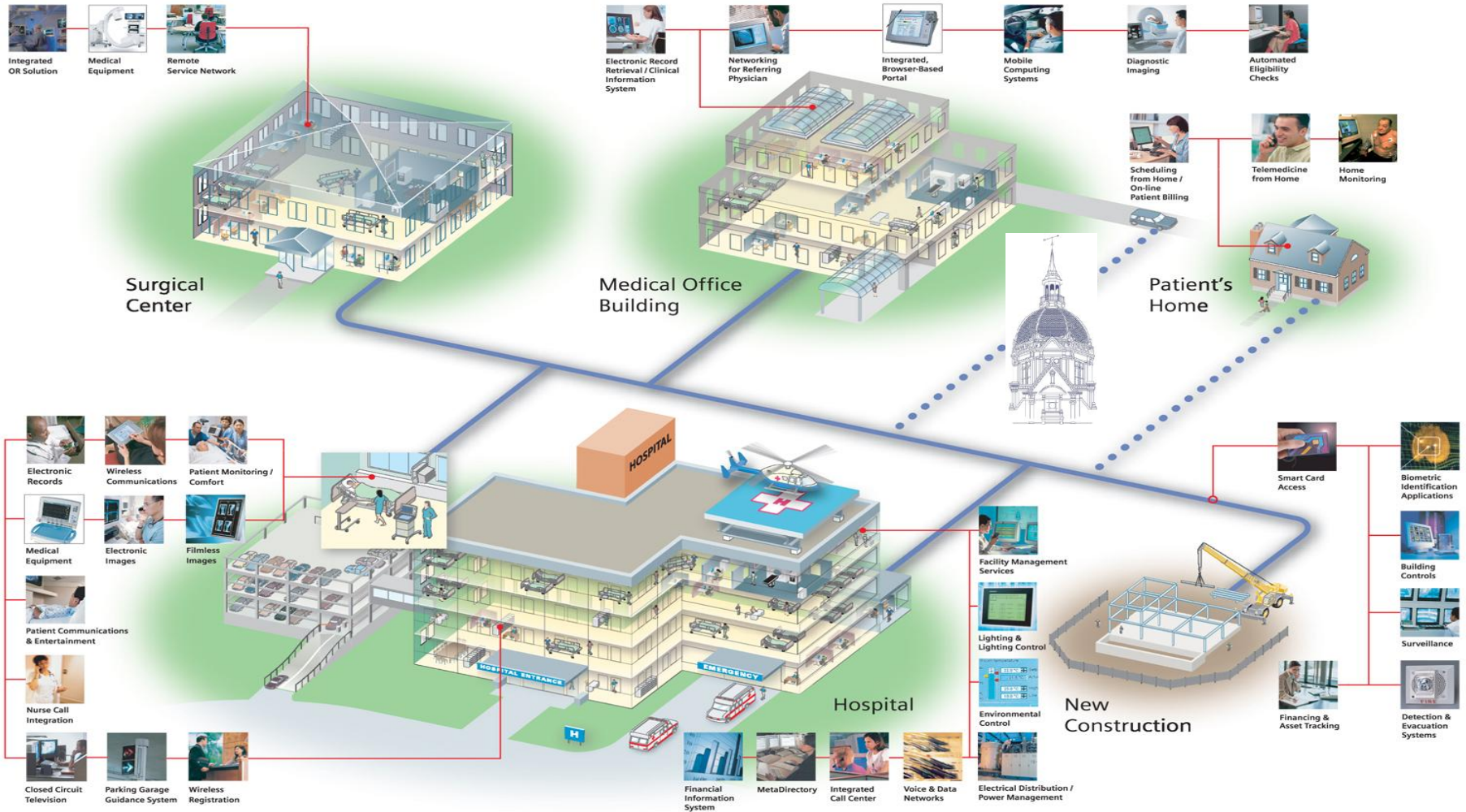


Stalder, Sdanowich, Foerstner

June 2011

# Enterprise-wide Life Cycle Management

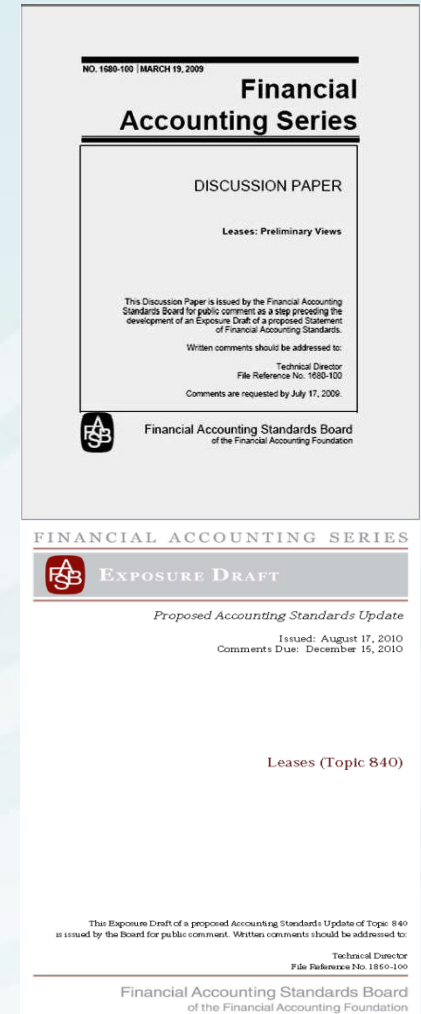
Where do we get the capital meet our financial requirements



# Financing Capital Equipment FASB 13 Overview

# Exploration of pending (FAS 13) “Accounting for Leases” reporting

- FASB – IASB PwC Project at Johns Hopkins --- Accounting for Leases
- Preliminary views published March 2009
- Exposure draft published August 2010
- A final standard is expected in 2012
- Effective date no earlier than 2016



# Exploration of pending (FAS 13) “Accounting for Leases” reporting

- The proposed changes will eliminate operating leases
- Balance sheet will be grossed up with an debt obligation
- Broad Impacts on Debt Covenants and Credit Ratings
- Real estate and equipment financing strategy (Lease vs Own), models for forecasting, etc.

# Perceived Problems with Current Accounting

- Current lease accounting is considered “broken.”
- Belief that operating leases give rise to assets and liabilities and should be recognized in the financial statements of the lessee.
- The existence of two very different models (operating v. capital leases) means similar transactions can be accounted for in different ways, reducing comparability.
- Current accounting is complex
- Dividing line between operating and capital leases is a “bright line” rule rather than being principles-based.
- The current accounting is conceptually flawed – for a simple lease, the definitions of both an asset and a liability clearly are met

## Executive Summary of Discussion Paper

- Elimination of operating lease accounting (lessees would treat all leases similar to how capital leases are accounted for today)
- Balance sheets would be “grossed up” to reflect right-to-use assets and lease obligation liabilities
- Expense will be higher during the early part of the lease term due to required use of effective interest method for interest expense
- Rent expense being replaced with interest and depreciation / amortization expense
- Application to existing leases (NO Grandfather clause)
- Possible exception for plain vanilla capital leases

# Executive Summary of Exposure Draft

## Lessees Accounting

- The proposal effectively eliminates off-balance sheet accounting for most leases. **All assets currently leased under operating leases would be brought onto the balance sheet, removing the distinction between capital and operating leases**
- The new asset: representing the right to use the leased item for the lease term and liability representing the obligation to pay rentals would be recognized and carried at amortized cost, based on the present value of payments over the term of the lease
- The lease term would include optional renewal periods that are "more likely than not" to be exercised This a significant departure from current accounting which (absent a penalty) generally only included non-cancellable periods in the lease term
- Lease payments used to measure the initial value of the asset and liability would include: contingentll amounts, such as rents based on a percentage of sales or rent increases linked to variables such as the Consumer Price Index (CPI). Today, contingent rents are generally excluded from minimum lease payments and reflected in the period they arise

# Executive Summary of Exposure Draft

## Lessees Accounting

- Lease renewal and contingent rents would need to be continually reassessed, and the related estimates adjusted as facts and circumstances change. Under current accounting, absent a modification or binding exercise of an extension option, there is no reassessment of lease term and contingent rentals
- Income statement: geography and the recognition pattern for lease expenses would change. Straight-line rent expense would be replaced by amortization and interest expense. This would result in an acceleration of expense recognition, as interest on the obligation would be greater in the earlier years, similar to a mortgage.

# Executive Summary of Discussion Paper

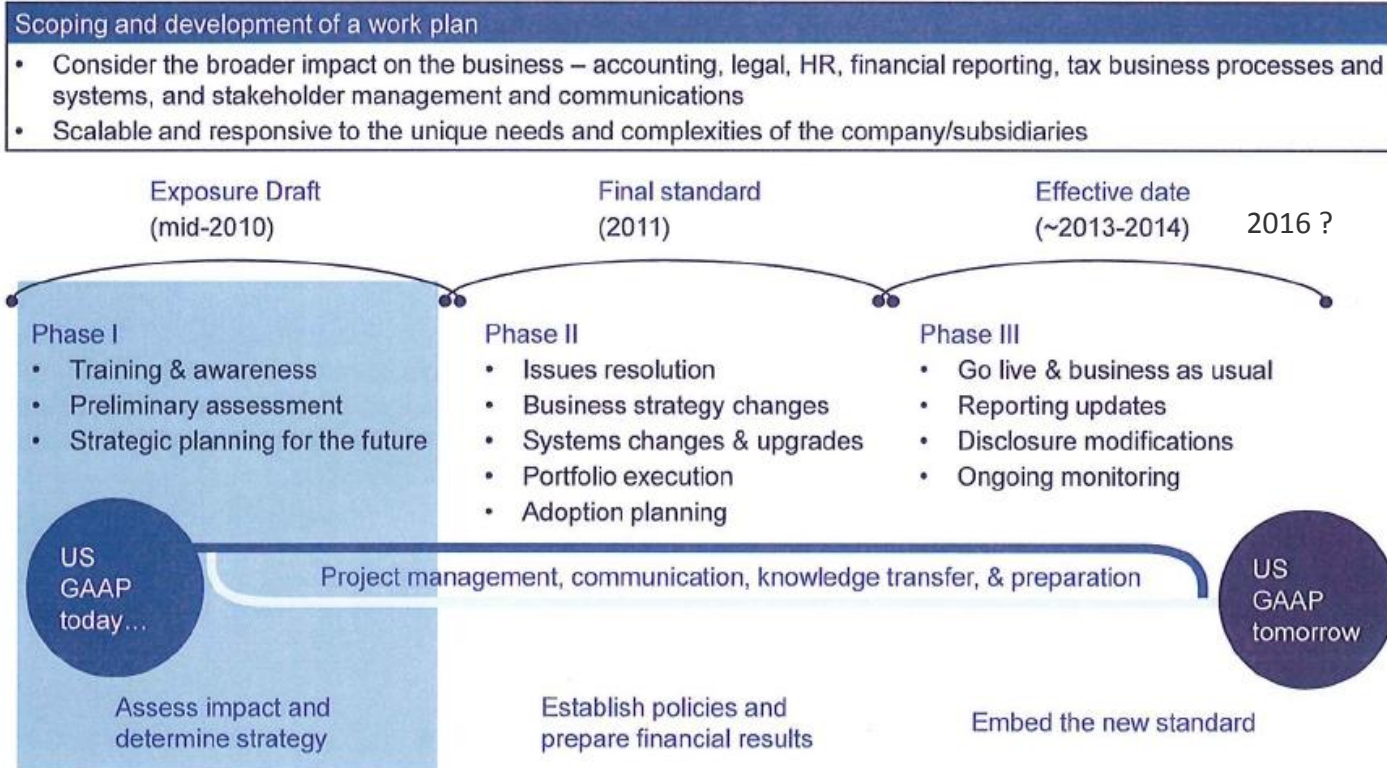
## Lessees Accounting

- **The boards are proposing a dual model for lessor accounting. Depending on the economic characteristics of the lease, a lessor would apply either a performance obligation approach or a de-recognition approach**
- The performance obligation approach would be used for leases where the lessor retains exposure to significant risks or benefits associated with the leased asset either during the term of the contract or subsequent to the term of the contract.
- Under this approach, the lessor would recognize a lease receivable, representing the right to receive rental payments from the lessee, with a corresponding performance obligation, representing the obligation to permit the lessee to use the leased asset.
- The de-recognition approach would be followed for all other leases. The lessor would recognize a receivable representing the right to receive rental payments from the lessee and record revenue. In addition, the carrying value of the leased asset that is considered to have been transferred to the lessee would be derecognized and recorded as cost of sales.
- Under either approach, lessors would need to estimate the lease term and contingent payments and adjust these estimates as facts and circumstances change.

# Exploration of pending (FAS 13) Executive Summary of Exposure Draft

- How is information tracked
- How are changes in assumptions managed
- Who can commit the organization to a lease
- How is this information communicated throughout the organization
- Do approval processes need to change
- Impact on systems and controls
- Impact on “lease versus buy” decision
- Does leasing continue to make sense?
- Impact on current and future debt covenants Ability to renegotiate covenants based on changes in GAAP
- Are terms clearly defined – what constitutes “debt”
- Any restrictions on future borrowings due to changes in leverage

# Exploration of pending (FAS 13) “Accounting for Leases” reporting



# What skill sets are required from your financier

Healthcare finance is a specialty whose primary expertise must include infrastructure/facility, primary use and secondary use equipment for hospitals, outpatient healthcare facilities and healthcare providers. It should utilize a consultative approach to first understand its client's unique situation and then to apply its extensive knowledge of GAAP, IFRS, Tax, and Managerial Accounting to structure and deliver the best fit solution for its clients.

# Expertise

Healthcare truly understands how to structure transactions that meet all of the GAAP, Tax, and managerial accounting issues existing in large lease transactions. The financier must understand all the issues and the technical answers and have proven ability to clearly and concisely communicate and effectively negotiate customer beneficial structures to Auditors for successful GAAP/IFRS/Tax lease treatment.

Key Criteria	Importance	CGCF Attributes
Transaction Structuring	<ul style="list-style-type: none"> <li>Structures with proper consideration of GAAP/IFRS/Tax and Managerial Accounting Effects</li> </ul>	<ul style="list-style-type: none"> <li>Experts in GAAP, IFRS, and Tax issues relating to proper lease structuring</li> <li>Leverage knowledge to ensure best fit structure for the client</li> <li>Specialize in Term, Lease, and SLB</li> </ul>
Financing Capabilities	<ul style="list-style-type: none"> <li>Experience/Expertise</li> <li>Competitive Rate</li> <li>Installation/Progress Funding</li> <li>Multiple Vendors</li> <li>Multiple Currencies</li> </ul>	<ul style="list-style-type: none"> <li>Management team with combined 60+ years of leasing experience</li> <li>Non-bank chartered portfolio allows maximum flexibility in structuring</li> <li>Successfully managed projects with 50+ vendors over 100 different locations</li> </ul>
Customer Service	<ul style="list-style-type: none"> <li>Quick and Seamless Execution</li> <li>Coordination of Multiple Vendors and Progress Funding</li> </ul>	<ul style="list-style-type: none"> <li>Industry high of 1:3 admin personnel to sales representatives</li> <li>Dedicated project team to address all of your needs</li> <li>Assistance with asset reporting and annual operating lease totals for audits</li> </ul>

# Healthcare Finance

The financier must work with for-profit and not-for-profit entities to construct and achieve creative, cost effective, and timely financing alternatives for conventional and non-conventional asset purchases. Through our extensive knowledge and understanding of the Medical marketplace we are able to help our clients achieve maximum ROI and minimize up front capital outlay. Typical project assets include:

## Non-Traditional Assets

- Co-Generation
- Building Technologies (Badging systems, electrical renovation, etc.
- Medical Construction
- Outpatient Diagnostic and Surgical subsidiaries (Construction, T & I).
- Energy and Automation.
- Maintenance
- Waste and disposal
- Laundry and facility equipment
- Aviation
- EMR initiatives (Cloud versions as well).
- FF&E

## Traditional Assets

- RIS/PACS
- Radiology
- Oncology
- Ultrasound
- Surgery suites
- Lab Equipment
- Monitoring
- I.T. related servers and desktop hardware
- Enterprise software
- Storage devices
- Networking equipment
- Telecommunications

# Capabilities

Back-office capabilities are exemplified by our experience in managing large and complex transactions including long installation funding periods (progress payments to vendors), numerous delivery schedules, multiple vendors, and multiple property locations, currencies, and tax jurisdictions.

- Fixed rate financing
- Two to fifteen year terms
- Capital leases
- Tax leases
- Off balance sheet financing
- First Amendment leases
- TRAC leases
- Lease lines of credit
- Multiple currency transactions
- Synthetic and reverse synthetic leases
- Aircraft financing
- Lease lines of credit
- New and used equipment
- Sale lease back
- Refinancing
- Revolvers secured by fixed assets
- Customized early buy out structures
- Customized in-country documentation

# Questions?

