Financial Accounting for Equipment Leases

Talking Points related to concerns about financial accounting for equipment leases.

Lease Accounting

Recent events including the collapse of the Enron Corporation have brought into focus the general topic of the use of "off-balance sheet" accounting. This focus on the general topic of "off-balance sheet" vehicles has brought attention to *leasing* as one of the vehicles for achieving "off-balance sheet" accounting. Most of the attention on *leasing* has been inquiry rather than critical. The following talking points are intended to provide information on the history and practice of financial accounting for leases.

- Equipment leasing is a major means that companies of all types and sizes all over the world acquire the use of equipment for productive purposes. Annual volume in the United States has grown steadily over thirty years to an amount of an estimated $244 Billion in new equipment in 2002.

- Financial accounting for leases (FAS 13) has been in place as GAAP for 25 years.
    - Financial accounting for leases is not new.
    - It is completely transparent (lease obligations must be disclosed fully in the footnotes).
    - There is a great body of interpretation and technical bulletins from FASB and EITF decisions to guide audit practice and others who use financial statements such as rating agencies, lenders and investors.

- Equipment leases, whether capitalized by the lessee or not, represent tangible productive assets.

- Lessees do not capitalize the equipment under lease because they do not own the property. FAS 13 and IAS 17 have well established and understood tests to indicate ownership. For the lessee to capitalize the equipment it does not own would be a misrepresentation. (U.S. GAAP requires detailed disclosure of lease terms including duration, obligations, options and any guarantees).

- If FAS 13 tests of ownership indicate that the lessee is the owner, the company must capitalize the equipment.

- Companies lease equipment for a variety of reasons including, but seldom exclusively, to avoid capitalization of the acquired equipment.
  The reasons most often given for utilizing leasing are:
    - Obtain a fixed rate source of money usually for a slightly longer period than loans
    - Avoid technological obsolescence
    - Match cash flow to the use of productive assets
    - Convenience
    - Flexibility as to deployment of equipment
    - Equipment management and replacement strategy
    - Efficient use of the tax incentives for investing in equipment
    - Achieve a financial statements objective such as amount of assets and debt
    - Achieve / maintain financial ratios

- While financial accounting for leases has not required capitalization by the lessees in as many as half of all equipment leases, there is not a history of significant delinquency nor default of the leases. In addition, there is no record of investors or lenders alleging that they were misled or defrauded by financial accounting standards that do not lead to capitalization of leased assets.

- Institutions that provide equipment leasing as a core financial product are most often conservative financial institutions such as banks, insurance companies and subsidiaries of manufacturers.
  - These institutions are engaged in equipment leasing to earn a profit.
  - These companies make arms length decisions in offering leases.
  - These institutions provide capital for productive purposes and intend to have it repaid.
  - These institutions do not regard whether a lease is capitalized or not to add risk.

- To the degree that 25 years experience with FAS 13, Accounting for Leases, has identified issues in financial accounting for leases that should be officially reviewed and possibly changed, The ELA Board of Directors in 1998 passed a resolution asking FASB to put financial accounting for leases on its project agenda. FASB has indicated that other financial accounting issues have a higher priority.

Special Purpose Entities

- Special Purpose Entity (SPE) is a tool used by many companies to meet real commercial objectives of the parties

- SPEs facilitate commerce and protect the interests of the parties participating. They are often intended to be looked through as they serve purposes that don't change the business nature of the transaction. In addition to leases, an SPE is used in securitizing credit card receivables, student loans, mortgages, auto loans, home equity loans, joint ventures, and mutual funds.

- When an SPE is used in a lease, the SPE is a trust, corporation, or limited liability company holds title to or a leasehold interest in the leased property for the benefits of others.

- SPEs divide legal and equitable ownership of the SPE's assets, so the SPE is the owner of the assets for legal purposes, but the owners of the trust are the "real" or economic owners of the assets of the SPE.

- Financings are structured with SPEs for the following reasons:

  Reduce risk for lenders and investors An SPE may afford its owner-participant with the same limitation of personal liability as a stockholder of a corporation. An SPE may provide the owner participant with protection from claims concerning breach of environmental law or tort risk arising from the assets.

  Manage liability for investors Lenders and other participants, like lessees, do not want to take owner credit risk and want their claim to the assets to be free of the risk attendant to liens. The SPE is prohibited from engaging in other transactions, which is not possible without the inserting an SPE in the transaction. Also, lenders and participants believe that a grantor or business trust will provide protection against the potential bankruptcy of the owner.

  Broaden capital market participation to reduce financing costs for borrowers A trust permits a broader universe of participants. For example, certain financial institutions, either by charter or policy, may not hold a direct interest in the property and would be precluded as participants without the trust structure.

  Facilitate transferability of ownership to reduce costs for investors and borrowers A trust permits the owner-participant to easily transfer its interest without having to re-document the transaction.

Enable passing through tax benefits for investors SPEs can be structured so that its income is not taxed at the SPE level but distributed to the owners, as is the case in mutual funds.

Obtain fiduciary and expert administrative services to reduce cost and facilitate financings for all parties In addition to providing administrative services, including funds management, record-keeping, reporting, and notifying, trustees manage the activities of the trust with a high duty of care as established in trust law.

Synthetic Leases

What is a Synthetic Lease?

- A synthetic lease is an operating lease of fixed assets **primarily used for** real estate that allows the lessee or user of an asset to take depreciation benefits associated with ownership for tax purposes.
- It is a common method of financing that combines leasing and secured lending techniques and practices. Leases of real estate, for example, are based more on corporate lending and underwriting practices rather than real estate finance.
- It has been used to finance a wide variety of assets including energy production facilities, manufacturing equipment, aircraft, corporate headquarters and distribution centers.

How Do They Work?

- An asset is acquired by a leasing company and leased to a user for a defined period of time, typically five to twenty years, depending on the type of asset and the funding used by the lessor to acquire the asset. Lessors purchase assets at an arms' length price, expected to represent the fair value of the asset.
- Rent is predetermined and may be fixed or floating at the direction of the lessee. Leases do not normally contain rent escalators or contingent rent obligations.
- The lessee is granted the option to purchase the asset at a fixed price determined at the inception of the lease that is equal to the fair market value of the asset at the time of purchase.
- If the lessee does not purchase the asset by the end of the lease term, then the asset is sold to a third party and the proceeds of the sale are applied to retire the lessor's investment. All sale proceeds in excess of the lessor's investment are normally paid to the lessee, enabling the lessee to enjoy any appreciation in the value of the asset.
- If the asset is not sold but returned to the lessor or if the proceeds of sale are inadequate to repay the lessor's full investment balance, then the lessee may be required to make an additional rent payment in the amount of the shortfall. This "guaranty" along with the other payments previously made by the lessee under the lease must, on a discounted basis, be less than 90% of the original value of the asset.

Why Do Companies Use Them?

- Lowest cost operating lease available – Lease rates are close to a company's incremental cost of borrowing rather than traditional lease rates so lessees can avoid the expensive equity of **real estate investment trusts (REITs**) or developers.
- Because of the purchase option, synthetic leases give companies long-term **use** over **business** assets on pre-negotiated terms.
- Provides 100% financing where most real estate financing advances significantly less.
- Accesses alternative sources of capital, creating greater liquidity for companies in managing their overall funding requirements.
- Preserves borrowing capacity under credit facilities and bond indentures.
- Efficient use of tax benefits associated with fixed assets under operating leases.
- Keeps a non-producing asset, like real estate, off balance sheet.
- Allows for acquisition of assets beyond capital budget, enhancing company growth.
- Improves return on assets.
- Can monetize existing corporate personal property assets.

How Does the Accounting Work?

- Synthetic leases are treated as operating leases under FASB Statement 13 and related literature: the present value of all rentals and guaranteed payment obligations must be less than 90% of the asset value, the term of the lease may not exceed 75% of the useful life of the asset, the lessee's purchase option may not be a bargain and ownership of the asset may not automatically transfer to the lessee at the end of the lease term.
- Statement 13 is based upon a risks and rewards model of ownership that is used to determine which party is considered the owner of an asset.
- The rules under Statement 13 and related standards create transparency in accounting for leases through the disclosure of operating lease commitments required in financial statements.
- Companies doing sale/leasebacks of equipment may not recognize a gain on sale so leases can not be used to generate earnings from existing assets.
- Special purpose entity (SPE) owners of the assets are sometimes used, but they are not required. When used, these entities are carefully structured in compliance with accounting rules and are capitalized with sufficient equity. The investment in these entities shows up on the balance sheet of owners.
- Because of the continuing involvement of the lessee through the purchase option and residual guaranty, sale/leasebacks of real estate do not work with synthetic leases under FASB Statement 98, effectively limiting the product application to acquisitions and build-to-suits.

<u>Misconceptions about Synthetic Leases</u>

- "*Synthetic leases hide off balance sheet debt*" – Like all operating leases, **FAS 13, which is U.S. GAAP, requires detailed footnote disclosure of all obligations and guarantees,** including minimum lease payments. Further, management often provides additional disclosure of actual arrangements in the financial statements. Analysts at credit rating agencies and debt covenants under borrowing facilities normally capitalize operating leases as debt along with the associated asset. A lessee's liability is confined to its obligations under the lease which have a finite limit and the lessee is not obligated to repay third party debt directly.

- "*Synthetic leases are short-term and expose companies to refinancing risk*" – There is nothing inherent that limits synthetic leases to a short term. Users of synthetic leases typically dictate the desired length of term and type of financing based on their overall strategy of managing their corporate obligations. Recently, short term financing has been valued because of the low interest rate environment, significantly reducing the cost of leasing and improving corporate earnings. Leases can be structured for terms such as 20 years if the asset's useful life and the corporate credit can support it.

- *"Synthetic leases have a hidden balloon payment"* - Financing a purchase option or refinancing a synthetic lease is akin to renewing a corporate credit facility or retiring corporate bonds. Creditworthy borrowers normally develop appropriate scheduling of their liabilities in order to mitigate against market and credit risk as best as possible and actively manage their interest rate exposure as well.

- *"**Assets** can decline in value exposing companies to a risk of loss"* – Under accounting rules, purchase options are structured at expected fair value and residual guarantees are limited so the likelihood of loss is remote. If there were a permanent decline in the value of an asset during the lease, a lessee would be required to recognize that impairment immediately. Because the lessee is entitled to any appreciation in the asset, companies benefit through this form of lease as opposed to a conventional real estate lease.

- *"Synthetic leases use SPEs that are a sham"* – Synthetic leases do not by their nature require SPEs, although they are often used for a variety of commercial purposes to limit bankruptcy and environmental risk or reduce the cost to transfer title. SPEs and their equity investments are always structured to comply with accounting requirements - SPE's assets must be legally isolated from the parent company and an independent third party must have a substantive investment at risk. The most common form of SPE used in leasing is a trust which is quite different from an operating partnership, for example.

- *"Synthetic leases provide tax advantages that boost earnings"* – The tax benefits of a synthetic lease, which is used primarily in real estate transactions are insignificant. Only the building can be depreciated, and the depreciation is taken over a period of 39 years using the straight line method.

In summary, synthetic leases are an attractive, low-cost form of leasing that gives creditworthy companies access to alternative sources of capital that facilitates the acquisition of corporate fixed assets designed to increase corporate revenues and performance.

Enron's Use of SPEs vs. the Use of SPEs in Leasing

- Enron failed to comply with accounting rules for consolidation of entities, income on sale recognition and disclosure when it used SPEs to finance the sale if assets, recording large profits that were ultimately reversed. The SPEs were capitalized with approximately 3% equity and 97% debt

- Most of Enron's problems came from partnerships, (SPEs), that were owned by supposed third parties that combined to provide 3% equity capital to the SPEs. 3% is the minimum threshold required by the consolidation accounting rules to allow an SPE to be considered a substantive entity. In several cases the investors were Enron employees. In other cases the investors included other SPEs that Enron had a major ownership interest in. Enron did not disclose existence of the SPEs nor did Enron consolidate them.

- Enron effectively repaid the SPE owners' capital investment through fees, or agreed to return the equity after a period of time - the result was no remaining at-risk equity invested. Enron did not consolidate the SPEs.

- Enron guaranteed the debt of these vehicles and contributed stock to keep the SPEs solvent. Enron did not disclose that the debt guarantees and that the guarantees were unlimited.

- The SPEs borrowed money and bought assets from Enron. The SPEs acquired the Enron assets at prices above market and Enron recorded the sales with large gains.

- As the assets declined in value, Enron had to contribute more stock and as Enron's stock price dropped, this created an increasingly quick downward spiral for the company. The losses coupled with Enron's lack of adequate capitalization led to its bankruptcy.

- Off balance sheet accounting did not cause the Enron bankruptcy, the failed business deals did. Rules exist to have caused Enron to account for the transactions on books or reported in footnotes, but they failed to comply with the rules. Rules also exist that would have prevented the recognition of the sales and gains.

Comparison of Enron SPEs vs. Off-balance Sheet Lease Products:

Enron	**Lease Products**
All parties agree that Enron should have consolidated the SPEs or at least they should have booked the losses.	Off-balance sheet lease structures are tested every day as we work with our clients and their Big 5 auditors.
All parties agree that Enron should have reported the amount and terms of their off-balance sheet obligations.	Off-balance sheet lease structures qualify as operating leases under US GAAP (FAS 13), thus receiving off-balance sheet treatment. The accounting rule requires lessees to disclose future minimum lease obligations as well as lease terms, including any residual guarantees.
The asset sales were not arm's length so no true third party would have ever entered the transactions.	Lease structures are arm's length transactions at fair market values.
There was no third party equity capital at risk.	When we use SPEs they are adequately capitalized with equity provided by true third party investors to comply with the EITF rules for at-risk equity.
Enron guaranteed the debt of the SPEs, Enron covered all losses of the SPEs and Enron's liabilities were unlimited.	Lessees' liabilities are limited to the terms of the lease.

US GAAP Operating Lease Footnote Disclosure Rules

The following are direct copies of the footnote requirements for lessees to report operating leases:

From SFAS 13 paragraph 16:

"b. For operating leases having initial or remaining noncancelable lease terms in excess of one year:

- (1) Future minimum rental payments required as of the date of the latest balance sheet presented, in the aggregate and for each of the five succeeding fiscal years.
- (2) The total of minimum rentals to be received in the future under noncancelable subleases as of the date of the latest balance sheet presented.

c. For all operating leases, rental expense for each period for which an income statement is presented, with separate amounts for minimum rentals, contingent rentals, and sublease rentals. Rental payments under leases with terms of a month or less that were not renewed need not be included.

d. A general description of the lessee's leasing arrangements including, but not limited to, the following:

- (1) The basis on which contingent rental payments are determined.
- (2) The existence and terms of renewal or purchase options and escalation clauses.
- (3) Restrictions imposed by lease agreements, such as those concerning dividends, additional debt, and further leasing."

From EITF 90-15 Response to Question 1:

"The SEC staff believes the consensus, along with appropriate disclosures, provides timely guidance with respect to certain leasing transactions involving SPEs that were of the most concern to the SEC staff. These included sale-leaseback transactions involving personal property, real property when the property is built to the lessee's specifications, and property meeting the specifications of the lessee that is purchased by the lessor.

All leasing transactions should be carefully analyzed, particularly those including any potential penalties or involving special-purpose property, in accordance with Statement 13, as amended. Registrants' disclosures should include a general description of the leasing arrangements as required by paragraph 16(d) of Statement 13. The SEC staff believes such disclosures should include the significant terms of leasing arrangements, including renewal or purchase options, escalation clauses, obligations with respect to refinancing of the lessor's debt, significant penalties (as defined in Statement 98), and the provisions of any significant guarantees, such as residual value guarantees. In addition, Financial Reporting Codification Section 501, Management's Discussion and Analysis, requires disclosure of any known demands, commitments, events, or uncertainties that will result in or that are reasonably likely to have a material impact (or for which management cannot make such determination) on the registrant's liquidity, capital resources, or income from continuing operations or would cause reported financial information not to be indicative of future operating results or of future financial condition. In addition, Article 5 of Regulation S-X requires disclosure of all material commitments and contingent liabilities."

About the Equipment Leasing Association

The Equipment Leasing Association prepared “Financial Accounting for Equipment Leases” for the exclusive use by ELA members.

Organized in 1961, the Equipment Leasing Association (ELA) is a non-profit association that represents companies involved in the dynamic equipment leasing and finance industry to the business community, government and media. ELA's diverse membership consists of independent leasing companies, banks, captives, financial services corporations, broker/packagers and investment banks, as well as service providers like accountants, consultants, equipment managers, executive recruiters, insurance companies, lawyers, publishers, and software providers. ELA promotes the leasing industry as a major source of funds for capital investment in the U.S and other countries. ELA maintains an informational portal for financial decision-makers at http://www.leaseassistant.org. Headquartered in Arlington, Va., ELA has more than 850 member companies and a staff of 27 professionals. Equipment leasing is estimated to be a $244 billion industry in 2002.

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