The Handbook of LEASING:

TECHNIQUES & ANALYSIS

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Preface

During our years of teaching lease seminars and consulting throughout the United States and Europe, we have been able to isolate numerous problems that occur in the leasing industry which have not been adequately addressed in current texts on the subject of leasing. The few existing books on leasing tend to concentrate on either the Lease versus Buy decision, or on the legal aspects of structuring leases. The purpose of *HANDBOOK ON LEASING: Techniques and Analysis* is to provide a general overview of the many problems encountered in the leasing industry without undue concentration on one aspect of leasing. The book is evenly balanced between the needs of the lessor and those of the lessee.

Lessors or potential lessors are confronted with numerous problems such as:

1. *How to Compute Lease Yields.* Yield analysis is fully explained using both the advanced financial calculator and lease tables for leveraged and nonleveraged leases. Over twenty-three basic lease yields commonly used in the leasing industry are explained.
2. *Understanding of State of the Art Analytical Techniques.* Adjusted Internal Rate of Return, Modified Return on Equity, Adjusted Net Present Value, Standard Sinking Fund, and the Multiple Investment Methods are discussed in depth.
3. *Structuring Leases.* Twenty three major groups of lease-structuring variables are discussed in context of lessor requirements, lessee needs, and risk considerations. Risk assessment deals with the ten "C"s of lease creditworthiness.
4. *IRS Definition of a Lease.* Only under true IRS operating leases does the lessor receive the full tax benefits. Therefore, Revenue Ruling 55-540 and Revenue Procedure 75-21 along with an IRS Equipment Leasing Guide are examined so that the lessor may properly structure a lease to gain such tax benefits. Additionally, the new safe harbor IRS rulings affecting leasing are reviewed in depth, section 168(f)8.
5. *Management and Analysis of Leasing Companies.* Specialized financial statements are presented which are helpful in managing a lease company. Additionally, a fourteen-variable sensitivity model is described which pinpoints the critical variables that determine the profitability of a leasing company.

6. *Accounting for Capital Leases.* This subject is explained in depth using journal entries and "T" Accounts. Sales-Type, Direct Financing, and Leveraged Leases are individually analyzed in terms of their accounting and disclosure requirements.
7. *Legal Issues in Lease Transactions.* Nine areas of legal concern are examined to better inform lessors of their potential legal liability. The new federal bankruptcy act is discussed along with the Uniform Consumer Credit Code and other topics of interest to lessors. Additionally, a lease agreement is broken down into twenty-two topical areas and the legal implications of each is discussed.
8. *Income Tax Considerations.* Investment tax credit, depreciation (ACRs), and interest deductions are discussed from the lessor's viewpoint. Methods of enhancing lease yields through the proper use of these variables are discussed.

Lessees or potential lessees are also confronted with unique problems encountered in the leasing environment such as the following:

1. *The Effects of the Capital Lease on Financial Statements.* Capital lease accounting requirements, according to FASB statement Number 13, can adversely affect the financial statements and financial ratios of the lessee. The complete effect of the capital lease versus the operating lease is examined.
2. *Factors Influencing Leasing's Popularity.* Twenty major reasons on leasing's popularity as a form of equipment financing are discussed in depth.
3. *The Lease versus Buy Decision.* The seven essential steps of the Lease versus Buy decision are examined in depth. Most authors discuss only the first step—the financial decision—but the other six steps are the elements of the decision process that often make leasing preferable to buying. Liquidity preference, nonfinancial considerations and other steps are included in the process.
4. *Qualitative Reasons to Lease.* Thirty-six difficult to quantify, qualitative reasons why leasing might be preferable to buying are discussed.
5. *Accounting and Reporting for Leases.* How a lessee accounts for both operating and capital leases is explained along with disclosure requirements.

Throughout the book, problems confronting lessors are also discussed in terms of their impact on the lessee. For example, lease yields are generally considered a concern of the lessor—but what is an income yield to a lessor is also an interest expense to the lessee.

HANDBOOK ON LEASING: Techniques and Analysis is intended to be a reference source for both uninitiated and experienced leasing company personnel. Heavy emphasis is placed on understanding lease structuring and its impact on lease yields. Lease sales personnel will find the book an extremely useful reference when creating sales brochures and programs. In fact, much of the book's content was derived from in-house seminars delivered to banks and leasing companies' management and sales personnel.

In summary, the book provides the reader with a comprehensive understanding of the financial, accounting, structuring, and legal considerations required for the proper structuring of leases from both the lessee's and lessor's viewpoint.

Numerous legal, tax, and industry specialists were consulted during the preparation of *HANDBOOK ON LEASING: Techniques and Analysis.* The authors would like to express their appreciation to them and especially to Jonathan M. Ruga, MBA, CPA, J.D., who wrote the majority of Chapters 11, 12, and 13.

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Factors Influencing Leasing's Popularity in Today's Economy

In view of an estimated $160 billion dollars invested in leased equipment in the United States, businessmen must look to leasing during the 1980s as a viable alternative to the more conventional forms of equipment financing. Today the use of equipment from satellites to hospital beds is obtained through leasing. Modern management is becoming increasingly aware of the flexible options and advantages this emerging form of financing offers. Leasing companies have grown nationally from a handful of lessors twenty years ago to thousands of public, private, and bank subsidiary leasing companies today.

Although leasing has become extremely popular during the last two decades, it is certainly not a novel concept to the world of business. Leasing finds its origin in antiquity. Leasing of farmland and ships occurred in Phoenician times. In medieval times, real estate was leased to feudal tenants who paid their rent with commodities grown on the land their masters owned. However, the leasing of factory machinery, office equipment. machine tools, railroad cars, and computers is a relatively new concept in leasing. An industrial equipment leasing boom began in the mid 1950s and experienced its most rapid growth in the 1960s, when leasing expanded into nine major areas:

1. *Aircraft*—jets and allied service equipment
2. *Autos*—for personal and business use
3. *Computers*—including central processing units and peripheral equipment
4. *Furnishings*—for hotels, motels, and office buildings
5. *Industrial Machinery and Equipment*—including machine tools and heavy equipment used in construction, mining, and oil exploration
6. *Medical Equipment*—leased primarily to hospitals and medical clinics

7. *Office Equipment*—including typewriters, calculators and copying equipment
8. *Railroad Cars*—flat cars, hoppers, and refrigerated cars
9. *Trucks*—frequently including complete truck maintenance and other services

Insight into the numerous and complex factors that have led to an expansion of leasing into these previously unexploited areas is essential to an understanding of leasing. Understanding the underlying causes of leasing's popularity will better prepare lessees in negotiating and structuring leases. Then, too, lessors can predict profitable new opportunities within the industry through an improved awareness of past trends.

The popularity of leasing is primarily the result of the following factors:

1. PSYCHOLOGY OF USE PREFERENCE OVER OWNERSHIP
2. OBSOLESCENCE HEDGE
3. AFFORDABILITY TO LESSEES
4. ADDITIONAL SOURCE OF DEBT FINANCING CAUSED BY THE DRYING UP OF CONVENTIONAL CAPITAL FINANCING SOURCES: STOCKS AND BONDS, AND COMMERCIAL BANK LOANS
5. INFLATION HEDGE
6. TAX ADVANTAGES TO LESSORS AND LESSEES
7. LACK OF TAX ADVANTAGES & BUDGET RESTRAINTS OF NONPROFIT ORGANIZATIONS
8. INDIVIDUAL TAX SHELTERS
9. DIVERSIFICATION OF FINANCING SOURCES
10. RISK-TAKING LESSORS
11. RESTRICTED OWNERSHIP
12. CONSERVATION OF WORKING CAPITAL
13. VERTICAL, HORIZONTAL, AND CONGLOMERATE INTEGRATION
14. LOWER AFTER-TAX PRESENT VALUE OF COSTS
15. OFF-BALANCE SHEET FINANCING
16. ECONOMIES OF SCALE IN LESSOR PURCHASING AND SERVICING
17. PROFITABLE EXPERIENCE OF THE LEASING INDUSTRY
18. INTERNATIONAL LEASING TO MULTINATIONAL AND FOREIGN BUSINESS
19. CONVENIENCE TO THE LESSEE
20. FLEXIBILITY IN LEASE STRUCTURING
21. NONFINANCIAL SERVICES

ANALYSIS OF CAUSAL FACTORS

Psychology of Use Preference Over Ownership

Enlightened businessmen realize that the use of a piece of equipment is far more important to the production of income than a piece of paper conveying title to the equipment. It is the use of equipment that produces profit, not ownership. In fact, if equipment can be used for most of its economic life without its user having the full legal responsibilities, risk, and burdens of ownership, then why should that user ever desire to own it? Even farmers, who may have traditionally valued land ownership, now readily acknowledge that the USE of land is more important than the OWNERSHIP of it. Numerous farmers and ranchers lease tracts of land in order to increase production of cattle or crops. Psychologically, however, many people are unwilling to separate the concept of asset use from asset ownership. We have spoken to owners of businesses in developing countries where we have heard the remark, "I don't want to lease because there is no prestige or recognition without ownership of the equipment." Success, to many people, is still measured by ownership rather than by use of assets. Until a nation is psychologically prepared for the self-assumed loss of prestige and success that purportedly occurs when an asset's use is obtained with a lease rather than with conventional ownership methods, leasing will not gain in popularity as rapidly as it has in countries where a change in emphasis of USE over OWNERSHIP has occurred.

A similar change in emphasis has occurred in the accounting field. Until World War II, the accounting profession tended to judge a company's success by its balance sheet—what it OWNED. Net worth was the all-important yardstick. As companies continued into the post-war expansionary period, they financed much of their growth with borrowed funds. The lenders of these funds were more interested in having their interest paid when due than in the net worth of the company. Net worth has value only in bankruptcy liquidation which is a more remote occurrence than lack of profit or liquidity problems. Thus, a shift in accounting emphasis occurred in which the income statement came into prominence. The income statement measures the results of the USE of what is owned. It is from the cash results of net income that interest to creditors is paid. The balance sheet, therefore, began to take a secondary position. For example, the LIFO inventory method better matches inflationary rises in costs with inflated revenue shown on the income statement. But this method is detrimental to the balance sheet which carries inventory at costs far below market prices. Consequently, LIFO balance sheets understate costs in order to make the income statement more accurate. Thus, measuring the results of the USE of assets on the income statement has become more important than measuring the OWNERSHIP of assets on the balance sheet.

Since many leases are a form of off-balance sheet financing (certain operating leases do not appear on the face of the balance sheet), a company's return on assets appears higher than if the lease were capitalized as an asset and corresponding liability. Such improvement in return on investment is apparent because net income is divided by a smaller asset base. Since operating results are frequently judged by return on assets, leasing an asset without obtaining ownership or the resultant capitalization and inclusion in the balance sheet is helpful to many lessees.

Obsolescence Hedge

Another reason why emphasis of USE over OWNERSHIP has occurred is because of the penalties attached to the ownership of certain equipment, such as computers, which have been developed by rapidly growing, high-technology industries. Some computers have become obsolete between the order date and the delivery date. Who wants to own an outmoded piece of equipment? Short-term, cancelable leases permit firms to avoid the pitfalls of owning obsolete equipment. If a piece of equipment is outdated, the lessee cancels the lease and orders updated equipment. Usually, however, leases are only cancelable after a short noncancelable period such as six months to one year.

A new lease type known as the "upgrade lease" has recently been developed where automatic replacement of obsolete equipment is written into the lease agreement. These leases are usually provided by lessors who manufacture the leased equipment and are in a position to provide updated models to their lessees. As long as technological advances continue in certain industries, the short-term cancelable lease and the upgrade lease will be a popular means of hedging against economic and physical obsolescence.

Affordability to Lessees

The preferable use of assets obtained through LEASING compared to use obtained through OWNERSHIP is further enhanced by inflation. Inflationary price increases have priced certain assets virtually beyond ownership possibilities. Much farm and ranchland could never be profitably utilized if the farmer had to purchase the land at today's prices. This explains why many tracts of land are leased today. Land is becoming prohibitively expensive. Certain types of medical equipment are also extremely costly. Doctors in medical clinics often enter into joint venture leases. These leases allow them the use of expensive equipment well beyond the purchase capability of an individual member of the group. New home starts are constantly being overshadowed by multiple-unit starts (apartments) which will be leased–few can now afford homes or condominiums. By the 1990s few young couples will be able to afford a new home. Leasing will be their only alternative. The same trend, of course, is pervading the equipment industry. As equipment is priced beyond a company's purchasing ability, no alternatives remain but to lease.

Additional Source of Debt Financing Caused by the Drying Up of Conventional Capital Financing Sources: Stocks and Bonds, and Commercial Bank Loans

Adding to the rapid growth in the volume of leasing since the 1960s have been continued capital needs for business expansion and modernization combined with a limited availability of capital funds from the usual channels of equity stock issued and bond financing. Fewer stock and bond issues during the 1970s resulted in a shortage of new investment capital for many small- and intermediate-sized firms. Many economic factors led to the drying up of conventional capital financing sources. Notable among them are: (1) the use of loanable funds for government spending and consumer credit and (2) shifting of equity investors away from the stock market to higher yielding investments in the money market, real estate, etc.