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# (Don't) Look Deep into My Lease

*Terms can be mesmerizing, but companies get a rude awakening when leasing's real cost is revealed.*
Linda Corman, CFO Magazine
July 01, 2006

The promise of low monthly payments had enticed Rojacks Food Stores into leasing restaurant equipment rather than buying its own. But when the end of the lease loomed in 2000, the Mansfield, Massachusetts, chain still needed the shelving, refrigeration, and other items for which it was being charged. The leasing company, GE Capital, set a buyout price of $500,000. Suddenly, the lease arrangement seemed like a very bad deal.

Andrew Almquist, who had joined Rojacks as vice president and controller that year, sought help from consultants. An appraiser was hired, and the leasing company was persuaded to reduce the proposed buyout price by half. For the now-defunct Rojacks, it was a narrow escape from a plight that companies often encounter when they become entangled in unfavorable lease arrangements.

"Leasing is like buying a used car," says Almquist, now finance vice president and controller of Dedham, Massachusetts, restaurant chain Papa Gino's. Lessees that take just a quick glance under the hood won't learn much about how the lease operates. And unless a careful study is made, as Almquist puts it, "The leasing companies hold all the cards."

It is unquestionably a big game. With the total value of equipment being leased by companies rising — from $213 billion in 2005 to an estimated $229 billion this year, according to the Equipment Leasing Association of America (ELA) — leasing represents more than a quarter of all investment in equipment.

Further, the rules are about to come under review. The Securities and Exchange Commission has put leasing standards high on the list of items in a reconsideration of off-balance-sheet accounting. The Financial Accounting Standards Board is preparing to take a position as well. About half of American companies now cite off-balance-sheet accounting as among the reasons they choose to lease, rather than buy, equipment (see "On Borrowed Time" at the end of this article).

**A Review of the Pitfalls**
But whatever accounting changes are made in the future, it is worth reviewing the pitfalls that lead to lessee complaints — mainly when they discover some costly contract term that was overlooked originally.

In choosing whether to buy or lease, of course, companies weigh the cost of borrowing for purchased equipment against monthly lease payments, figuring in any tax advantages from leasing. Lessors, whether they are banks, commercial finance companies, or other entities, often present leasing as the more attractive option because of its low monthly costs and its convenience, among other reasons.

A 2004 survey by Global Insight gave the number-one reason for leasing — listed by 65 percent of the 150 companies in the Waltham, Massachusetts, economic forecaster's survey — as the discipline it imposes on the maintenance and replacement of equipment. Protection against obsolescence was cited by 54 percent, and off-balance-sheet accounting by 53 percent. Convenience scored with 51 percent. The efficient use of tax incentives was cited by 36 percent.

But for companies like Rojacks, which failed to anticipate the high residual value of the equipment, the concentration on low monthly and up-front payments disguises the true costs of leasing.

Large corporations aren't immune from making basic cost miscalculations, either. When Cleveland-based industrial-equipment maker Eaton Corp. entered a contract to lease computer servers some years ago, the deciding factor should

have been residual-value predictions, according to vice president and treasurer Bob Parmenter, who was not involved in the decision at the time. Those who did call the shots, however, were seduced by the convenience factor.

"They looked at month-to-month instead of total costs, so the bias was toward leasing," Parmenter says. "When leases came to their normal end, rather than deciding to dispose of the equipment or find a new lease, they continued to lease. It was a very bad economic decision."

Among their mistakes, Almquist and Parmenter's predecessors failed to recognize that some lessors expect the high back-end returns to offset the low payments they dangle up-front. According to industry statistics, lessors on average realize 15 percent yields on the equipment they lease, says Susan Franklin, CEO of American River Partners, a Cohasset, Massachusetts-based consulting firm.

"Most lessors make money through some obfuscation in the lease," maintains Michael Keeler, CEO of Ecologic Leasing Solutions, a lease management outsourcing company in Great Falls, Virginia. "If the rates are pushed down at the beginning of the lease, the rates at the back end go up."

There are more-standard reasons that front-end costs are low, maintains ELA president Michael Fleming. Smaller monthly payments reflect higher residual values of the equipment, and also come with longer lease terms. Back-end terms are simply meant to protect the leasing company, which assumes the risks associated with the value of the equipment. "It isn't that the lessors obfuscate," says Fleming. "The main problem is that lessees just don't think about the lease as an ongoing thing that has a beginning and an end."

Still, a lessee that pays too little attention to that end can incur significant costs. Lessors often set deadlines for lease-renewal notification as much as six months before the end of the lease, for example, and being late can subject the lessee to steep penalties or commit it to another lease term at the same rates. Such costly results are common, leasing experts say, because lessees often don't recognize the importance of leased equipment until they have to replace it.

Returning equipment on time doesn't always prevent add-on costs, either. Lease terms often have "all or nothing" clauses, meaning, for example, that the return of 95 of 100 leased computers doesn't keep the company from incurring full lease payments. Sometimes a few items may be lost or damaged, or there might be an unexpected need to retain a few computers, yet with an all-or-nothing clause the company still pays in full.

"If you have a company leasing 100 computers, all installed at the same time, unless you're brain-dead you'll understand that a moment will come at the end of, say, three years when you have to transition to the next wave of technology," counters ELA president Fleming. Companies should be able to see in advance the need to keep back a few computers, and then they can negotiate "a staged end of the lease," he says. "You can put in language that allows a transition."

**Beware Automatic Renewals**

Other lease terms, too, burden lessees with requirements that seem onerous or subjective. Some lessors, for instance, require the use of the original boxes for returns, or designate a return location far from the lessee. Leasing companies may set tough standards for determining "normal wear and tear" for returned items, or add steep charges in the case of missing parts, even if those parts are superfluous.

Lessees also may find that the up-front deposit isn't applied to the last month's payment, as they expect. Sometimes deposits go for such things as restocking instead — offsetting the lessor's cost.

"To understand the full costs, you need to load up the lease, operational, and financing costs," says Ecologic's Keeler.

"Make sure you have control over the management of leases so you don't go into automatic renewals," adds Michael Caglarcan, CEO of Captara, a provider of enterprise lease management services, in San Francisco. "In our experience, 20 to 30 percent of existing leases are in evergreen state. You pay through the nose as soon as you renew."

Lease terms usually call for buyout prices to be based on fair market value at the end of the lease, with values agreed on by lessor and lessee. Lessees, however, are often in a vulnerable negotiating position — especially if alternatives to

buying the leased equipment are limited. Lessors may make matters worse by foot-dragging in negotiations, leading to continued uneconomic lease payments, or perhaps triggering automatic lease renewals.

**"Lost (Track of) Our Lease"**
Joseph C. Lane, chairman of the Equipment Leasing and Finance Foundation and former chairman of the ELA, agrees that lessors plan to profit from the back end of leases. Echoing the ELA's Fleming, he argues that they deserve to benefit to offset their risks as equipment owners. To qualify for operating lease accounting, the present value of a lessee's committed payments may not be greater than 90 percent of the original equipment cost. So the lessor must plan to recover at least 10 percent of the original equipment cost by remarketing the assets at the end of the lease simply to recover the initial investment. While it plans to make more than that, the lessor also bears the risk that the value will not be there in the future.

"On any playground there are kids that play badly," says Lane. "In this industry, there have been some that have intentionally dragged their feet in negotiations in order to get rent payments for an extended negotiation period. And, there have been those who have found 42 scratches on a bulldozer after a three-year lease and defined 26 scratches as normal wear and tear." But, he adds, "nearly all [lessors] try to conduct themselves in a fair way, because they are driven by repeat business."

Unlike most leasing companies, many lessees manage their process through decentralized operations. They lack systems for monitoring deadlines, or lose track during personnel changes or mergers. Such complications make lease-related errors, like missing a notification deadline, as common as they are expensive.

When Bob Parmenter became Eaton's treasurer nine years ago and assumed oversight of leasing, he found that the company had inadvertently renewed some leases again and again. In effect, it was paying for the same equipment many times over. "There was an enormous amount of cost leakage as a result of renewing on a month-to-month basis," he says. "We could have acquired the equipment for as little as 2 months' payments, and we found some leases going on for 8, 10, 12 months."

**Know Thyself — and Thy Lessor**
From their companies' problems, Almquist and Parmenter learned they must understand both how lessors make money and how they as lessees manage their leased equipment in the real world. Did their companies tend to use computers for 48 months rather than 36 months, making a 36-month lease inefficient, for example?

Such risks must be factored into a company's analysis not only in determining favorable lease terms, but in making the calculation about the relative merits of leasing versus buying.

"Some companies are very diligent about looking at rates, but fail to go back and test the performance of leases," says American River's Franklin. They figure that "as long as they're staying within budget, there's nothing glaringly wrong." Costs can be reduced in two main ways: by negotiating contracts that are not full of traps and by improving the management of company leasing internally, so that the chances of missed notification deadlines are reduced and equipment is returned promptly as scheduled.

Experienced lessees and consultants cite a number of clauses they have included in contracts that they now consider indispensable. For example, Dave Huber, vice president of financial planning and analysis at Horizon Blue Cross Blue Shield of New Jersey, found that his company had repeatedly renewed lease contracts for servers and PCs. The American River client was able to negotiate terms of a new server contract that reduced lease payments that were to have been made beyond the end of a lease term. Huber now tries to negotiate up-front a potential buyout price that is a percentage of the original cost of the equipment. He also seeks short notification periods and specifically disallows interim rent to minimize unexpected additional costs.

At Papa Gino's, Almquist now lives by lessons he learned for negotiating leases. He won't enter into an agreement unless there is a provision for arbitration for negotiating the fair market value for a buyout, for example. When Papa Gino's was faced with stalling by lessors of credit-card swipe machines, PCs, and other equipment, Almquist unstuck the negotiations by getting tough — threatening to cut lessors out of a $5 million deal unless they softened.

"What I learned in this case is how wide open 'fair market value' is," he says. "It's a matter of interpretation as opposed to hard facts."

*Linda Corman is a freelance writer based in New York.*

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**Path of Lease Resistance**

Some tough product-return terms that lessors try to install:

- "All or nothing" clauses may call for full payment if even a few items are not returned.
- Moving a piece of equipment could force the lessor to buy it.
- Returns in original boxes or to distant locations may be required.
- Steep charges may apply for even superfluous missing parts.
- "Keep well" fees often make the lessor whole if it cannot redeploy the equipment at the same rate.
- Unreasonable wear-and-tear standards may result in penalties.
- Up-front deposits may be applied for such unexpected charges as restocking, preventing the money from being returned.

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**On Borrowed Time**
**The Changes Ahead for Lease Accounting**

When the Financial Accounting Standards Board conducts its promised review of the off-balance-sheet treatment now allowed for equipment leases, a company's lease-versus-buy equation will certainly change. The degree of the change, though, will be open to debate.

Finance executives like Andrew Almquist of Papa Gino's say that the FASB revisions will "make leasing substantially less attractive." But Michael Fleming, president of the Equipment Leasing Association (ELA), believes that if reforms are managed properly, the effect on leasing will be minimal. ELA studies show that the leases most companies employ aren't designed primarily for balance-sheet reasons. Some companies do, of course, work to reduce their balance-sheet liabilities and assets as part of a broader financial strategy. "But while every company goes through determining that kind of mix," says Fleming, "it's a secondary consideration to such things as the convenience of leasing."

Association studies show that only about 1 percent of current leases are synthetic leases, those structured as financings for tax purposes but designed as leases purely for accounting purposes — and the type that most concerns reformers.

The ELA wants to make sure that any reforms to lease accounting acknowledge economic realities. If regulators devise a new, principles-based system, "there are a lot of issues to be measured and dealt with that are just as complicated as leasing is now," says Fleming. FASB, for example, will have to evaluate such elements as options to buy leased equipment. "How are you going to add that to the asset value?"

Another task for the association will be to propose a materiality standard that allows companies to continue relying on footnotes for small leasing deals.

"We think FASB ought to address carving out equipment acquisitions at certain levels. Probably below $200,000 would be a good number to exempt," says Fleming. — *Roy Harris*

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