

Lease Basics – An Overview by Dynamic Funding, Inc.



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Introduction

Most organizations face the need to acquire equipment necessary to conduct daily activities of operating as a business. They need everything including manufacturing equipment, office equipment, furniture, computers, communications systems, etc. How to pay for these items can place a severe burden on the financial health of the company. Most often companies will try to pay cash either from operating capital or through bank financing. Paying cash can potentially use up large portions of their operating budget. Bank financing can sometimes be difficult to arrange particularly if the company already has a large amount of debt.

Leasing is a viable option when acquiring new equipment. Many organizations effectively use leasing for many reasons including cash flow management, a hedge against technological obsolescence, or sometimes just because it is more convenient. This paper offers a brief overview of lease terms and summarizes the benefits of leasing.

Disclaimers

The intent of this overview is to provide the basics with respect to leasing. However, it would be prudent for any organization considering leasing as an option to conduct the following reviews.

- Finance Department Review
- Accounting Review
- Tax/Legal Review

These reviews are necessary in order to justify leasing as the most attractive option using the organization's financial information, accounting policies, and tax and legal practices.

Lease Basics – Definition and Types

Definition of a Lease

A lease is a contract in which one party conveys the use of an asset to another party for a specific period of time at a predetermined rate. That is, a lease is a transaction between a lessor and a lessee in which the lessor transfers possession and use of property for a consideration, but retains all right, title and interest in and to the property over a specified term after which the property is returned to the lessor.

There are essentially four parties to a lease: the lessor; the lessee; the supplier; the lender. The lessor is the legal owner of the equipment who purchases the equipment (generally selected by the lessee) from the supplier (normally also selected by the lessee) and pays for the equipment. The lessee leases the equipment from the lessor and pays periodic rents to the lessor. In some cases the lessor is also the lender, but typically, the lessor will “borrow” the funds necessary to purchase the equipment from an outside lender.

Lease Types

This overview focuses primarily on two types of leases, capital leases and operating leases. Each provides unique applications within an organization. The primary characteristics of these lease types are presented below.

Capital Lease

A capital lease is also known as a financial lease and has the characteristics of a purchase agreement. It is essentially a 100% loan. Full payout and \$1.00 Buy Out are also terms associated with a capital lease. A capital lease has three basic characteristics: (1) it has a term equal to or greater than 12 months; (2) it is a “net” lease in that the lessee is responsible for the incidence of ownership; (3) a capital lease is full pay out.

With respect to term, a capital lease must have a term equal to or greater than 12 months. This is what distinguishes a lease from a rental. A rental is generally considered to be an instrument with a term less than 12 months. This distinction is from an accounting point of view. Rentals are neither shown on the balance sheet of the one renting the equipment for usage nor do they appear as a footnote to the financial statements. On the other hand, capital leases do appear on the balance sheet of the lessee and additional detailed disclosure is contained in the footnotes to the financial statements. When an asset is entered onto the balance sheet, along with its corresponding liability with respect to the lease, the asset is said to be “capitalized.”

The second characteristic of a capital lease has to do with responsibility of ownership. That is, a capital lease is a “net” lease. A net lease means that the lessee is responsible for the incidence of ownership. In other words, the lessee is responsible for maintenance and repairs. Net leases typically contain a “hell or high water” clause that states that even if the equipment fails to function, the lessee is still responsible to make rental payments. Net means the lessor is providing only one thing – the money or financing. This is why lease leases are called finance leases.

Full payout is the third characteristic of a capital lease. Full payout means that the sum of the rentals will always be equal to the equipment cost plus the lessor’s targeted profit (or interest) in the transaction. What typically occurs is that at the end of the lease the lessee will usually purchase the equipment from the lessor for a nominal sum, normally \$1.00. This type of contract will explicitly include a \$1.00 purchase option. The reason for the nominal fee is that there needs to be consideration paid for legal transfer of title. There are instances where the purchase option is something other than \$1.00. In these cases the purchase option is specified as a fixed percentage of the equipment cost. This fixed amount is specified in the lease contract.

Operating Lease

An operating lease, also known as a fair market value lease, has the characteristics of a usage, or rental, agreement. An operating lease meets none of the four criteria set forth by the Financial Accounting Standards Board in Financial Accounting Statement No. 13 (FASB 13). These criteria are as follows:



1. Title to the property is automatically transferred to the lessee by or at the end of the lease term;
2. The lease contains a bargain purchase option;
3. The lease term is equal to or greater than 75% of the estimated economic life of the leased property;
4. The present value of the minimum lease payments at the beginning of the lease term is equal or greater than 90% of the fair market value of the property. The discount rate to determine present value shall be the lessee's incremental borrowing rate.

If any one of the FASB 13 criteria is true, then by definition the lease is a capital lease. The first two items have to do with title transfer. With an operating lease, the title remains with the lessor at the end of the lease term. Hence, there is no automatic transfer of title. In the case of a capital lease, a \$1.00 buy out is definitely considered to be a "bargain purchase option." For an operating lease, the lessee and lessor can determine a "fair market value" for the equipment and agree on this amount as a mutually acceptable transfer price. The fair market value at the end of term is not considered a bargain purchase price. Some leases contain a fixed purchase option, or not to exceed purchase option. As long as these are not considered to be a bargain, then the lease can still qualify as an operating lease.

The third and fourth criteria are a bit more complicated in determining if a lease qualifies as an operating lease. With respect to economic life, from an accounting point of view this is defined as the life of the asset in the hands of multiple users given normal repairs, upkeep and maintenance. For technology equipment, it is best to obtain an opinion from an independent auditor on economic life.

Finally, for the fourth criteria, the easiest way to determine the present value of the minimum lease payments at the beginning of the lease term is to use the lessee's incremental borrowing rate. Think of this as the rate that the lessee would pay on a secured loan with an equal term to the lease being considered.

Similar to a capital lease, an operating lease has a term equal to or greater than 12 months. If a lease can be categorized as an operating lease, then from an accounting point of view any and all lease payments are fully tax deductible as an operating expense. Additionally, an operating lease qualifies for off-balance sheet financing. That is, since the lessee can fully deduct the lease payments as an operating expense, then the lessee does not have to list the equipment as an asset nor do they have to list a corresponding liability for the lease. The footnotes to the financial statements will identify all operating leases.

Most operating leases are "net" leases. Similar to a capital lease, the lessee is responsible for maintenance, repairs, insurance, etc. That is, the lessee must keep the equipment in good working order. However, on occasion, operating leases are written as "full service" leases where the lessor is responsible for maintenance, repairs, insurance, etc.

Additionally, at the end of term for an operating lease the lessee has several options with respect to disposition of the equipment. The lessee can: (1) return the equipment to the lessor; (2) purchase the equipment at fair market value; (3) continue to lease the

equipment. Many times lessees will purchase the equipment at a mutually agreed fair market value. One option available to lessees, particularly for technology equipment, is the option to upgrade the equipment. Normally the lessor will provide a new lease for an upgrade that is co-terminus with the original lease.

Myths of Leasing

There are several misconceptions with respect to leasing that companies use to justify using cash to acquire new equipment. Specifically, and more commonly, the following myths exist:

- Leasing is expensive
- Leasing is complex
- Leasing prohibits ownership
- Lease contracts are non-cancelable
- Leasing reduces tax benefits
- Leasing lowers EBITDA
- Leasing prohibits company's ability to control assets

The following addresses each of these concerns and shows that leasing can be an effective alternative for acquiring new, or used, equipment.

Myth: Leasing is Expensive

Companies expecting to use cash to purchase new equipment should consider the following:

- Cash is a component of working capital – why use working capital to purchase assets?
- Working capital is best used for operations – assets are normally best procured using medium-term financing, such as a lease.
- There is an opportunity cost associated with cash – that is, can the cash be put to a more profitable use elsewhere?
- Companies should consider an after-tax net present value analysis to objectively compare the overall costs of lease versus cash (or bank loan) purchase.

The components of an after-tax net present value analysis include monthly lease payments and their associated tax advantages, initial cash outlays (cash purchase or down payment for bank loan), and depreciation and its tax advantages.

Myth: Leasing is Complex

Complex compared to what? Leasing is no more complex than securing bank financing. Usually, to qualify for a lease all a company has to do is complete a simple credit application. Other times the company will be required to provide audited financial

statements. The level of complexity is usually dependant on factors such as the size of the transaction, the type of equipment, the financial health of the company, etc.

Myth: Leasing Prohibits Ownership

Traditionally, companies purchase assets, use those assets to generate revenue, depreciate those assets to recover their cost, and then dispose of them when they no longer can produce profitably. Company management must take into consideration two issues:

1. What is the useful life of the asset versus its economic life?
2. Where is the value obtained – from using the asset or owning it?

If the answer to the first question that its useful life is longer than it's economic live (time it takes to depreciate the asset to a zero book value), then it is probably advantageous to own the asset. If however, the asset's useful life is less than or equal to it's economic life (take technology for example), then management must consider the answer to the second question. Clearly, the profitable use derived from any equipment comes from using it, not necessarily owning it. Hence, leasing these assets make more business sense.

However, if ownership of an asset is critical to an organization, then leasing can still be used as a vehicle to accomplish this goal. Financial (or capital) leases provide a means for 100% financing for an asset. Title transfers from the lessor to the lessee at the end of the lease term. Operating leases can be structured with purchase options at the end of the lease term allowing the lessee an alternative for ownership.

Myth: Lease Contracts are non-Cancelable

Generally, this is true if the customer decides at some point during the term of the lease that they would simply wish to own the equipment and not incur the monthly lease costs any further. If a lease worked like an amortized bank loan, then the customer could simply pay off the principle owed. However, lessors, including Dynamic Funding, Inc. do not always fund the lease transaction themselves. Many times they obtain funds from an third party. These funds have a specific maturity date and simply paying them off is not feasible or profitable.

In cases where the lessee wishes to upgrade their equipment (mostly for high technology items such as computers or telecommunications equipment), then a lease company will work with the customer (the lessee) to discontinue the lease on the outgoing equipment and create a new lease on the new equipment.

In either case, if a customer decides to purchase leased equipment or upgrade the equipment, then Dynamic Funding will negotiate with the customer on how best to discontinue or restructure a lease.

Myth: Leasing Reduces Tax Benefits

Tax benefits depend on the type of lease. Lease payments for an operating lease are tax deductible. For a financial lease, the asset can be capitalized such that depreciation and interest are tax deductible.

More importantly, if the tax depreciable life is longer than the term of the lease and the lease payments are tax deductible (such as an operating lease), then leasing will be more advantageous. If the tax life is short or if the asset qualifies for accelerated tax depreciation, then purchase may be the better alternative.

Myth: Leasing Lowers EBITDA

EBITDA is defined as earnings before interest, taxes, depreciation, and amortization. EBITDA is a measure of a company's earnings from operations. Operating leases do impact EBITDA (the monthly lease payment is treated as an expense), but these also qualify for off balance sheet financing.

Finance leases do not impact EBITDA because the asset is capitalized. That is depreciation and interest are not deducted when determining EBITDA.

Myth: Leasing Prohibits a Company's Ability to Control its Assets

This is true in the sense that most master lease agreements prohibit a lessee from moving an asset from one location to another without notifying the lessor. However, it is usually just a formality for a company to inform the lessor where an asset is located, and that they intend on moving it to a new location if necessary.

Benefits of Leasing – Why Lease

The benefits associated with leasing are mostly economic. However, many times an organization will justify leasing for convenience. The following factors are all reasons why organizations use leasing to their advantage:

- Cash Flow
 - No down payment required – a bank loan, for example, usually requires a down payment. Payments are based on equipment cost less any down payment. A lease requires no down payment and in the case of a Fair Market Value (Operating Lease) the residual value is factored into the lease resulting in lower lease payments.
 - No large initial outlay of cash – if using cash to purchase equipment.
 - Conserves working capital (working capital is current assets less current liabilities) – typically don't want to use working capital for medium-term financing needs.
 - Tax benefits are transferred from lessor to lessee.
 - Structured leases are available to help manage budgeting cycle and meet cash flow needs – a step lease, for example.
 - Bundle hardware, software, and services into a lease.
- Financial Reporting
 - Off balance sheet financing

- Typically for operating leases. Neither the asset nor the debt is reported on the balance sheet. Income statement shows lease payment as an operating expense.
 - Impact on Financial Ratios – Current Ratio (a measure of liquidity), Return on Assets (ROA) (a measure of profitability), and Debt to Equity ratio (a measure of capital structure):
 - $\text{Current Ratio} = \text{Current Assets} / \text{Current Liabilities}$ – impact when comparing lease to purchase with either cash or bank loan. In case of purchasing with bank loan, equipment becomes asset, but not a current asset, and the loan becomes a current liability. The current ratio is lowered as a result of a higher value for current liabilities. In the case of purchasing equipment with cash, the equipment becomes an asset, but not a current asset. Current liabilities are not impacted because no financing is used to acquire the equipment. However, cash is reduced causing the current ratio to be lowered. An operating lease has no impact on either current assets or current liabilities.
 - $\text{Return on Assets (ROA)} = \text{Net Income} / \text{Total Assets}$. When financing with bank loan, total assets increases, but net income decreases (must make loan payments). Net result is lower ROA. When purchasing with cash, total assets remains the same (cash is replaced by value of equipment), hence there is no change in ROA. However, with an operating lease, net income decreases by the value of the lease payment (usually less than that for a bank loan), but total assets remains the same. Net result is a larger ROA.
 - $\text{Debt to Equity} = \text{Total Debt} / \text{Shareholder's Equity}$ – this ratio is also known as leverage. Shareholder's equity is the net result of total assets less total liabilities. This ratio is affected when purchasing with bank financing (loan). Total debt is increased and shareholder's equity is decreased causing this ratio to be higher than compared to leasing. With an operating lease there is no impact on either debt or equity.
 - Note that operating leases are disclosed in the Footnotes of the financial reports.
- Impact on earnings
- Depreciation – for a cash purchase net income is affected by deducting depreciation for the equipment purchased – normally on a linear basis.
 - Depreciation plus Interest – in the case of purchase through bank financing (a loan), net income takes a double hit with deductions for both depreciation and the interest expense. Depreciation remains the same throughout the useful life (from an accounting standpoint) of the asset. Interest is greater in the early periods of the loan term and decreases in the latter periods.
 - Operating Lease – for an operating lease, the monthly lease payment is the only expense item that affects net income. Comparing this to the above case of depreciation plus interest expense, more often than not lease payments in the early periods of the lease is likely to be less than depreciation plus interest

expense. This causes earnings (and corresponding, earnings per share) to be higher.

- Lending Covenants – many times lending institutions (banks) impose lending covenants, or restrictions, based on the value of the debt to equity ratio. That is, banks will limit the company’s ability to borrow money if their debt to equity ratio is higher than what the bank is comfortable with. Operating leases do not affect the debt to equity ratio leaving the company the ability to borrow if necessary.
 - Book Losses – operating leases can preclude potential book losses. Assume an asset was purchased but because of obsolescence (this happens with technology related assets) has a zero book value before the end of its depreciation schedule and becomes useless to the company. If this is a material transaction (significantly impacts financial statements), then the auditors may require that the asset be written off. Such an unexpected write-off causes a loss that can often be a big hit to earnings. With an operating lease, the asset is off balance sheet. If the asset becomes obsolete there is no asset to write off.
- Technology Hedge
 - Leasing is a hedge against technology, particularly with respect to operating leases where the lessor takes a residual position – the burden of technological risk is borne by the lessor. At the end of the lease term, the lessee has the option to return the asset. If the then fair market value of the asset is less than the residual that the lessor assumed, the lessor bears this loss.
 - The lessee is protected from fair market value fluctuations on any equipment, not necessarily high technology equipment, where the lessor assumes a residual position.
 - Technology Refresh – if the lessee chooses to swap the asset for one of newer technology, then the existing lease may be terminated and a new lease initiated.
 - Tax Advantages
 - Faster tax write-off – as previously mentioned the lease payment is expensed lessening the tax burden on the company. The overall tax burden (over the lease life of the asset) is lessened if the lease term is shorter than the tax depreciation life of the asset.
 - Mitigation of Alternative Minimum Tax (AMT) – Cash or bank financed purchases can trigger AMT when depreciation expenses are large enough. Operating leases will not trigger AMT.
 - Mid-quarter convention under the Modified Accelerated Cost Recovery System (MACRS) – this convention is triggered if more than 40% of the company’s property is purchased in the fiscal fourth quarter. This condition could result in reducing the amount of MACRS the company can claim. Operating leases will not trigger this convention.

- Convenience
 - Faster response time than loans – banks are regulated causing them to be much more cautious. This could cause delays in loan processing. Typically a lessor’s process for approving a lease request is a much simpler process that includes the client completing a one-page lease application and the lessor performing credit check.
 - Faster appropriation from operating budgets – cash or bank financed purchases typically are funded from capital budgets. Approval can be time consuming. Operating leases are typically funded from a pre-approved operating budget.
 - Master lease agreements – this makes follow on transactions much easier. The lessee would not need to negotiate new lease contracts when acquiring additional equipment.
 - Flexibility at end of term options – lessee can select from following set of options:
 - Return the asset
 - Purchase the asset
 - Renew the lease

Summary

Leasing may not always the best option for enterprises. There are situations where outright purchase is the best alternative. However, even if cash purchase is the better option, leasing may still be used to help manage cash flow, for example. Or, instead of using an operating lease, a capital lease may be the best option. In any case, businesses should understand the value of leasing based on their unique requirements.

Leasing can not only help an organization manage its cash flow, leasing can also improve financial reporting by keeping purchases off the balance sheet and improving the income statement. Leasing can also be used as a hedge against advances in technology. A company can use leasing to upgrade new technology on a timely basis. Finally, it is just sometimes more convenient to lease rather than purchase by taking advantage of the speed to process a lease and flexibility of terms within a lease.

When considering the financial aspects of leasing versus purchase, leasing is many times less expensive. The time value of money takes a huge role in determining whether a lease is more advantageous than purchase. Dynamic Funding, Inc. has financial modeling tools that can help evaluate lease versus purchase using your customer’s financial information. It is best that we are involved at the outset of the acquisition process to ensure you have all the right information with respect to leasing.

About Dynamic Funding, Inc.

Dynamic Funding, Inc. is a Colorado based, service oriented, independent equipment leasing company. Founded in 1996, Dynamic Funding, Inc. is a full service lessor that provides financing for business equipment, software, and services. DFI’s customers



include commercial, non-profit, and government enterprises. We market our services directly to end customers and also through partnerships with equipment manufacturers, distributors, resellers, software providers, and technology consultants.

Contact DFI by calling 800-641-5215, visiting our website at www.dynamicfundinginc.com, or by calling one of our team members directly.

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