OPERATING LEASES: THE POOR RELATION?

BANKS MAY BE MISSING ACCOUNTING BENEFITS

GRAHAM WALKER explores three aspects of operating leases and residual value risk:
how residual value risk can be transferred; how residual value insurance can be applied to the accounting treatment of operating leases; and the effect on earnings of converting operating leases to finance leases for accounting purposes.

The growth trend of operating lease business in Australia may lead to a conclusion that this is a financing product "stuck in infancy". Thirteen-month moving averages compiled by the Australian Equipment Lessors Association reveal a flat growth trend line for the operating lease category since 1994, contrasting with steady growth in both lease and non-lease finance.

Industry participants may put forward a variety of reasons: inertia in the wake of an established finance lease product, resistance to change and uncertainty about management of the residual position of the leased asset.

The latter issue – residual value exposure – should not be a major concern for financial institutions: as with many business risks, it can be insured economically. The insurance also gives the lessor maximum flexibility in the way it deals with retained equity in the equipment at the end of the lease term.

In addition to these benefits, residual value insurance can achieve significant improvement in income statement reporting for lessors. Converting operating leases to finance leases for accounting purposes can, in certain circumstances, improve reported earnings, particularly in the early years of a lease portfolio.

RESIDUAL VALUE INSURANCE

Residual value insurance has two uses for financial institutions which write leases: asset value cover and the management of financial reporting.

Asset value cover

Rather than self-insure, a bank may seek the comfort of knowing that any loss incurred as a result of the end sale value of a leased asset being lower than the residual amount is covered by an insurance policy. Insurance at this level will transfer the substantial economic risk from the bank to the residual value insurer, in a similar way that mortgage insurance for retail housing loans protects the bank from losses arising from a shortfall between loan balance and property selling value.

This insurance is offered by specialist residual value insurers, which will cover a range of assets not characterised by a high level of obsolescence. Motor vehicles, transport equipment, aircraft, railway rolling stock and some industrial equipment, such as forklifts and electricity-generating units, can be suitable.

Other support contracts can be used to cover residual risk: manufacturers' buyback guarantees and residual value guarantees are the most common alternatives. With these, the following aspects need to be considered:

• A manufacturer's buy-back guarantee may be on favourable terms if the manufacturer is motivated by a desire to sell product. However, many manufacturers are reluctant to build large contingent liabilities in their books.
• Buy-back guarantees are, by their nature, equipment-specific. A financier will need a large number of manufacturers in the loop to cover all equipment types. This process is time-consuming: first in terms of setting the agreements and administering the many relationships, and second because of the need to assess each manufacturer's credit quality and commitment to the Australian mar-
ket (the bank will need to assess the par-
ties' ability to honour a buy-back four,
five or more years in the future).

- Residual value guarantees generally
  include a call option over the equipment
  in favour of the guarantor. Presence of
  the call option sacrifices the retained
  equity in the asset at the end of the lease
  term and leaves no flexibility for the
  lessor or lessee as to the future use of the
  equipment. The equipment will be
  claimed by the guarantor if there is any
  profit to be made. With residual value
  insurance, the decision to claim on the
  insurance policy is solely that of the
  insured party.

Residual value insurance has the
advantages of flexibility, choice and one-
party relationship management (within
the underwriting guidelines applied by
the insurer).

Insurance is also cost-effective.
Premiums are charged as a percentage
of the residual value insured. When the pre-
mium is amortised over the entire
amount financed, the cost is generally no
more than the margin a bank would
charge to accept equipment risk.

Management of financial reporting
Residual value insurance can be used to
accelerate the growth of a leasing com-
pany’s earnings and capital by allowing
leases to be booked as direct financing
leases rather than as operating leases.

When the option of self-insurance is
chosen for a new operating lease portfo-
lio, depreciation charges are incurred
which initially will have the effect of
depressing reported earnings. Accordingly, ballooning earnings are
reported in later years, instead of the
steady, predictable earnings flow which
is generally favoured. Spreadsheet mod-
els can demonstrate how earnings from a
lessor’s operating lease portfolio can be
stabilised by booking direct financing
leases for accounting purposes rather
than operating leases.

It is important to note the reporting
requirements of the accounting standard
for leases AASB 1008 (or AAS 17) as the
specifications of this standard drive the
end result for operating lessors.

Where substantially all of the risks and
benefits of ownership of the leased prop-
erty effectively remain with the lessor,
the lease is an operating lease. Where
substantially all of the risks and benefits
effectively pass to the lessee, a finance
lease exists.

The effective passing, from lessor to
lessee, of substantially all of the risks and
benefits of ownership could normally be
assumed where:
- the lease is non-cancellable; and,
- either of the following tests is met:
  - the lease term is for 75% or more of
    the useful life of the leased property
    (however, if the beginning of the lease
    term falls within the last 25% of the total
    useful life of the leased property, includ-
    ing earlier years of use, this criterion
    would not be appropriate for purposes of
    classifying the lease); or
  - the present value, at the beginning of
    the lease term, of the minimum lease pay-
    ments equals or exceeds 90% of the fair
    value of the leased property to the lessor
    at the inception of the lease. The discount rate
to be used in calculating the present value
is the interest rate implicit in the lease.
The definition of minimum lease payments under the accounting standard is critical: it means the rental payments over the lease term, including, among other things, a guaranteed residual value, if any.

 Guaranteed residual value is defined for the lessor, in turn, as that part of the residual value which is guaranteed by the lessee or by a third party unrelated to the lessor who is financially capable of discharging the obligations under the guarantee.

 It is the ability of the lessor to pass the residual value risk on to parties other than the lessee that enables the lessor to convert an operating lease to a finance lease for accounting purposes without affecting either the economic/legal status of the lease or the accounting treatment of the lease in the lessee's books. The amount of the residual value risk to be assumed by the third party will need to be enough to take the present value of the minimum lease payments over the 90%-of-fair-value test. The residual value insurance amount can be determined relatively accurately by discounting the minimum lease payments before any insurance amount, and deducting it from 90% of the fair value of the asset. By calculating the future value of that difference, the amount of residual value insurance is determined.

 A relatively simple model demonstrates the difference in reported results that can result. Using an example of a motor vehicle portfolio growing at 7.5% pa, funded 8% by equity and 92% by debt, and carrying the minimum level of residual value insurance needed to convert the operating leases to finance leases, it can be shown that the organisation will finish year five with retained earnings for accounting purposes nearly 23% higher than if the operating lease method is used. In addition, the reported earnings will be a much smoother trend, enabling the organisation to report much more favourable earnings in the earlier years of the portfolio. Whether the result will apply to every situation depends on the profile of each portfolio - whether it is growing or declining, for example - but the assumptions used need not be extraordinary to achieve the improvement.

 The three graphs demonstrate the results visually, using example input of $7.5 million of leases per month with an average term of four years and a 40% residual value.

 Figure 1 compares year-by-year income statement reporting for leases written in Year 1. As could be expected, finance
lease accounting gives a smoother flow of earnings, favouring earlier years.

Figure 2 shows the year-by-year position of retained earnings for leases written in Year 1. Naturally, the final Year 4 position is almost identical as the amount of profit in the transaction will eventually be the same under either accounting method.

However, the little-appreciated effect of accounting on a finance lease basis is demonstrated in Figure 3 which compares the combined (Years 1 to 4), cumulative portfolio effect of the two methods on retained earnings, using a reasonable set of assumptions for portfolio growth, gearing and interest-rate margin. In the example, the financial institution ends Year 5 with $5.2 million more in reported retained earnings (more "equity capital"). One of the main reasons for this result is the cumulative effect, year by year, of the depreciation charges to the income statement under operating lease accounting compared with the continued smoother income reporting for finance leases.

CONCLUSION
Technically, and in terms of risk mitigation, there seems no reason why the operating lease product cannot begin to flourish in this country as it has in the US. Perhaps, as in the case of asset securitisation, the acceptance of more sophisticated forms of financing takes more time.

Another factor may be the preponderance in Australia of private companies which have few or no external reporting requirements (one of the features of operating leases being off-balance-sheet reporting). The latter explanation may diminish as the Australian economy grows and listed companies increase.