

Assessing a Lease

By BNET Editorial

published on BNET.com 6/26/2007

Leasing equipment can make a major difference to a company's finances, particularly in relation to capital expenditure. For example, money not spent on purchasing high-tech items (which may quickly become obsolete) can be released for other uses. Leasing also has tax advantages. But it's not always the best solution—it pays to look at the plus and minus points carefully.

What to Do

Leasing means making regular payments—regarded as rental expenses—to use an asset owned by another party, usually for a shorter period than the asset's useful life. Capital leases commit the lessee to regular payments for a specified period, and may not be canceled. They usually involve complex contracts and can have a significant effect on a company's tax position. The lessee also takes on most of the advantages and disadvantages of actually owning the asset—and for this reason, capital leases are declared as assets in financial records.

If a lease meets any one of four conditions (set by the U.S. Financial Accounting Standards Board), then it must be regarded as a capital lease. The conditions are:

- The life of the lease is greater than 75% of the life of the asset.
- Ownership of the asset transfers to the lessee when the lease term ends.
- The lessee has the opportunity to buy the asset at the end of the lease term, at a favorable price, or renew the lease at a very favorable rent.
- The present value of the lease payments (allowing for a suitable discount), is greater than 90% of the asset's market value.

A common type of capital lease is the *lease back* or *sale and lease back*—when an asset is sold to a new owner, who leases it back to the seller at an agreed rate over a specified period. This enables the original owner to raise capital and benefit from tax advantages.

In a *leveraged lease*, money is borrowed to acquire a specific asset, which is then leased out. So there are three parties involved: the lender of the money, the lessor of the equipment, and the lessee using it.

A lease is taken out for a specified period, with agreed payments made at regular intervals (usually every month, quarter or year) Capital leases tend to be for very long periods, so they may be reviewed every five years.

The *fixed charge cover ratio* is a calculation used to determine whether a company can afford to take on a lease. The formula is earnings before interest and taxes (EBIT) plus lease expenses, divided by interest plus lease expenses:

$$\text{EBIT} + \text{Lease Expenses} / \text{Interest} + \text{Lease Expenses} = \text{Fixed charge cover ratio}$$

What You Need to Know

- A lease payment is effectively the same thing as a debt payment, and should be taken just as seriously.
- In theory, companies leasing a large proportion of their assets could present a deceptive view of their financial position—so accounting regulations compel them to declare leasing commitments. However, this need only be a note on the balance sheet, so it's worth watching out for.
- It may be quicker to lease rather than buy, but in the end it could work out more expensive. For example, interest on a lease is often higher than interest on a debt. Calculating net-present-value for each option is a useful way to compare costs.
- In the case of default on a leveraged lease, the lender is only entitled to pursue the lessee for payments—not the owner of the asset.

Where to Learn More

Web Site:

The Equipment Leasing and Finance Association: www.chooseleasing.org/Glossary.cfm