



Accounting for the Purchase and Sale of Lease Portfolios

A primer in lease accounting for buyers, sellers, and operators

By David Chaiton

In the post-Enron environment, lessors are increasingly discovering that their usual forms of agreement for the sale or purchase of lease receivables are attracting an increased level of scrutiny. To a large extent, this is an unfortunate side effect of widely publicized abuses of the accounting rules by a small number of companies. But it is due, in part, to a recognition that certain practices have developed in the leasing industry in connection with the sale of lease receivables that are inconsistent with the notion of a non-recourse, off-balance sheet, true sale of receivables.

To further complicate matters, equipment lease receivables often include a software and/or a service fee component. This can have a profound

effect on the way in which a sale of receivables is treated under various accounting and true-sale legal rules.

Higher Standard of Care

The issue of how to treat receivables in financial statements is an extremely important one for directors of companies as well, who are obligated to approve the financial statements prior to their submission to the shareholders of the company. The annual financial statements of public companies are also audited and reviewed by the corporation's audit committee. Shareholders and creditors then rely on these statements when making their investment and credit decisions. Should the financial statements prove misleading, and the directors knew or ought to have known that they were

misleading and incorrect and that the plaintiff was within a predictable class of persons who might be expected to rely on the statements, then the offending directors might well find themselves on the unhappy side of a judgment holding them liable to the reliant injured party.

Furthermore, given the sophistication of modern leasing businesses, directors will increasingly attract and be held to a higher standard of care by courts in these types of lawsuits. So too, they may be drawn into situations where investors, secured creditors, governmental authorities, and other 'beautiful losers' who in the past simply fell from the vine whenever insolvency occurred, now find the courts receptive to allegations of misjudgment, or worse, and the search for deep pockets intensifies. Words like 'fraud' are often tossed about with

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abandon as the investigators complete their task. More often than not, the central issue in the inquiry will be one of accounting and the prodigious efforts that were made to circumvent one potential treatment or another, efforts which in the absence of insolvency or some similar disaster would be hailed as innovative, creative – even ingenious. Ever amorphous, and far from ‘bright’, the line dividing fair presentation from misrepresentation emerges in the clear light of hindsight as one allegedly well known, forever understood, and now crossed with the foul deception of self-serving, manipulative, ill-conceived, deliberate shades of meaning actively deployed to lull the innocent into slumber. Or so they say...

Well-Documented Management

The point here is that the directors and officers of leasing companies need to recognize and internalize the need for knowledgeable, conservative, and well-documented management. To some that would seem an impossible task if for no other reason than the fact that others appear to be engaged in the same type of transactions, assuming risks that carry the just entitlement of reward for those clever enough to exploit them, and dismissal for the rest if inaction results in competitors assuming dominant positions in the marketplace.

Here, then, are the basic accounting rules to apply under Generally Accepted Accounting Principles (GAAP):

As a threshold matter, the lessor and the buyer should ask whether ‘true sale’ treatment is appropriate for the transaction in question. As a general rule, in order to have a true sale: the buyer must not have excessive recourse to the lessor; and the lessor must be willing to give up control over the

lease portfolio, including the right to any possible upside in the portfolio. Otherwise, the transaction looks more like a loan and should be treated as such under the applicable accounting rules.

For a variety of reasons, a non-recourse true sale may not be feasible in certain situations. The following outlines a few examples.

• LESSEE CREDIT RISK

The buyer may not be willing to accept the credit risk of the more challenging lessees in the portfolio without recourse to the lessor. With limited exceptions, in order to be a true sale, the sale must be without recourse to the lessor.

• CONTROL BY THE SELLER RECAPTURE OF UPSIDE

The lessor may not be willing to give up the potential upside in the portfolio and may desire an option to buy the portfolio back. With limited exceptions, the lessor must be willing to give up not only control over the portfolio but also the ability to obtain the upside if the lessor wants to have the transaction treated as a true sale.

• LEGAL AND DOCUMENTATION RISK

In some heavily negotiated lease transactions, the underlying lease receivable may not constitute a firm, non-cancelable payment obligation of the lessee. For example, the lease may not contain a strong hell-or-high-water clause or waiver of defenses against assignees. Another example is where a lessor who is also the manufacturer uses a combined form of lease and maintenance service agreement. If the agreement is not properly drafted, a maintenance breach by the lessor can lead to a defense to payment of rent by the lessee. Indeed, in certain types

of transactions, such as consumer finance, it may be impossible to separate service/warranty performance from the payment obligation under a lease. In commercial lease transactions it is unlikely that a buyer will be willing to purchase a lease portfolio without recourse to the lessor if the leases can be canceled upon a performance breach by the lessor.

• PERFORMANCE RISK

Sometimes the receivables are ‘future receivables’ that do not exist at the time of transfer and have not been earned by performance of the lessor. Receivables that relate to future service obligations or future deliverables that have not been earned by performance may be difficult to sell on a non-recourse basis. A buyer is often willing to accept lessee credit risk but not the risk that the receivable may not exist or be enforceable.

In all the foregoing examples, either there are risks inherent in the lease receivables that the buyer is unwilling to assume, or the lessor is not willing to give up the potential upside in the asset for the price that the buyer is willing to pay. Added to these, of course, is the fact that sellers and buyers often have incompatible goals in embarking on the deal, which frequently leads to distortions in the documentation that obscure or confuse the transactional characterization requirements of the parties. As a result, the buyer may not be willing to purchase the lease receivables without recourse to the lessor, or the lessor may not be willing to give up control over the lease receivables. In any of these cases, the parties should acknowledge the situation at the outset and not try to get off-balance sheet and true-sale treatment which would raise issues with respect to the recording of the transactions on the corporation’s books of which the officers and directors must be cognizant.

True-Sales

For accounting purposes, the existence of a true sale primarily turns on two key questions:

- Has the risk of loss shifted to the buyer? In order to constitute a true sale, the buyer must assume the risk that the lessee is financially unable to pay on the lease receivables. In other words, the buyer must not have excessive recourse to the lessor. Prohibited recourse can take many forms, including direct recourse, contract damages, put rights, holdbacks from the purchase price, reserves, guaranties, collateral, or subordination of other payment streams owned by lessor. Some forms of limited recourse are, however, permitted but their availability must be scrupulously analyzed.
- Has the buyer acquired the benefits of ownership of the lease receivable? In order to constitute a true sale, the buyer must be entitled to all the benefits of ownership, including any upside inherent in the lease receivables. For example, if the lessor sells a lease rental stream at a time when discount rates are high, the lessor might like the idea of having a repurchase right so that the lessor could repurchase the receivables and refinance them at a lower rate if discount rates should drop. However, this degree of control over the lease receivables and ability to recapture upside is inconsistent with the notion of a true sale.

Although these concepts may appear simple and straightforward, the true-sale analysis in a typical lease portfolio sale transaction can become quite complicated. The following list shows that the true-sale characterization of a transaction requires careful consideration of all the facts and circumstances, so in many cases no single factor is determinative:

1. intent of the parties – both words and conduct
2. notice to the lessees of the assignment – notice is indicative of sale
3. representations and warranties – should speak as of date of transaction, not prospectively – none should be made as to collectability or financial inability of lessees to pay

4. covenants – ongoing covenants are dangerous to characterization as true-sale transaction – as a general rule, covenant breaches should not give rise to a put or other recourse that may lead to a return of the purchase price
5. security interest in the leased equipment – should ensure that the excess value of the equipment over and above the present value of the remaining rent does not secure other amounts independently owed to the buyer by the seller ('cross-collateralization' in loan parlance)
6. prepayment rights for upgrades or early terminations – effectively allow refinancing of lease receivables at lower discount rate and for a higher price if interest rates drop and therefore would appear to be inconsistent with the notion of a true sale
7. maintenance of leased products – breach must not give rise to a right of the buyer to put the purchased lease receivables back to lessor or a right to some other form of recourse – better to have right to replace service provider if that would help to mitigate future losses
8. collection of lease receivables – if by lessor, may look like a loan – however, may be outweighed by other factors such as direct notification to lessee, retention of right to assume administration upon lessor's default, for example
9. cost of enforcement of the lease – one of the risks accepted by buyer in a true sale, therefore, lessor must be careful that it does not inadvertently end up bearing the costs of enforcement, for example, where residual interest of lessor and/or service fees are subordinated to buyer's recovery of costs
10. remarketing of equipment on lessee default – permitted under true-sale analysis so long as for market rate compensation
11. repurchase or put rights – if too broad, transaction looks more like loan
12. indemnities from the lessor – may be acceptable for third party claims such as patent indemnity, but should not go too far

Lease Classification under GAAP

In accounting for a lease transaction, one must first classify the lease as an operating lease or a direct financing lease. Basically, if the lease is a direct financing lease, the present value of the minimum rent is referred to in accounting parlance as a 'finance receivable'. Under a direct financing lease, if the lease rents are assigned to a funder, it is possible to record an immediate sale of the finance receivable that is generated by the lease. However, if the lease is an operating lease and the rental payments are assigned to a funder, the transaction cannot be treated as a sale of a receivable. The proceeds from the assignment must be reflected as a debt on the balance sheet of the company. The difference is quite important in both balance sheet disclosure and in income calculation.

There are a number of circumstances where GAAP does not permit the recognition of income on a bulk sale of leases, many of which are detailed elsewhere in this presentation. In dealing with revenue recognition it is essential to ensure that recourse losses are both limited and accurately estimated, and that there are no de facto practices of, for example, repurchasing leases in default whether or not the company has a recourse obligation to do so. Also, the recording of a discounted stretch value (DSV) and other residual values on leases may indicate there has been no transfer of the risks and rewards of ownership.

Initial Direct Costs (IDCs)

In accounting for leases, it is appropriate for the lessor to record the direct costs incurred in acquiring a lease as an expense of the accounting period. To avoid showing an operating loss merely through the acquisition of leases, it is also appropriate to record sufficient income to exactly offset the initial direct costs. Initial direct costs, defined in the CICA Handbook, s.3065.03(1), are restricted to costs directly associated with negotiating and executing a specific leasing transaction and exclude supervisory and administrative costs, among others.

Allowances for Doubtful Accounts

It is normal in accounting to record a provision for lease losses, or bad debts, as an expense in the income statement and as an increase in the balance sheet valuation account for finance receivables called the 'allowance for doubtful accounts'. Every entry in accounting has two parts (thus, 'double-entry accounting'). If you wish to reduce the value of finance receivables, you do so by both an increase in an expense (bad debt expense or provision for doubtful accounts) and a deduction from the finance receivable balance. When a specific lease is identified as a bad debt and the amount of loss is determined, the actual loss is recorded as a reduction of finance receivables balance and a reduction of the allowance for doubtful accounts balance (called a 'bad debt write-off').

Income on Finance Leases – Sum of the Digits Versus Actuarial Basis

GAAP requires income on a finance lease to be recorded in a manner similar to interest on a loan. This is referred to as the actuarial basis. This method results in income being recognized over the lease term on a basis that produces a constant rate of return on the investment in the lease.

In contrast, the 'sum of the digits' (SOD) method to record interest income (which is called finance income) provides a close approximation of the actuarial method for short-term leases that do not

have a residual value. The calculation assumes equal periodic payments to totally amortize the unearned income on a lease. This would be similar to the method used by a bank when it receives equal periodic payments on a car loan but where there is no balance of principal left at the end of the loan period. Where a lease portfolio contains leases with quarterly or other non-monthly payment terms, or with high recorded residual values (such as a large portfolio of automobile leases with significant recorded residual value), the use of the SOD method rather than the actuarial method to record finance income on these leases would overstate income in the early years of the lease term. The overstatement is offset by an understatement of income in the later years of the lease term – only the timing of recording the interest income varies.

Residual Values – DSVs

In preparing their financial statements some leasing companies have adopted the 'aggressive' stance with respect to bargain purchase option leases – that some lessees would fail to exercise such options causing the leases in question to fall into stretch or overhold periods. While it is not unusual at the end of the term of small ticket leases for the termination date to be forgotten by a lessee, it is not appropriate, however, to assume at inception of the lease that the lessee will continue to make lease payments beyond the expiration of the initial lease term ('post-diem payments'), and to record this estimate in income. This is contrary to s.3400 of the CICA Handbook

on revenue recognition as well as to the lease accounting section, s.3065. It would only be proper to record such income in the period in which it is received but not earlier. Accordingly, since GAAP does not permit the recording of contingent gains, this practice distorts financial results by artificially increasing income.

Conclusion

As you find yourselves regaled with the delights of lease accounting, it is well worth remembering that the failure to comply with these standards may result in more than mere embarrassment when creditors and investors are left in the lurch in any insolvency, or following a reassessment of tax (under several statutes

which depend upon clarity in characterization and consequential reporting). It is a tangled web that has been woven, a slippery slope for those who begin on the wrong foot, and a bad day for all of us when the sheriff arrives at our doorstep carrying bundles of wildly enthusiastic love notes from aspirants of every stripe – the appalled, the crushed, the victims – or just plain enthusiastic plaintiffs who will compete vigorously for their ratable share of your financial estate.

ABOUT THE AUTHOR: David Chaiton is widely recognized as an expert in equipment financing, leasing, asset-based lending, corporate finance, and banking matters, has been involved in complex bankruptcy and receivership engagements and represents banks, insurance companies, leasing companies, and other purveyors of financial services. A former director of the Canadian Finance & Leasing Association, David was a member of its legal committee and was recognized for his contribution to the development of the vehicle leasing and equipment finance industry in Canada when he received its member of the year award.
¹ Consideration of the new rules under discussion is beyond the scope of this primer.

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