LEASE ACCOUNTING

By Steven A. Carstens, CPA

In the past couple years, Lease Here, Pay Here has jumped to the forefront of dealer conversation, promising improved cash flows through deferred sales tax and deferred federal tax. While many dealers rushed to jump on the leasing bandwagon, few stopped to consider the accounting implications of leasing on their business.

Firstly, lets define a few leasing basics. There are two types of leases for accounting purposes. An operating lease is generally a short term lease which is treated similarly to a rental operation where the inventory remains on your books as a depreciating asset and you simply collect rental income each month. A capital lease is generally a longer term lease which is treated similarly to a Buy Here, Pay Here sale, with the inventory being sold off the books and a lease receivable being established for the balance due from the customer.

Does it matter which type of lease I do? If you need a bank loan, then yes it does. Very few banks have lines of credit specifically for Lease Here, Pay Here operations, but because a capital lease is treated very similarly to a Buy Here, Pay Here sale, bankers are often able to retrofit Buy Here, Pay Here lines of credit to support capital leases.

While a capital lease might be the answer for your banking woes, capital leases do have draw backs. Capital leases do not have the same favorable federal tax treatment that operating leases enjoy and there are certain legal issues related to capital leases. Capital leases look a lot like a sale, and a sale is subject to Regulation Z disclosures, which lease contracts do not have. If a court finds your lease is too similar to a sale, you could end up with legal problems because you did not make the required Regulation Z disclosures. However with careful planning there maybe middle ground between legal and accounting considerations.

Accounting rules and legal rules are not the same and therefore it is possible to structure a lease such that your attorney feels comfortable it will not be construed as a sale, while for accounting purposes meeting the requirements for capital lease treatment. Accounting for leases is governed by ASC 840, which states that if a lease meets any one of the following four criteria, it may be treated like a capital lease:

1) The lessor transfers ownership of the asset to the lessee at the end of the lease term.

2) A bargain purchase option is given to the lessee. This is an option that allows the lessee, upon termination of the lease, to purchase the leased asset at a price significantly lower than the expected fair market value of the asset.
3) The life of the lease is equal to or greater than 75% of the economic life of the asset.
4) The present value of the minimum lease payments (MLP) is equal to or greater than 90% of the fair market value of leased property.

Rule 4 effectively states that if the present value of the lease payments the customer has to make exceeds 90% of the value of the vehicle; the lease is a capital lease. While most dealers are going to try and collect the most money possible during the lease, state laws regarding lease residuals and interest rates will ultimately determine whether you can meet the 90% rule.

It should be noted that current GAAP accounting rules are being rewritten and the new rules are expected to become effective sometime in 2015 or 2016. As of March 2014, the latest lessor accounting rules define leases into 2 categories. Type-A (sale type leasing) and Type-B (operating leasing). These changes to the lease accounting rules may ultimately require new accounting practices as well as changes to current leasing software but we will have to wait for the final lease rules to be issued.

Leasing may be the future, in certain states, but until lines of credit become available for operating leases, dealers will continue to have to jump through hoops to make leasing work in the Buy Here, Pay Here environment.