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Finance Leasing Under The New Accounting Rules: An Update

Gil Sandler

This article reviews the means by which the synthetic lease has survived in various forms in compliance with the new accounting rules. It also discusses some other increasingly popular forms of finance leases.

As the banks and finance leasing companies dig out from under the rubble of the Enron implosion,[1] the accounting rules have once again been finalized, for at least the present. In December 2003, the FASB issued FIN 46 (R), a substantive revision to FIN 46, to codify the accounting profession's view of when and how the accounts and assets of a thinly capitalized lessor entity using a structured operating lease would be required to be consolidated by the lessee.

Originally issued in January 2003, after hundreds of comments and dozens of internal debates, FIN 46[2] purported to relieve the unbearable itch that began with Enron's[3] creative abuse of special-purpose entities, or SPEs. FIN 46 at first seemed designed to abolish most, if not all, SPEs customarily used as lessors in synthetic and other structured finance leases of real estate and equipment. The methodology introduced was the classification of an SPE-like lessor creature known as a variable-interest entity, or VIE, which would have to be consolidated with the lessee. Other forms of lessor entities considered were a voting interest entity, or VOE, which could presumably control its own fate, and a substantive operating entity, or SOE, with significant assets and business interests, neither of which would be a VIE, or require consolidation with the lessee.

A VOE was controlled by its major equity holders who could vote their respective interests, to exercise control over the affairs of the entity, and those interests would assure a reasonable degree of autonomy from the interests of the lessee. Similarly, an SOE had its own independent business interests and could not be controlled by a lessee. By contrast, a VIE was an entity which, due to an equity capitalization insufficient to finance its operations or absorb reasonably estimated losses, needed subordinated financial support from other parties, such as the lessee, thereby lacking autonomy. The variable interests in the VIE would then be analyzed and the VIE would then be consolidated by the ''primary beneficiary''—defined as the party with the first and greatest risk of loss and the strongest interest in the residual benefit of the transaction or enterprise. In the synthetic and other structured operating leases involving a VIE lessor, the lessee would bear the greatest, and usually the first, loss and have the predominant interest in the residual value of the leased property.

Though initially feared to cripple the popular synthetic lease, FIN 46 caused many early ripples, but few waves. In the spirit of issuing transparent, though often obtuse, financial statements, previously heavy users of synthetics brought their real estate onto their balance sheets. New synthetic lease volume shrank due to both the overreaction to Enronian ''gimmickry'' and the general slowdown in new property development. This gave the Big 4[4] accounting firms time to work with their clients to develop a series of responses to FIN 46, many of which found their way into FIN 46 (R) a year later.

Both FIN 46 and its equally complex successor, FIN 46 (R),[5] are highly technical, and despite extensive appendices and a few examples,[6] remain largely inscrutable to all but the most seasoned accounting

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professionals. A detailed analysis of most of the provisions of FIN 46 (R), and even a listing of major changes from the original, are beyond the scope of this article. Rather, this article reflects the means by which synthetic lease have been restructured to comply with the new rules, and discusses some other increasingly popular forms of finance leases.

Now, nearly three years after Enron's whistle was blown and Pandora's box opened to reveal dozens of manipulative imitators, it is almost business as usual at the major banks offering synthetic and structured finance leases, with a few notable exceptions. First and foremost, nearly all of the synthetic and similar finance leases are using multi-asset lessors. These lessors, which are not VIEs, are owned or controlled by major bank holding companies and financial institutions which consolidate their accounts. Second, corporate lessees whose financial statements must now include detailed disclosures of residual interests and risks under synthetic leased assets, are actively considering, and often choosing, other forms of finance leases.

The "New" Synthetic Lease

Although FIN 46 (R) eliminated the SOE, it preserved both the concept of a VOE as self-determinative,[7] and added an exemption from VIE analysis for a lessor comprising a separate business[8] with independent means and decision-making capacity. Appendix C to the rule describes the characteristics of a ''business'' in somewhat convoluted, academic form.[9] However, Para.4(h) states quite clearly that a qualifying business lessor of a synthetic or other structured lease need not be evaluated for VIE status unless:

1. The lessee participated in the design of the lessor entity;
2. Substantially all of the lessor's activities involve the lessee or its related parties;
3. The lessee provided more than half of the equity, subordinated debt or other financial support of the lessor based on the fair values of the interests in the lessor; or
4. The lessor's activities are primarily related to securitization, asset-backed financing or single-lessee leases.

This notion is consistent with another provision in Para. 12, which states that a variable interest in specified assets of a VIE, presumably a lessor that didn't quite qualify for the separate ''business'' exclusion under Appendix C, will be considered a variable interest in a VIE only if the specified assets constitute more than half of the total assets of the entity. Para. 12 continues to exempt the expected losses of a lessee providing an RVG unless the fair value of the leased property is more than half of the fair value of all of the lessor's assets.

The second condition of FIN 46 (R) enabling multi-asset leasing companies to continue to provide synthetic and structured finance leases with little or minimal equity requires the lessor entity to avoid ''silo'' treatment. If a lessor entity leasing multiple properties to different lessees finances each property with non-recourse financing, it could be viewed as a VIE of each specified discrete asset leased to each lessee. Then, each lessee that provided an RVG would bear the primary risk of loss and become the ''primary beneficiary.''[10] Similarly, lessees that received fixed-price purchase options would be viewed as the primary beneficiary, unless another variable interest holder had the primary risk of loss or a more substantial residual return. FIN 46 (R) provides an escape hatch by stating that the interest in these discrete assets is not a silo unless those assets are essentially the only source or payment of specified liabilities encumbering those specified assets.[11] This seems to have resulted in a consensus determination by the Big 4 accounting firms that, if the lessor entity contributes or maintains a combination of equity and/or recourse debt of at least five percent of the fair value of each leased asset, there is presumptively another source of payment, and these discrete assets will not comprise a ''silo'' or separate VIE. Ironically, this same silo provision excludes entities that have not otherwise been given VIE classification.[12]

These two features capture the essence of the distinction between a multi-asset leasing company—now, either a VOE or otherwise exempt from VIE analysis—and the formerly dangerous SPE, which is now a VIE. In addition, FIN 46 (R) also contains scope exceptions for other common types of lessor entities. Para. 4 excludes, among others, non-profit organizations, employee benefit plans, registered investment companies (such as REITs), separate accounts of life insurance entities and governmental entities or their subsidiaries not organized to circumvent the rules. Ostensibly, these types of entities are excluded because they are governed by separate bodies of accounting principles, and separate rules will eventually emerge. However, the practical effect is to enable certain types of institutional lenders and investors to enter into credit-tenant leases (''CTLs'') and sale-leasebacks with creditworthy lessees with less than the minimum equity required for a VIE.

Another potentially vexing problem remained for lessees continuing to use synthetic leases, even when they leased from multi-asset lessors not requiring a VIE determination. FIN 45 introduced a new requirement that residual value guarantees be analyzed for estimated risk of future loss, and that the present value be booked as a liability on the guarantor's balance sheet. If, for example, an unaffiliated third-party guarantor or insurer would be paid a premium of four percent of the value or cost of the asset whose value was guaranteed, that might be indicative of a risk of future loss. The present value of that loss would then be amortized over the lease term, resulting in an additional expense charged to the lessee's profit and loss

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statement. Theoretically, this requirement could have substantially reduced one of the principal benefits of the low-rent, non-amortizing synthetic lease.

Fortunately, however, clearer thinking prevailed. Lessees' accountants have become comfortable with appraisers' estimates of future value, and at least in the case of newer, well-located corporate office, industrial and retail properties the value of which was unlikely to decline, they can book offsetting entries for unearned income and prepaid rent. Although this requirement tends to limit non-amortizing synthetic leases to properties with stable values, leases of special-purpose properties should schedule rents to amortize financing consistent with estimated residual values.

VIE Lessors

Lessor entities unable to qualify as a ''business'', VOE or meet the multi-asset lessor tests described above can still offer their clients operating leases if they can avoid VIE classification. This would require a minimum of 10 percent equity, unless it can be demonstrated that a lesser amount is sufficient.[13] This presumption is one-way: that is, less than 10 percent is rebuttably presumed to be insufficient, but 10% is not presumed to be sufficient absent further proof of sufficiency.[14]

The determination of sufficiency of equity requires careful consideration of the funds necessary to absorb estimated losses and finance an entity's operations without added subordinated financial support from other sources.[15] Higher risk properties whose values can be expected to decline, such as special-purpose properties and older technologically limited properties, could be expected to require more equity. Alternatively, subordinated financial support may be unnecessary because, for example, the property is being net-leased under a CTL to a highly rated lessee for a term sufficient to amortize substantially all of the debt, less equity may be required. Typically, the lessee could demonstrate that leases of such assets, special purpose or otherwise, involve relatively little risk and the minimal equity is similar to the equity customarily invested in similar lease of similar properties.[16]

Assuming sufficient equity, whether more or less than 10 percent, the lessor entity would not be a VIE, and the lessor could enter into a synthetic or similar lease including a lessee RVG and fixed-price purchase option.[17]

Other Forms Of Finance Leases

The combination of intensive analysis and expanded disclosure has led many former synthetic lessees to seek alternatives. Many have opted to add their corporate real estate to their balance sheet, and assume that the enhanced transparency will offset the declines in performance measure and operating ratios.[18] Rating agencies have dramatically heightened their scrutiny and monitoring of default triggers in off-balance sheet financing leases, as well as direct debt. Thus, seemingly stable companies with leveraged real estate supported by residual value guarantees or involving the risk of future write-downs can be penalized by rating analysis and disclosures.

In addition, multi-asset lessors associated with financial institutions have begun to offer longer term debt and equity financing for investment-grade lessees and preferred customers. These operating leases are originated by multi-asset lessors, not VIEs, and may have lease terms ranging from 10-20 years. The lessor may invest minimal equity at risk over the longer-than-usual lease term,[19] but may protect its investment and longer-term commitment with strong financial covenants. These provisions can provide an ''early warning'' of credit declines, and an acceleration of unpaid rents in the even of an uncured default. As a viable option to synthetic leases, the senior, and occasionally subordinated, debt tranches previously funded in the bank market for shorter term leases are now being funded in the long-term CTL and capital markets for investment-grade lessees.

Longer-term leases can also be structured to amortize debt to levels commensurate with estimated residual values and hybrid leases[20] may contain some form of residual value guarantee of unamortized investment. In this manner, financially strong lessees can achieve lower, credit-based rents than in developer or ''true'' leases requiring more traditional, higher cost equity,[21] without the higher rents required by the self-amortizing CTL or Sec. 1031 ''full-payout'' leases.[22]

Leasing companies are also offering low-cost capital leases. Unlike operating leases, these leases do not remove the real property from the lessee's balance sheet, but a trimmer balance sheet is no longer a universally desired benefit. Assuming the property is expected to retain its residual value, as confirmed by an appraisal of future value at the end of the lease term, the lessee can avoid the need to book depreciation as a charge to reported income.

Finally, both traditional and non-traditional sale-leasebacks continue to provide cost-effective off-balance-sheet financing and operating lease treatment. A comparison of direct on-balance sheet financing with a sale-leaseback is beyond the scope of this article. However, a strong seller-lessee can obtain long-term financing on favorable terms in the CTL or capital markets without surrendering possession or control of the leased property. In many cases, the annualized gains on the sale of the property can effectively reduce the already low rents resulting from low debt rates and minimal equity.[23] This rent offset, coupled with the absence of a depreciation charge to income, can have the effect of neutralizing the amortization component included in a self-amortizing lease structure.[24]

Conclusion

Now that the dust has begun to settle on consistent ac-

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counting treatment, financial and real estate professionals can turn to their main business of financing and leasing real property. The synthetic lease remains available to strong lessees as an attractive low-rent, short-term, non-amortizing lease of newer, commercially viable properties, so long as the lessor is a multi-asset leasing company that can avoid VIE analysis and classification.

Direct ownership of real estate, accompanied by recourse bank or capital markets financing, and other forms of leases have emerged to provide useful alternatives to synthetic leases. While lacking certain of the financial reporting advantages, these leases more closely resemble the more conventional ''true'' leases of real property. Newer hybrid leases and sale-leasebacks can also provide reduced rents by combining low capital markets debt financing with the minimal equity required of multi-asset lessors.

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[1] As this article was being prepared, the financial media reported that Enron's former CEO, Kenneth Lay, was finally being indicted. Various subordinate officials, including former President Jeff Skilling, and former CFO, Andrew Fastow, have been indicted and apparently induced to cooperate.

[2] FASB Interpretation No. 46: Consolidation of Variable Interest Entities-an Interpretation of ARB NO. 51 (January 2003).

[3] Enron was hardly alone in allegedly hiding liabilities and fabricating non-cash income through the use of SPEs. Global Crossing, Tyco, WorldCom, Qwest, and Enron's cross-town rival Dynegy all allegedly took hefty writedowns for some form of financial chicanery involving roundtripping or bogus sales of assets to controlled entities.

[4] The fifth major accounting firm, Arthur Andersen, was a casualty of the Enron debacle.

[5] FASB Interpretation No. 46 (revised December 2003), herein called FIN 46 (R). Unless otherwise indicated, all paragraph references are to Paragraphs of FIN 46 (R).

[6] The examples in Appendix A, Expected Losses. Expected Residual Returns and Expected Variability, seem particularly confusing.

[7] See Appendix B, Para. B3 of the new rule.

[8] See Para 4 (h).

[9] See Appendix C, Para. C3, and EITF 98-3.

[10] FIN 46 (R), Appendix B, Para. B24.

[11] FIN 46 (R), Para. 13.

[12] See Note 10 above.

[13] See Para. 9.

[14] See Appendix E, Para. E23.

[15] Para. 9, sub. a.

[16] Para. 9, sub. b.

[17] See Para. 5.

[18] Among the primary advantages of the synthetic lease are (A) the improvement of reported earnings through the avoidance of book depreciation on owned real property and retention of low, non-amortizing rents; and (B) the reduction of total assets and liabilities and resulting improvement in the return on assets ratio.

[19] Typically, synthetic leases have terms of five to seven years, depending on bank credit constraints.

[20] It should be disclosed that RealVest Capital Corporation, the author's investment banking firm, specializes in structuring hybrid finance-type leases.

[21] Equity investors in real estate usually require cash returns of seven percent to 10 percent and a long-term internal rate of return ranging from 12 percent to 15 percent, depending on the property type. If a developer/investor lease requires 15 percent to 25 percent of equity, or some combination of equity and mezzanine debt, the rent must be higher and the purchase and renewal options must be ''at market.''

[22] Sec. 1031 of the Internal Revenue Code allows ''like-kind'' properties to be exchanged without triggering a taxable sale by carrying over the basis of the exchanged property. This has fostered the development of a multi-billion dollar market for small and medium size investment properties net-leased to creditworthy retailers and financed with self-amortizing mortgages. Such properties can be swapped for other commercial or retail properties once they reach the ''crossover'' point of generating ''phantom'' income.

[23] The credit of an investment-grade seller-lessee can often enable the buyer-lessor to obtain lower rates for 95 percent of the sale price in the capital markets than in the commercial mortgage market, and the reduction of equity from to five percent from a higher rate further reduces the required rents.

[24] It should be disclosed that the author's firm markets a specialized sale-leaseback structure that provides the described benefits from a sale of appreciated property without requiring the current payment of taxes normally due on sale of the property.

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