

# Equipment Leasing: Facts, Advice, Warnings

Kenneth D. Goodman

EQUIPMENT LEASING continues to gain in popularity in the United States. A recent Gallup Survey shows that 71% of companies lease (up from 64% in 1984). The increase has been spurred by recent changes in financial reporting and tax rules, and by bankers' continued reluctance to offer competitive equipment finance terms directly to their customers. Because of these factors, more companies find themselves looking at lease transactions for the first time, and more and more they find them confusing and intimidating.

Equipment vendors today work with leasing companies on a regular basis, so your local copier or computer salesman will probably introduce you to a lease broker or leasing company sales rep the next time you're considering their equipment. This person will promise to make it possible for you to acquire the machine you really want for just pennies per hour, or a few hundred dollars per month.

The purpose of this article is to: familiarize you with some of the sales techniques you might run across in dealing with leasing companies and their sales people, to alert you to some of the less scrupulous practices; and, to discuss protecting your interests when entering into an equipment lease transaction.

When entering into a lease agreement, or a time purchase contract for that matter, you are agreeing to pay for the use of money over a period of time. Sometimes lease pricing also takes into consideration tax benefits, risk of obsolescence, maintenance costs and similar factors, but most of the finance lease contracts you'll be looking at don't include these considerations.

Naturally, you'll want to know what you are really paying for the money being offered to you. The fee for the use of the money is usually expressed in terms of "interest rate." One of the first questions you'll want an answer to is "What am I really paying?" or "What's the

interest rate on this deal?"

In response to that question, some leasing reps will cringe and others will mutter something about your getting 'our best rate' or "our best deal possible." But you're not that gullible: you're good with that financial calculator you got for Christmas and no one is going to fool you, right? So you set out to figure out the true yield on the proposal in front of you. A cinch? A couple of easy computations? Don't be silly.

## Rate Games

Let's take a look at some of the ways lessors build the yield of a lease transaction. Some of these might be a part of the next lease proposal you're offered, so it is helpful to understand them.

For example, we'll take a fairly standard sort of transaction: a 60-month lease on \$10,000 worth of equipment (including tax) at a monthly payment of \$235. At the end of the lease term, you get title to the equipment for \$1. This transaction yields the lessor interest at an annual percentage rate (APR) of 15.01%. Simple so far, right?

But wait, the lessor now says that his company requires the first and last monthly rentals paid in advance. Seems harmless enough, but if you agree, he has raised his yield to 15.60%. Or perhaps the first and the last *two* months in advance (16.24%). Think you're careful? I've seen Chief Financial Officers of major companies miss this nuance in their calculations.

Now let's say that you are offered the same lease with a purchase option at lease end for 10% of original cost (easier to get the IRS to treat it as a lease instead of a sale contract, you're told). (Not true, by the way.) There's a lot more to qualifying a lease for tax purposes than that. This figure, instead of the \$1.00 option you had a moment ago, raises the APR from 15.01 to 17.09%, assuming you exercise the option (and you might be asked to

guarantee that you will).

How about security deposits? You might be asked for the "standard" ten percent (to be held in a reserve account, non-interest bearing, and returned to you at lease end, of course). The addition of this clause raises the yield of our basic transaction to 17.9% (the lessor is laying out less money but not reducing the payment) and that's if they give it back!

If it is applied to the ever present 10% purchase option, the yield is now 20.10% unless, of course, you're also paying first and last two in advance as well, in which case we're up to 21.83%. Starting to get the idea? And remember: *The monthly payment has stayed the same in each of these examples.*

## Rate Fraud

The foregoing techniques increase yields and, therefore, the profits of leasing transactions. While some are slightly questionable, most are quite legitimate. But you must also watch out for the crooks who use blatantly fraudulent schemes such as the "tax-on-tax routine." It goes something like this:

"Mr. Customer, in figuring out your lease payment, we first take the equipment cost which is \$10,000 plus sales tax of 6% bringing the total amount to be financed to \$10,600.00." So far, so good.

"Now we take this amount and multiply it by our standard rate factor of .0235 (or 23.50 per thousand) giving us monthly a payment of \$249.10, which, adding the use tax, comes to \$264.05." Boom—you just paid six percent more than you were supposed to (use tax on top of sales tax) and incidentally, increased the lessor's yield from about 15% to 18% APR. For the record, you pay one or the other, not both.

Another ploy is for the lessor to reduce the net cost of the equipment but fail to pass the savings along in computing your lease (See "The 1.9% Syndrome" on page 48).

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Remember, as a rule, if it doesn't seem right, it isn't.

### **Lease Options and Contract Wording**

It is not only possible to add profit "with the pencil" (by manipulation of numbers), it is also possible to do so with contract wording. Let's look at a few examples.

In most leases offered on small and mid-size transactions, the customer is granted an option to purchase the equipment at the end of the lease term, and/or to renew the lease at that time. This amount is specified and promised at the time the lease is quoted (the most common being ten percent of original cost). Sound good? Better get it in writing, because usually, it isn't in the lease agreement.

What the lease does say is that at its completion, you will return the equipment, at a point specified by the lessor, and at your expense. That shipment alone, if you're in California and the warehouse is in Connecticut, could cost you hundreds, or even thousands of dollars.

To protect yourself, you'll want the leasing company to give you a written option to purchase signed by the same officer who signed the lease and not just by their local salesman who, we both know, does not have the authority to sign his expense account, let alone a corporate commitment.

There have been situations, by the way, where sales people have issued these options without their company's consent.

When the option is presented, the company may refuse to honor it. (I've been involved in several litigations over this point and the result usually hinges over the concept of "Apparent Authority." In other words, did you have reason to believe that the guy had the authority to commit to you?)

Next you'll want to look at the "small print" in the purchase option agreement. Most every such document says something like, "Lessee may exercise this option by giving Lessor not less than thirty days prior written notice accompanied by the purchase option amount."

So, 59 months from now, you'll get a call from your lessor, advising you that your lease is about to expire and reminding you to exercise your

purchase option, right? In Wonderland perhaps, but on Earth you're more likely to hear (25 days before the expiration of the lease term), "Sorry, but your option to purchase just expired and now, if you still want the equipment, it will cost you \$ ..... (insert a figure consistent with the phrase 'whatever the traffic will bear')."

That is, of course, if they call you at all. Because, you see, many leases contain a little provision called the "Auto Rollover Clause." This is also

sometimes called the "Holdover Rental" or "Automatic Renewal Provision."

What it says is that if you don't notify the lessor well in advance, and I've seen the notice requirement be as much as six months in advance of lease expiration, the lease renews for an additional month, year, or even three-year period. Care to be looking at *another* three years of payments for a totally obsolete copier?

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## A Word About Vendors

For every incompetent or unscrupulous leasing salesperson, there is at least one equipment sales rep of like skills and ethics. Make sure you know a little about the company selling you your equipment.

This is particularly important with equipment such as computers, where it seems that new dealers spring up by the hour. Find out who their present customers are and call some of them. Ask pointed questions about follow-up and honesty. If you don't like the answers, go someplace else. It's a lot cheaper in the long run.

### In Closing

I remember seeing a poster some years ago that said, in the Olde English lettering usually reserved for such homilies, something like this:

*"There is nothing that smneone can't make a little worse and sell for a little less, and the person who thinks of price only is that man's lawful prey"*

My company has never had the cheapest rates in town. We can't because we offer things like upgrade options and a lot of personal service to both vendor and lessee. We feel we offer great value to our customers, as do a number of our competitors who aren't the cheapest in town either.

When shopping for a lessor, consider these factors as well. ~

*Kenneth Goodman is executive vice president, Marketing, for Balboa Business Credit, a Tarzana, California-based general equipment lessor. He is a Certified Lease Professional, a designation awarded to less than 30 individuals by the Western Association of Equipment Lessors, for whom he also serves as vice chairman of the Broker Committee. He has been in the equipment leasing business since 1970.*

JANUARY • 1990

Article reprinted from Photo  
Lab Management magazine  
January 1990