What You Need to Know About Vendor Guarantees

Potential Impacts of New Lease and Revenue Accounting Standards

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For many years, leasing has offered an attractive way for a manufacturer (vendor) to increase market share and increase gross margin. Often leasing provides a user of a manufacturer's equipment with a lower monthly payment versus a loan, and provides the full gross margin to the manufacturer, as equipment is often sold by the manufacturer to the leasing entity at list price. A lease may be offered directly by a manufacturer or its captive financing entity or, alternatively, by a dealer, bank or independent financing entity. In any case, it is an agreement conveying the right to use property, plant or equipment for a stated period of time, usually for a specified price, as opposed to an outright sale. This can be beneficial to both parties: the cost to a customer or end-user for leasing the property (lessee) usually is less than if the customer acquired the property via a purchase. As a result, the manufacturer or dealer is able to reach more customers.

Manufacturers sometimes use lease financing or vendor-leasing programs to enhance sales. In these programs, the manufacturer may lease an asset to a customer rather than using a direct sale. Or the manufacturer may sell the equipment either directly to the lessor, who then provides the lease financing to the manufacturer's customers, or to a dealer, who may provide lease financing under an arrangement with one or more finance companies or banks. If the lease transaction is with an unrelated end user, and is a direct financing or sales-type lease, then the manufacturer has passed substantial risks and rewards of ownership to the lessee and a sale may be recognized.

One means of promoting leasing and equipment sales at the full gross margin is by putting in place a manufacturer or vendor guarantee program. In essence, a vendor guarantee program provides assistance to a financing entity that purchases equipment from a manufacturer and then leases that equipment to the manufacturer's customer. Because the financing entity is independent of the manufacturer, it requires some mitigation of the risks of owning and leasing the equipment.

Types of Residual Guarantees

One type of assistance required by a financing entity, whether the organization is captive to the manufacturer or independent, is to mitigate its residual value risk. This type of risk mitigation is especially important for high-tech equipment where residual values may change—often fall—unpredictably during the lease term. To overcome possible risks, a manufacturer can offer one or more types of residual guarantees:

- **Priority remarketing agreements** that require priority effort from the manufacturer in the reselling of the returned equipment ahead of new equipment.

- **Repurchase agreements** that require the vendor to repurchase a lessor's equipment that has been returned or repossessed.
- **Net loss indemnity agreements** that provide for loss reimbursements by vendors to independent lessors for losses of any sort such as repossessions or salvage, up to a certain percentage, say 3% to 5%, of a block of leases funded over a fixed time period by the independent lessor. (1)

Guarantees to mitigate risk are important considerations in being able to execute a profitable lease. When the manufacturer guarantees a certain residual value amount, often the financing entity's profit is then guaranteed provided that the lessee does not default on its rental payments. Without the guarantee, the profit is at risk. Manufacturers are often the best at predicting what their equipment will be worth at the end of the lease so they are most comfortable providing the guarantee. Vendor residual value guarantees can be used to increase earnings and enhance yields, secure the remarketing expertise of the guarantor (manufacturer), achieve the desired accounting treatments as the lessor, manage exposure and meet internal underwriting and approval requirements (2).

Current Accounting Guidance

Under current leasing guidelines, leases can be categorized as Capital, Operating or Leveraged. From a lessor's perspective, classification into one of these categories depends on whether the lease agreement transfers substantially all of the risks and rewards of ownership of the asset. In order to be considered a Capital lease, both lessees and lessors must consider whether the lease agreement meets any one of the four following criteria laid out in ASC 840-10-25-1 as part of classifying the lease at inception:

- **Transfer of Ownership –** The lease allows for transfer of title to lessee at the end of the lease term for a nominal fee, for example, the minimum required by statutory regulation to transfer title.
- **Bargain Purchase Option –** The lease contains a bargain purchase option.
- **Lease Term –** The lease term equates to 75% or more of the estimated economic useful life of the asset (if the lease term begins within the last 25% of the estimated economic useful life, this criteria should not be used).
- **Minimum Lease Payments –** The present value at the beginning of the lease term of the minimum lease payments (excluding that portion of the payments representing executory costs) called for over the lease term in the agreement equals or exceeds 90% of the excess of the fair value of the leased property over any related investment tax credit retained (and expected to be realized by the lessor).

According to ASC 840-10-25, the current definition of minimum lease payments from a *lessee perspective* includes the minimum rental payments called for by the lease over the lease term; any guarantee by the lessee or a third party related to the lessee of the residual value at the expiration of the lease term (whether or not such guarantee constitutes a purchase of the leased property) and any payment at the end of the lease term which the *lessee* must make for failure to renew or extend the lease whether or not such payment constitutes a purchase of the leased property. From a *lessor perspective*, minimum lease payments include all the payments described above (lessee perspective) plus any guarantee of the residual value or of rental payments beyond the lease term by a third party unrelated to either the lessee or the lessor.

A common form of guarantee found in many of today's lease arrangements is a guarantee of the leased property's residual value. The residual value of leased property is defined as the estimated value at the end of the lease term. When a portion (or all) of the residual value is guaranteed by either the lessee, or a third party unrelated to either the lessee or the lessor (whether or not payment of the guarantee constitutes a purchase of the leased property), it is viewed as an additional payment to be included in the minimum lease payment stream included for purposes of analyzing the lease classification at inception. If the lessee agrees to guarantee the deficiency of the lessor's realized residual and a stated residual, the lessor should consider the stated residual, rather than an estimate of the deficiency, as the guarantee to be included in the minimum lease payments. However, in order to be viewed as a guarantee and included in the minimum lease payments, that amount must be determinable at the inception of the lease and not be viewed as contingent. A lease provision requiring the lessee to make up any residual value deficiency due to excessive wear and tear or damage upon the return of the leased property would not qualify as a guarantee, and instead be viewed similar to contingent rentals.

To record a sale, a manufacturer cannot retain substantial risks of ownership by providing various arrangements that assure the end user's or the purchaser's recovery of the investment [ASC 840-10-55-14 and EITF 95-1]. Current accounting rules limit the amount of any guarantee that a vendor may provide and still be able to recognize sales revenue on a sale. Under ASC 840-20-40-3, a vendor/seller of property cannot recognize a sale if the vendor/ seller retains substantial risks of ownership in the leased property. Substantial risk is generally determined under the principles of the FAS 13 "90% test." Consequently a seller/vendor cannot provide more than 10% support in a guarantee without being considered to have retained substantial risk of ownership. Support may be in the form of being obligated to guarantee a residual value, reacquire the property, provide a substitute asset, or secure a replacement lessee. Therefore common arrangements often have vendors provide a residual support guarantee that is limited to 10%.

New *Leases* Proposal and Interaction with New Revenue Standard

The tentative decision in FASB/ IASB lease accounting re-deliberations is to refer to the Revenue Recognition standards for guidance on determining whether the transfer meets the conditions of a sale. Under the new Revenue Recognition standard issued in May 2014 [ASC 606], companies recognize revenue when a performance obligation is satisfied. This generally occurs when or as the entity transfers promised goods or services to a customer. A transfer occurs when the customer obtains control of the good or service. A customer would obtain "control" when it can either (1) direct the use of, and obtain substantially all the benefits from, an asset, or (2) prevent other entities from directing the use of, and obtaining the benefits from, an asset. The proposed guidance defines the "benefits" of an asset as the potential cash flows that can be obtained directly or indirectly from the asset. Indicators that control has been transferred are: entity has a present right to receive payment, customer has legal title to the asset, customer has physical possession of the asset, customer has assumed the risks and rewards of asset ownership, and/or customer has accepted the asset.

ASC 606-10-25-23 through 30 discuss satisfying a performance obligation and transferring control.

- ASC 606-10-25-23 - An entity shall recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (that is, an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.
- ASC 606-10-25-25 - Control of an asset refers to the ability to direct the use of and obtain substantially all of the remaining benefits from the asset. Control includes the ability to prevent other entities from directing the use of and obtaining the benefits from an asset.
- ASC 606-10-25-26 - When evaluating whether a customer obtains control of an asset, an entity shall consider any agreement to repurchase the promised asset or a component of the promised asset.

Under this Revenue Recognition guidance, allowing the seller/vendor to have a repurchase option to reacquire the property would be an indicator that control has not been transferred. Including such an option *could* jeopardize sale treatment (even with Type A lease, where substantial risk and rewards are otherwise transferred to the user).

Possible Impacts

ASC 606-10-55-66 through 78 provide specific guidance for Repurchase Agreements. Sellers/vendors will need to reassess their guarantee programs in light of this new standard to understand the impact on the timing of their sale and profit recognition.

If the seller/vendor provides a residual support guarantee (or a put option) to the end user or to a third party purchaser, as is common today, this support would not be treated as retaining control and a sale could still be recognized as long as the guarantee does not create a significant economic incentive for the customer to exercise the option. The relationship of the repurchase price to the expected market value should be assessed, along with other factors, in making this determination [ASC 606-10-55-72 through 73]. Also, the user could guarantee the asset value to the seller, such as in a TRAC lease.

However, if the seller/vendor retains a buyback option at a guaranteed price (or a call option), this support would cause the seller to retain control and a sale could not be recognized [ASC 606-10-55-68]. If a Type A lease gives rise to selling profit but the lessee does not obtain control of the underlying asset as a result of the lease, the lessor defers that profit at lease commencement, reducing the lessor’s net investment in the lease at that date. The lessor would then recognize the deferred profit over the lease term in such a manner so as to produce, when combined with the interest income on the lease receivable and the residual asset, a constant periodic rate of return on the lease [ASC 840-30-35-23].

Conclusion

Seller/vendor involvement in a lease agreement guarantee remains a viable way to deliver value to a lessee, and that will not change with the proposed new leases proposal and the new Revenue Recognition standard. However, under the proposed changes, determining what type of guarantee program adds the most value to both the lessor and the lessee will change, and lessors should plan to analyze their current business practices for soundness prior to the effective date of the rule changes.

NOTE: This article is provided for informational purposes only. Readers are strongly advised to consult with their own financial, tax, and legal advisors in connection with the subject matter of this article.

(1) Sudhir P. Amembal, et al., *The Handbook of Equipment Leasing* (Salt Lake City: Amembal, Halladay & Isom, Lease Education and Consulting, 1988), page 520-521.
(2) David G. Mayer, *Business Leasing for Dummies* (New York: Hungry Minds, 2001), page 226.

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