BROOME COUNTY
DEPARTMENT OF
AUDIT AND CONTROL

LEASE ANALYSIS

JUNE 2002

Alex J. McLaughlin, Comptroller

Broome County
Department of Audit and Control
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DANIEL A. SCHOFIELD
Chairman of the Legislature

ALEX J. McLAUGHLIN
Comptroller

June 12, 2002

Jeffrey P. Kraham, County Executive:

The Department of Audit and Control has conducted an analysis of Broome County's leased equipment. The principle objective of our analysis was to assess the suitability of leasing as a financing vehicle for County acquisitions.

The audit was conducted in accordance with generally accepted auditing standards. Such standards require that the Department of Audit and Control plan and perform the audit to adequately assess the accuracy of the financial records and adequacy of the internal controls, and that we examine, on a test basis, sufficient, competent and relevant evidence to afford a reasonable basis for our conclusions.

Based on the results of our analysis, it is our opinion that leasing is sometimes not a viable financing option for County equipment acquisitions, and that alternatives for each case must be carefully weighed.

Sincerely,

Alex J. McLaughlin

Alex J. McLaughlin
Comptroller

cc: Daniel A Schofield, Chairman of the Legislature
Members of the Legislature
Louis P. Augostini, Clerk of the Legislature
Jerome Z. Knebel, Commissioner of Finance
Richard R. Blythe, Purchasing Director

Lease Analysis
Overview Narrative

We have analyzed various Broome County lease agreements. The purpose of the lease analysis was to evaluate the suitability of leasing as a financing vehicle for County equipment acquisitions.

For purposes of our analysis we developed a master list of equipment currently under lease. From that list, we selected a sample of eleven (11) lease contracts for more detailed examination.

For the leases we selected, we reviewed the contracts, noting the lease term, timing, and amounts of the lease payments. The total lifetime costs of the lease payments that we reviewed were in excess of $1.2 million.

We noted any special conditions in the lease contracts such as excess copy fees (overage), late fees, guaranteed residual value, bargain purchase options etc… We also obtained estimated purchase prices from New York State contracts and various vendors. Maintenance costs were also considered.

For each of the lease contracts, we calculated the implicit interest rate. The implicit interest rate is the financing cost incorporated into the lease payment by the lessor.

Finally, we reviewed the leased equipment contracts for the purpose of determining if they are being correctly accounted for in accordance with governmental accounting standards.

AUDIT FINDINGS, RECOMMENDATIONS AND RESPONSES

FINDING 1: THE COUNTY HAS NO POLICY REQUIRING AN EVALUATION OF FINANCING ALTERNATIVES FOR EQUIPMENT ACQUISITIONS

We analyzed the leases in our sample to determine if the cost of leasing the assets (based on the implied interest rate) was advantageous when compared to the cost of purchasing the assets by issuing debt. Of the nine leases examined, four leases had implicit interest rates higher than the rate at which the County could have issued debt to fund the acquisition. In two of the leases Broome County is paying an interest rate in excess of 16.5%.

Our analysis indicates that the four lease agreements noted above will cost Broome County almost $110,000 more over the lease terms than the cost of purchasing the same assets.

There is no policy in place requiring an evaluation of financing alternatives for equipment acquisitions.

RECOMMENDATION:

We recommend that Broome County implement a policy requiring that a lease vs. purchase analysis be prepared and submitted to the appropriate authority (the Broome County Legislature and/or the Board of Acquisition and Contracts) as support for all proposed lease agreements.

MANAGEMENT RESPONSE:

Management did not respond to this finding.

FINDING 2: LEASED EQUPMENT NOT CORRECTLY ACCOUNTED FOR IN COUNTY'S RECORDS

We reviewed the leases in our sample to determine whether or not they are being correctly accounted for in accordance with governmental accounting standards. We found that five of the eleven leases are being accounted for as operating type leases but have one or more characteristics that would require a lease to be capitalized (treated like a financing transaction in which an asset is acquired and an obligation is created). Accordingly, the leased equipment is not correctly accounted for in the County's financial records.

Governments are required to account for leases in accordance with the provisions of the Financial Accounting Standards Board's (FASB) statement number 13.

FASB 13 stipulates that if a lease transaction meets any one of the following criteria, the lease must be capitalized:

I) The lease transfers ownership of the property to the lessee by the end of the lease term.
II) The lease contains a bargain purchase option.
III) The lease term is equal to 75% or more of the estimated economic life of the leased property.
IV) The present value of the minimum lease payments at the inception of the lease, excluding executory costs, equals at least 90% of the fair value of the leased property.

The intended purpose of the criteria is to determine when the risks and benefits of ownership have been substantially transferred.

Not recording an asset and an obligation for capital lease agreements is considered "off balance sheet financing" which can distort the true capital structure of an organization.

RECOMMENDATION:

We recommend that the Department of Finance develop and implement a more formal system to identify and record capital leases in the accounting records.

We also recommend that the Department of Finance adjust the accounting records to properly reflect all capital leases.

MANAGEMENT RESPONSE:

I have received and reviewed the specific lease information relating to the draft report of your review of Broome County's leased equipment.

Our review confirms that the leases identified by you are capital leases.

In regards to the audit recommendations, we have taken the following steps.

We have developed a formal procedure for the review of leases and the determination of capital or operating status.

We have prepared correcting entries for the leases already identified.

We will review the remaining leases and prepare as necessary correcting entries for inclusion in the 2001 report.

Please note that one of the capital leases discovered in the audit is related to a proprietary fund and will require a depreciation entry. We will inform you of the details of this lease and any others found during our review of the remaining leases.