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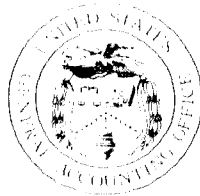
United States General Accounting Office

Report to the Chairman, Committee on  
Government Operations, House of  
Representatives

March 1991

# LEASE REFINANCING

## A DOD-Wide Program Is Not Currently Feasible



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**Accounting and Financial  
Management Division**

B-235188

**March 14, 1991**

The Honorable John Conyers, Jr.  
Chairman, Committee on Government  
Operations  
House of Representatives

Dear Mr. Chairman:

In response to your request, we evaluated the feasibility of implementing an Army-type equipment lease refinancing program throughout the Department of Defense (DOD). This report also addresses the type of information needed for a lease refinancing program and whether it is readily available to DOD and its components.

Our review showed that equipment leasing has declined and that DOD does not have the necessary financial information readily available for a lease refinancing program. We also concluded that DOD's systems do not record the information needed to financially manage leases and that available data are not always reliable.

As agreed with your office, unless you announce the contents of the report earlier, we will not distribute it until 30 days from the date of this letter. At that time, we will send copies to the Director, Office of Management and Budget; the Administrator of General Services; the Secretary of Defense; the Secretaries of the Army, Navy, and Air Force; and other interested parties. Copies will also be made available to others on request.

Please contact me at (202) 275-9454 if you or your staff have any questions concerning the report. Major contributors to this report are listed in appendix II.

Sincerely yours,

A handwritten signature in black ink, appearing to read 'Jeffrey C. Steinhoff'.

Jeffrey C. Steinhoff  
Director, Civil Audits

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# Executive Summary

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## Purpose

This report provides the results of GAO's review of the Army's equipment lease refinancing program, and the feasibility of an Army-type lease refinancing program for other Department of Defense (DOD) components. It is GAO's third and final report in response to a request from the Chairman, House Committee on Government Operations.

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## Background

Federal agencies acquire equipment by either obtaining the budget authority to purchase the equipment outright or by leasing the equipment. Some lease agreements include an option to purchase at a later date. For any lease, the lease payments include the equipment acquisition and finance cost components.

During 1989, GAO presented testimony and issued a report that pointed out as a rule, the lowest cost method of acquiring needed equipment is outright purchase. If, however, a lease is used to finance the equipment acquisition, a master lease program like the General Services Administration's (GSA) Master Installment Purchase System (MIPS) program has the potential to appreciably reduce costs. Similarly, an Army-type lease refinancing program, which uses the principles of a master lease, appears to be a reasonable method to reduce the financing cost component associated with existing leases.

On March 13, 1990, GAO issued a briefing report (GAO/AFMD-90-67BR) to the Chairman discussing the progress made by the Army under its equipment lease refinancing program. At that time, only a small portion of Army's leases were believed to be viable candidates for pooling and refinancing, and Army was renegotiating individual leases as an option to reduce lease costs.

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## Results in Brief

At the completion of its lease refinancing program, the Army found that none of its leases previously thought to be viable candidates were eligible for pooling and refinancing. The Army's lease refinancing contractor found that most of the Army's leases did not include assignable purchase options and, consequently, were not refinancable. The contractor also identified several problems with the reliability and availability of the Army's lease data.

A lease refinancing program similar to the Army's is not feasible DOD-wide because (1) the declining number and value of DOD leases over the years has reduced the likelihood of creating pools of eligible leases, which are necessary for refinancing, and (2) DOD's current lease

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reporting systems do not provide DOD management with the financial information needed for a lease refinancing program.

DOD's ongoing Corporate Information Management initiative to strengthen financial management by consolidating accounting and finance operations and systems provides an opportunity to develop procedures that would support the effective financial management of leases, including refinancing programs. Air Force's contract management systems, which maintain some lease information, could serve as a starting point for designing a consolidated DOD lease management system.

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## Principal Findings

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### Army's Lease Refinancing Program Did Not Identify Eligible Leases

The Army's contractor reviewed over 2,200 equipment leases and related modifications and found that none of these were eligible for refinancing under the Army's lease refinancing program. Many leases did not include an assignable purchase option or were already bought out. Others were for service contracts or were due to expire within 6 months. In addition, the contractor found that the Army did not routinely monitor lease finance cost components and that its financial systems did not record and report reliable information on lease purchase options and interest rates.

The Army has renegotiated one lease to reduce annual lease costs by \$1.3 million. In another renegotiation, Army officials were able to buy out a lease, resulting in \$32 million in savings over a 6-year period.

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### A DOD-Wide Lease Refinancing Program Is Not Currently Feasible

A lease refinancing program similar to the Army's is not currently feasible because the number and value of DOD's leases has declined and reduced the potential for creating pools of eligible leases. Between fiscal years 1985 and 1988, DOD's equipment lease obligations declined from \$868 million to \$515 million.

In the mid-1980s, the Congress provided DOD with \$150 million to implement a 5-year program to buy out automated data processing (ADP) equipment leases. By exercising its lease purchase options, DOD reduced requested ADP equipment leasing costs from \$842 million for fiscal year

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1984 to \$215 million for fiscal year 1988. The buyout program eliminated many leases that might have qualified for an Army-type lease refinancing program.

Although the Federal Acquisition Regulation provides guidance on equipment acquisition, it does not include guidance on the kind of cost analyses that should be done to support and document a decision to include a purchase option in a lease contract.

DOD's systems could not support a lease refinancing program. DOD uses two Defense-wide systems to centrally manage, monitor, and account for equipment leases. These systems were not designed as financial management systems and, as a result, do not record and report all specific lease financial information needed for a lease refinancing program. Information needed to manage a lease refinancing program includes each lease's assignable purchase options and dates, stated interest rate, commencement date, term, purchase price, number of payments, and payment amount.

The Army's and Navy's financial management systems do not record and report the lease interest rate or the information needed to compute the implicit lease interest rate. Air Force contract management systems do not record and report a stated interest rate for leases, but they do maintain the information needed to compute the implicit lease interest rate, which is needed to manage a lease refinancing program.

Additionally, the three military services' financial management systems for leases do not record and report capital lease acquisition and finance cost components separately in accordance with GAO's Policy and Procedures Manual for Guidance of Federal Agencies, Title 2.

As discussed in chapter 2, the Army's contractor found that DOD's financial management systems for Army lease contracts did not centrally record and report reliable lease information. GAO's tests of Navy and Air Force equipment leases showed problems similar to those experienced by the Army's contractor. GAO found that equipment leases are reviewed and processed in hundreds of DOD offices with no central financial management office to oversee and manage leasing operations.

DOD's Corporate Information Management initiative provides an opportunity to develop the financial management organizations and systems needed to manage leases and lease refinancing programs.

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## Recommendations

If leasing by DOD and its components increases in the future, pooling and refinancing may become economically viable. Therefore, GAO is making the following recommendations to ensure that DOD has the information needed to support a lease refinancing program.

GAO recommends that the Administrator of General Services amend the Federal Acquisition Regulation to provide specific guidance and criteria for agencies to use to identify leases that should include assignable purchase options.

GAO also recommends that the Secretary of Defense (1) ensure that DOD's components obtain, record, and maintain the information needed for a lease refinancing program, (2) instruct DOD components to record the lease acquisition cost component separately from the lease finance cost component on capital leases, and (3) design DOD's management information systems under the Corporate Information Management initiative to record and report specific lease financial information needed to implement a lease refinancing program.

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## Agency Comments

As agreed with the Chairman's office, we did not obtain agency comments on a draft of this report. The views of responsible agency officials were sought during the course of GAO's work and are incorporated where appropriate.

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**Abbreviations**

ADP	automated data processing
ARMS	Automation Resources Management System
CIM	Corporate Information Management
DCADS	Defense Contract Action Data System
DOD	Department of Defense
FAR	Federal Acquisition Regulation
GSA	General Services Administration
IG	inspector general
IPMS	Information Processing Management System
MIPS	Master Installment Purchase System

# Introduction

This is the final report in a series that responds to a March 1989 request from the Chairman, House Committee on Government Operations. We were asked to (1) review the General Services Administration's (GSA) proposed Master Installment Purchase System (MIPS) program, (2) assess the Army's lease refinancing program, and (3) determine the feasibility of expanding the Army lease refinancing program Department of Defense-wide. The Chairman was primarily interested in whether the proposed MIPS program had the potential to reduce future government equipment leasing costs. The Chairman was also interested in whether the Army's lease refinancing program was a viable means of reducing existing equipment lease costs throughout the Department of Defense (DOD).

We addressed the first objective in a report<sup>1</sup> and testimony,<sup>2</sup> which also provided background information on the Army's program. We also reported on the status of the Army's program in March 1990.<sup>3</sup>

Building on our previous work, this report addresses (1) the extent of leasing on a DOD-wide basis, (2) the results to date of the Army's lease refinancing program, and (3) the feasibility of applying an Army-type lease refinancing program to other DOD components.

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## Background

DOD leases real property (buildings and facilities) and personal property (equipment). At the end of fiscal year 1988, DOD components held 192 real property leases with annual obligations of over \$118 million. These leases were primarily for fuel storage buildings, residential buildings, and office buildings, with the majority of the properties leased at overseas locations. Overall, DOD and its components do not have a large enough real property lease program at this time to support a lease refinancing program. Accordingly, this report focuses on DOD equipment leasing.

Federal agencies can acquire needed equipment in two ways: by obtaining the budget authority to purchase the equipment outright or by leasing the equipment. Leasing is often selected when budget authority

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<sup>1</sup>Lease Refinancing: Observations on GSA's Proposed Master Leasing and Army's Lease Programs (GAO/AFMD-90-7, November 24, 1989).

<sup>2</sup>Lease Refinancing: Observations on GSA's Proposed Master Leasing and Army's Lease Refinancing Programs (GAO/T-AFMD-89-9, August 2, 1989).

<sup>3</sup>Lease Refinancing: Progress in Reducing Army's Equipment Leasing Costs (GAO/AFMD-90-67BR, March 13, 1990).

cannot be obtained to purchase the equipment. Consequently, the decision to lease is not always based solely on cost considerations. Under the lease option, agencies can (1) rent the equipment and renew leases annually for the period the equipment is needed, (2) lease the equipment with the option to purchase at a later date, or (3) lease the equipment with a provision that agencies will own the equipment at the end of the lease term.

## DOD Equipment Leasing

DOD components lease automated data processing (ADP) equipment and supplies, communications and construction equipment, industrial machinery, office machines, vehicles, and other miscellaneous equipment. The Army holds about 50 percent of DOD's equipment lease obligations with ADP equipment and supplies, communications equipment, office machines, and vehicles making up more than 90 percent of the Army's leases. About 68 percent of the Air Force's and Navy's lease obligations were for ADP equipment and supplies and for communications equipment. The remaining lease obligations consisted of miscellaneous types of equipment.

Table 1.1 shows equipment leases by DOD component. Appendix I provides more information on the types of equipment that DOD leases.

**Table 1.1: Equipment Leases by DOD Component as of September 30, 1988**

Dollars in thousands

DOD component	Number of leases	Dollars obligated	Percent of total obligations
Army	645	\$257,990	50
Navy	384	122,605	24
Air Force	280	88,853	17
Army Corps of Engineers	103	26,956	5
Defense Logistics Agency	47	18,215	4
<b>Total</b>	<b>1,459</b>	<b>\$514,619</b>	<b>100</b>

Source: DOD's Defense Contract Action Data System.

## Lease Cost Components

For any equipment lease, the lease payments include two key cost components: the cost of the equipment and financing costs. The equipment acquisition cost component reflects the amortization of the lessor's equipment acquisition costs over the number of years the lessor expects to hold and lease the equipment. The finance cost component reflects the lessor's cost to borrow money to acquire leased property. The finance

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cost component is primarily influenced by the interest rates available to the lessor and reflects the lessor's credit rating, rather than the credit rating of the lessee.

We have previously stated that, as a rule, the lowest cost method of acquiring needed equipment for federal agencies is outright purchase. If an agency leases equipment for the number of years the lessor planned to hold and lease the equipment, it will make aggregate lease payments that will pay the lessor its total equipment acquisition and finance costs. Because the government generally has a better credit rating than the lessor, the agency's lease payments will include a higher finance cost than if it had purchased the equipment outright. Also, lessors charge additional fees to compensate them for risk and uncertainty in case the agencies do not exercise their options to renew the leases as expected.

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### Lease Refinancing Programs Have the Potential to Reduce Costs

We have also reported that if a lease is used to finance equipment acquisition, a MIPS-type master lease program has the potential to reduce costs. Similarly, we pointed out that a lease refinancing program like the Army's, which uses the master lease concept, appears to be a reasonable method of reducing the financing cost component associated with existing leases that include purchase options.

As we stated in our November 1989 report, the proposed MIPS program has the potential to reduce total equipment lease costs on new leases because it is structured to separate lease equipment acquisition and financing costs. Specifically, the MIPS proposal entails (1) periodically creating pools of federal agency planned equipment leases, (2) raising the funds needed to purchase the equipment by selling financial interests in the pool of leases to private investors, (3) purchasing the equipment, (4) leasing the equipment to the federal agencies under a master lease for the pool of equipment, and (5) repaying investors from the master lease payments made by federal agencies.

Such a master lease arrangement would reduce lease finance costs because they would be based on the lower interest rates available to federal agencies, rather than the higher interest rates available to private sector lessors. Pools of leases would be attractive investments to private sector investors because (1) they would involve a large number of leases with large aggregate cash flows and (2) they would present minimal risk, since the government would probably not cancel an entire pool of leases.

The Army lease refinancing program, as structured, also has the potential to reduce existing equipment lease costs because, like the proposed MIPS program, it is designed to separate lease equipment acquisition and finance costs. Specifically, the Army program entails (1) identifying equipment leases with assignable purchase options, (2) creating pools of eligible leases, (3) raising the funds needed to exercise purchase options by selling financial interests in the pooled leases to private investors, (4) purchasing the equipment, (5) leasing the pooled equipment back to Army under a master lease, and (6) repaying investors from payments made by Army under the master lease.

Finance costs under the master lease would be based on Army's credit rating, as a federal agency, and, in most cases, would be lower than those obtainable by the original lessors. However, in our March 1990 briefing report, we stated that (1) DOD equipment leasing has declined, (2) the Army has a small pool of equipment leases that may be refinanced, and (3) the Army's contractor identified only 51 leases valued at \$3.7 million as priority leases for potential refinancing.

## Objectives, Scope, and Methodology

The objectives of this report were to (1) determine the extent of leasing DOD-wide, (2) assess the progress and results of Army's lease refinancing program, and (3) determine the feasibility of implementing a refinancing program similar to the Army's DOD-wide. To achieve our objectives, our methodology included the following.

- We discussed the Army's master lease refinancing program with responsible Army officials. To determine the objectives, scope, and results of the Army's lease refinancing program, we relied on the work completed by Army's contractor for the program. We also held discussions with key contractor personnel but did not evaluate their work.
- We reviewed and tested available financial and management records to determine, on a DOD-wide basis, the number, type, and dollar value of equipment leases of over \$25,000 held as of September 30, 1988. For this determination, we used the information recorded in DOD's Defense Contract Action Data System (DCADS). We used DCADS since, at the time of the review, it was the only centralized system that reported information on DOD leases. We did not audit DCADS for accuracy of its information.
- We reviewed Air Force and Navy equipment leases to evaluate the types of information available to DOD management if a lease refinancing program similar to the Army's was implemented. We also held discussions with officials from Navy and Air Force accounting, procurement, and administrative offices.

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- We documented for DOD components the financial management systems that record, account for, control, and report financial lease information. We also discussed the current lease management practices and financial management systems for leases with responsible DOD officials.
  - We reviewed DOD policies, procedures, and guidance relating to leases.

We performed our work from October 1989 through December 1990 in accordance with generally accepted government auditing standards. As agreed with the Chairman's office, we did not obtain agency comments on a draft of this report. The views of responsible agency officials were sought during the course of our work and are incorporated where appropriate.

# Army's Lease Refinancing Program Did Not Identify Eligible Leases for Refinancing

At the completion of its lease refinancing program, the Army found that none of its leases were eligible for pooling and refinancing. The Army's contractor found that most of the Army's leases did not include assignable purchase options and, consequently, were not refinancable. The Army's program, however, identified several problems with the reliability and availability of the management and financial information the Army maintained for its equipment leases.

As we discussed in our November 1989 report, the Army's lease refinancing program is focused on reducing the finance cost component of equipment lease payments and the fees built into lease payments to compensate lessors for the uncertainties associated with existing lease clauses that, among other things, make leases subject to annual renewals at the option of Army. The Army's program envisioned creating pools of leases under a standard master lease, securing financing to support equipment purchases by selling financial interests in the master lease to private investors, exercising equipment purchase options on pooled equipment, and leasing the purchased equipment back to the Army. Army cost savings would be realized because of lower financing costs under the master lease as opposed to the financing costs on individual leases.

During 1988, the Army engaged a private contractor to determine the feasibility of refinancing existing equipment leases by creating large pools of these leases and selling financial interests in these pools to private investors. Leases would be eligible for pooling and refinancing when (1) the lease included an assignable purchase option, (2) separate arrangements could be made for equipment maintenance, and (3) there was a continuing need for the equipment.

As we reported in our March 1990 report, the Army's contractor reviewed 2,203 equipment leases and related modifications,<sup>1</sup> representing over \$315 million in annual lease obligations, to select leases eligible for refinancing. The contractor determined that 2,039 of the leases with obligations of \$275 million were not eligible for refinancing because:

- the lease was a straight rental lease and did not include an assignable purchase option,

<sup>1</sup>The contractor evaluated Army leases in force during fiscal year 1988 and part of 1989. Leases may include numerous modifications. We did not attempt to determine whether the 2,203 leases and lease modifications included all of the 645 Army leases included in table 1.1.

- the lease had been bought out,
- the lease was for a service such as a telephone service and did not involve leasing equipment, or
- the lease had expired or would expire within 6 months.

The remaining 164 leases with obligations of \$40 million were initially selected for further review because, according to the accounting records, they appeared to be eligible for refinancing. The Army's contractor subsequently classified 51 of these, with obligations of \$3.7 million, as priority leases for refinancing. The contractor's detailed review of the legal provisions of these leases disclosed, however, that the Army could not initiate refinancing because either they did not have assignable purchase options or the leases were not eligible for refinancing because they had less than 6 months to run.

In addition, the Army's contractor encountered several problems when analyzing available management and financial information on Army's leases, as discussed further in chapter 3. The following are examples of these problems.

- Available lease information was unreliable. For example, 24 of the 51 priority leases were not recorded in the management and financial lease records.
- Several equipment procurement contracts were erroneously recorded as leases.
- Lease buyout prices, original purchase prices, monthly payment amounts, and remaining lease terms often were not available from lease contract files.
- Lease commencement dates could not be determined because equipment acceptance documents—receiving reports—were not in the lease files.
- Lease contracts did not reflect the lease's stated interest rate or the monthly payment amount exclusive of maintenance and service costs.

As we reported earlier, even though the Army could not initiate refinancing of the identified priority leases because they did not include assignable purchase options, the intensive review and analysis of its leases have resulted in some savings. For example, the Army has renegotiated one telecommunication equipment lease to reduce annual lease obligations by \$1.3 million. In another renegotiation, the Army bought out a nationwide telephone equipment lease that will result in a savings of \$32 million over a 6-year period.



# A DOD-Wide Lease Refinancing Program Similar to the Army's Is Not Feasible

A lease refinancing program similar to the Army's is not currently feasible DOD-wide for two major reasons. First, the declining number and value of DOD leases reduces the likelihood of creating pools of eligible leases, which are necessary for refinancing. Second, DOD's current lease reporting systems do not support a lease refinancing program.

Procedures that would support the effective financial management of leases, including potential refinancing programs, could be developed under DOD's ongoing initiatives to strengthen financial management by consolidating accounting and finance operations and systems. These initiatives are referred to collectively as the Corporate Information Management (CIM) initiative. The Air Force's contract management systems include basic lease information needed for effective lease management and refinancing programs and could serve as the starting point in a redesign effort.

## Decline in Number and Value of DOD Leases Reduces the Potential for Creating Refinanceable Lease Pools

We found that DOD's equipment lease program is declining overall and that the Army accounts for about 50 percent of all DOD equipment lease obligations. As stated in chapter 2, at the completion of its lease refinancing program, the Army found that none of its leases were eligible for refinancing. Also, many DOD equipment leases that would have been eligible for refinancing—those with assignable purchase options—were eliminated through a previous lease buyout program. Finally, Navy and Air Force officials told us that, similar to the Army, many of their remaining leases do not include assignable purchase options, which are necessary for a refinancing program.

In fiscal year 1985, DOD had 5,535 equipment leases with obligations of about \$868 million. By fiscal year 1988, the number of DOD equipment leases had decreased 74 percent to 1,459 leases with \$515 million in annual obligations. Overall, the decline in DOD's equipment lease program reduced the total number and value of equipment leases from which to select candidates for pooling and refinancing. Table 3.1 shows the overall decline in equipment lease obligations during the 4-year period from fiscal year 1985 through 1988.

**Chapter 3**  
**A DOD-Wide Lease Refinancing Program**  
**Similar to the Army's Is Not Feasible**

**Table 3.1: Equipment Lease Obligations During Fiscal Years 1985 Through 1988**

Dollars in millions				
<b>DOD component</b>	<b>1985</b>	<b>1986</b>	<b>1987</b>	<b>1988</b>
Army	\$295	\$346	\$267	\$258
Navy	265	242	189	123
Air Force	257	235	165	89
Army Corps of Engineers	18	23	40	27
Defense Logistics Agency	33	24	22	18
<b>Total</b>	<b>\$868</b>	<b>\$870</b>	<b>\$683</b>	<b>\$515</b>

Source: DOD's Defense Contract Action Data System.

**Buyout Program Eliminated Many Eligible Leases**

During fiscal years 1984 through 1988, DOD completed a 5-year lease buyout program, which involved identifying leases with purchase options and purchasing the equipment by exercising these options. Consequently, the buyout program eliminated from the DOD-wide equipment lease program many leases that could have been pooled and refinanced under an Army-type lease refinancing program. Buyout decisions were based on DOD equipment needs, the status of the equipment, and the lower total overall cost to the government.

The Congress authorized the buyout program and provided \$150 million in financing because it recognized that DOD components incurred unnecessary ADP equipment costs by leasing equipment when it should have been purchased—that is, when there was a long-term need for the equipment. The equipment was leased because DOD could not get the needed budgetary resources in a single year to purchase the equipment outright.

The DOD Inspector General reported that the buyout program reduced DOD's request for budget authority for ADP equipment leases from \$842 million for fiscal year 1984 to \$215 million for fiscal year 1988.<sup>1</sup> Overall, as confirmed by the experiences of Army's contractor discussed in chapter 2, the buyout program eliminated from DOD's inventory of equipment leases many leases that might have qualified for a lease refinancing program.

<sup>1</sup>Summary Report on the Defense-Wide Audit of Acquisition of Automatic Data Processing Equipment (Report No. 89-038, December 2, 1988).

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## **Navy and Air Force Leases Not Eligible for DOD-Wide Refinancing Program**

Navy and Air Force officials told us that, like the Army, they did not have many leases that could be considered eligible for refinancing. Furthermore, due to the lack of reliable or readily available data, a problem similar to that reported by the Army's contractor, we found that it was not practicable to fully assess the Navy's and Air Force's lease inventory. However, to confirm the statements of Navy and Air Force officials, we reviewed a judgmental sample of 21 Navy and Air Force leases and found that none were eligible for refinancing. The leases were ineligible for several reasons, including (1) the equipment had been purchased outright, (2) the leases did not include assignable purchase options, (3) the leases were due to expire within 6 months, or (4) the leases had been terminated.

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## **The FAR Lacks Criteria for Including Assignable Purchase Options in Leases**

Although the Federal Acquisition Regulation (FAR)<sup>2</sup> allows agencies to include assignable purchase options in leases, it does not include guidance on the kind of cost analyses that should be done to support and document a decision to include a purchase option in a lease contract. Such analyses should include comparing anticipated lease costs for a straight rental lease, including all expected lease renewals, with the costs for a lease with purchase option. The additional costs of a lease with a purchase option should be evaluated in terms of the agency's anticipated long-term need for the equipment and whether the agency anticipates the need to purchase the equipment in the future.<sup>3</sup>

The FAR provides for two primary acquisition methods: (1) the one-time, outright purchase of equipment and (2) the lease (rental) of equipment. The FAR provides that if a lease is warranted, a lease with a purchase option is generally preferable, but it does not include criteria for determining when to include purchase options in leases. Leases with purchase options allow agencies to initiate the purchase of leased equipment at specified times throughout the life of the lease at specified option prices.

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<sup>2</sup>The Federal Acquisition Regulation is the primary regulation for use by all federal executive agencies in their acquisition of supplies and services with appropriated funds.

<sup>3</sup>Recent changes in budget scoring procedures will also require consideration of total estimated acquisition costs under certain types of leases. Specifically, the managers' joint statement in the conference report accompanying the Budget Enforcement Act of 1990 explained that under the new scoring rules, budget authority for lease purchases (lease-to-ownership plans whereby the government receives title to the leased assets at the end of the lease term) will be scored in the year the budget authority is first made available. The budget authority will include the government's total estimated legal obligations, less implicit interest costs. See The Budget for Fiscal Year 1991: Scoring of GSA Lease-Purchases (GAO/AFMD-91-44, January 15, 1991).

The FAR provides that equipment should be purchased when it will be used for a period of time which will result in cumulative leasing costs exceeding the purchase cost. The FAR further provides that the lease method is appropriate when projected lease costs are less than the purchase price or as an interim measure when agencies immediately need the equipment to meet program or system goals but cannot justify the purchase of the equipment.

Our work and that of the Army's contractor indicates that many of DOD's existing leases do not include assignable purchase options, and, consequently, DOD components cannot initiate the pooling and refinancing of these leases when it would be advantageous to do so. Because the FAR does not require documentation of the decision to exclude an assignable purchase option or the rationale for that decision, we could not determine why many of DOD's current leases omit assignable purchase options. However, according to Army officials, the Army is planning to revise its lease policy to require both assignable purchase options and separate maintenance and servicing agreements.

Absent an assignable purchase option, successful renegotiation of an existing lease depends on the willingness and cooperation of the lessor. The lessor cannot be legally compelled to renegotiate the lease to reduce the costs to the government. As pointed out in chapter 2, the Army achieved substantial savings in future lease obligations when the lessors agreed to renegotiate two equipment leases.

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## **DOD Systems Do Not Record Reliable Information Needed to Support a Refinancing Program**

The DOD-wide and component systems that would be relied on to manage a lease refinancing program lack several critical features. First, the two systems used by DOD to record departmentwide lease information do not always contain reliable information. Second, the components' systems do not record and report key data needed to support a lease refinancing program. Third, the components do not have centrally available data needed to provide a means of monitoring the costs associated with a lease refinancing program.

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## **Information Needed to Support a Lease Refinancing Program**

The information needed to determine if a lease should be refinanced must be available to support a lease refinancing decision. At a minimum, managers need to know the lease's stated interest rate on leases with assignable purchase options before they make lease refinancing decisions. In addition, other information such as the type of lease, equipment receipt dates, description of equipment, and the location of

administrative and accounting lease files should also be available to support refinancing decisions.

A lease refinancing decision essentially entails comparing the interest rate associated with the finance cost component of an existing lease payment with the interest rate that would be available on the refinanced lease. If the interest rate available to the lessee through refinancing is lower than the existing rate, the lease may be a candidate for refinancing. The final refinancing decision will be based on the remaining period on the lease or the period of time the lessee anticipates leasing the equipment.

On some leases, the interest rate related to the finance cost component of the total lease payment is explicitly stated, while for other leases an implicit interest rate<sup>4</sup> must be computed. If the lease interest rate is not stated, an implicit interest rate can be calculated using the lease commencement date, equipment purchase price at commencement date, lease term and number of payments, and the lease payment amount exclusive of maintenance and service costs.

For example, a 5-year lease for computer equipment with a purchase price of \$42,000 that requires aggregate lease payments of \$60,000 (\$1,000 a month for 60 months) would carry an annual implicit interest rate of 15.04 percent. This is the approximate interest rate related to the finance cost component the lessor has built into the total lease payments on the leased computer. Thus, for our example lease, the lessee would pay the lessor the equipment purchase price of \$42,000 and \$18,000 in finance costs over the 60-month term of the lease.

GAO's Policy and Procedures Manual for Guidance of Federal Agencies, Title 2, also contains specific requirements on recording and reporting lease information. These standards require that agencies separately record and report the two cost elements of a capital lease—the acquisition and finance cost components. The acquisition cost component is the present value of scheduled lease payments based on the Treasury borrowing rate for the term of the lease. The acquisition cost should be recorded in an asset account—leased equipment—and the acquisition cost of leased equipment should be depreciated and recognized as an expense over the term of the lease.

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<sup>4</sup>The implicit lease interest rate is the interest rate that, when used to compute the present value of minimum lease payments (less executory costs and the unguaranteed residual value), will result in a present value, at the beginning of the lease term, equal to the purchase price of the leased property.

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The agency's liability for total lease payments should also be recorded. The difference between the aggregate lease payments to be made and the leased asset's acquisition cost is the finance cost component of the lease. As lease payments are made, the lease liability is reduced and the lease finance cost component is recognized as an expense.

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## DOD-Wide Systems

DOD's departmentwide systems do not always contain reliable information on equipment leases. DOD uses two Defense-wide systems to manage, monitor, and account for equipment leases: (1) the Defense Contract Action Data System (DCADS), which tracks and reports on all contract obligations, including leases, and (2) the Automation Resources Management System (ARMS), which tracks and reports on purchased and leased ADP equipment worldwide. These systems, however, have not always recorded and reported all lease obligations and do not record and report all information needed to support a lease refinancing program.

DCADS is a centralized system that provides DOD managers with information on all contract obligations including lease obligations. Specifically, the system records and reports the contracting office location, contractor name and address, total obligations, type of contract, and a brief description of the equipment or property being leased. The system also maintains information on the types of business the contracts are awarded to, such as small, minority owned, or nonprofit. The system does not record and report lease information needed to support refinancing decisions, particularly the lease's interest rate, purchase price of the leased equipment, lease term, total lease payment amount, and, if the lease included a purchase option, the buyout price.

DOD's Inspector General (IG) reported that the information in DCADS is unreliable. In a report entitled, Survey of Data Integrity in Contract Tracking Systems (89-071, April 20, 1989), the DOD IG stated that error rates in DCADS information were as high as 18 percent and that 19 contracts valued at \$13.8 million were not recorded in the system. In another report entitled, Audit of the Validity of Competition Statistics Being Reported by DOD (89-062, March 28, 1989), the DOD IG estimated that about \$13.2 billion in contract obligations were not recorded in DCADS.

The Defense Logistics Agency operates ARMS, which monitors and reports on DOD's worldwide inventory of ADP equipment. Specifically, ARMS maintains an inventory of ADP equipment, provides information on the distribution and use of this equipment, maintains a data base on the

management of ADP equipment, and supports analyses showing how information technology supports achievement of DOD's mission. While ARMS is not considered a financial system, it is designed to include some information to support a lease refinancing program such as the type of lease, equipment purchase price, monthly lease payment amount, monthly maintenance amount, and equipment installation date. The system does not, however, record and report the lease commencement date and lease term needed to compute an implicit interest rate, nor does the system include a stated lease interest rate.

In addition, our tests of ARMS information disclosed serious reliability problems. Overall, for the 27 items we tested, the information in ARMS was 100 percent incorrect. Based on lease type, age, location, aggregate unpaid lease payments, and monthly lease payments, we selected a judgmental sample of 27 leased ADP items recorded in ARMS. We found that 15 items had been purchased, 4 items had been returned to the lessor, and 8 items could not be located.

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## DOD Component Systems

Army and Navy financial management systems do not record and report the lease interest rate or the information needed to compute the implicit lease interest rate. Although Air Force contract management systems for ADP equipment leases do not record and report a stated interest rate for leases, they do record and report information needed to compute implicit lease interest rates. We did not identify any other Air Force systems that account for other types of equipment leases. In addition, the components' systems do not record and report lease information in accordance with Title 2 and DOD's accounting standards. Also, the components lack centrally available data needed to monitor a lease refinancing program.

## Components Do Not Record Needed Data

Army and Navy lease financial management systems record and report on lease inventory-type information for its lease contracts. Specifically,

- The Army requires that its commands provide ARMS with specific information on ADP acquisitions and leases. For leases, this includes the periodic lease payment, equipment purchase price, type of lease, and description of equipment. The Army does not require its commands to record and report the lease's stated interest rate, if any, or the lease's commencement date and term, which are needed to compute the implicit interest rate.
- The Navy does not have a Navy-wide financial management system for contracts including leases. Such systems are operated at the command

level and are unique to each command. For example, the Washington Naval Regional Contracting Center's Procurement Status Tracking System tracks the status of leases and records the contract type, equipment description, contractor name, and expiration date of contracted funds while its Automated Procurement Accounting Data Entry system records leased equipment descriptions, delivery dates, prices, purchase amounts, discount terms and other information. Neither system includes the lease interest rate or the information needed to compute an implicit interest rate. Officials from the Naval Sea Systems Command and the Space and Naval Warfare Systems Command told us that their financial management systems for contracts, including leases, do not state a lease interest rate or provide the information needed to compute an implicit interest rate.

Air Force systems for ADP equipment leases record and report the information needed to compute implicit interest rates on leases. This information includes the lease period, including option years; monthly payment amount; purchase option price; and purchase price prior to the lease being awarded. Air Force's Information Processing Management System (IPMS) maintains an inventory of ADP equipment and reports this information to ARMS. IPMS is replacing Air Force's Management Support System and is currently being installed at 212 of Air Force's 451 data processing centers.

In addition, the DOD components' financial management systems for leases do not record and report leases and lease payments in accordance with Title 2. Recording the finance cost component separately from the acquisition costs, as required, would help provide the information needed to support refinancing decisions. The capital lease accounting standards found in Title 2 have been incorporated in DOD's Accounting Manual, but we found that not all DOD components account for the finance cost component separately from the acquisition cost component for capital leases, as shown in the following examples.

- The Army's policy is to follow Title 2 accounting standards for recording capital lease transactions. However, we found that some Army accounting personnel are not following the accounting standards prescribed by Title 2 and DOD. For example, at the Communications Electronics Command, we were told that support offices do not separate capital lease information from other reported accounting information before it is reported to the Comptroller's office. As a result, accounting staff cannot identify capital lease transactions to separate and record their acquisition and finance cost components.



- Navy policies do not comply with Title 2 and DOD's accounting principles and standards for recording capital leases. The Navy's policies require that lease-to-ownership costs be expensed. For example, we identified a capital lease under a lease-to-ownership plan with monthly payments of \$3,704. The monthly payment included \$2,446 for the interest and acquisition cost components and \$1,258 for equipment maintenance. However, the total amount of \$3,704 was recorded in an expense account with an offsetting entry recorded to accounts payable, rather than (1) allocating a portion of the \$2,446 to interest expense to show the Navy's interest cost for the leased equipment and (2) separately recording the \$1,258 as a maintenance cost.
- Air Force accounting regulations for ADP equipment leases do not contain specific guidance for recording the acquisition and finance cost components for capital leases. In reviewing 11 of the Air Force's leases, we identified one lease with an option to purchase that was not recorded as a capital lease. Lease monthly payments of \$74,000 were recorded in an expense account, rather than recording a portion of these payments as interest expense.

#### Components Lack Centrally Available Data

Even if refinancing candidates were available for a refinancing program, DOD managers would have difficulty identifying them because needed data are not centrally available. As we mentioned in chapter 2, the Army's contractor found that DOD's financial management systems for Army lease contracts did not record and report reliable information on leases with purchase options, lease interest rates, or the information needed to compute an implicit lease interest rate. To overcome this lack of information, the contractor had to visit a number of Army procurement and administrative offices nationwide to review individual lease files and to identify Army's equipment leases eligible for a refinancing program. This initial review of Army lease files took about 9 months to complete because the Army lacked reliable, centralized financial management information on leases.

Our tests of Navy and Air Force equipment lease records found problems similar to those experienced by the Army's contractor. Specifically, we found that equipment leases are reviewed and processed in hundreds of DOD offices worldwide with no central financial management office to oversee and manage leasing operations, including potential lease refinancing programs.

The Navy and Air Force do not routinely monitor their leasing operations to evaluate costs, particularly lease finance costs. In reviewing their leases, we found that because the Navy and Air Force did not have

central lease records, we had to locate and review individual lease contract files in local procurement and administrative offices. The Air Force's 13 major commands use over 400 purchasing offices to acquire equipment through outright purchase or lease. The Navy's 8 major commands are supported by over 2,800 purchasing offices worldwide that purchase and lease equipment. The offices that initially procure equipment and maintain the lease files sometimes transfer the files to other administrative offices. In some cases, lease files are transferred to those locations where the leased equipment is being used.

In addition to the lack of centralized information, the components do not have an overall means of monitoring lease acquisition costs to ensure that the lowest practicable costs are incurred. DOD and its components treat and manage equipment leases like any other procurement contract even though leases contain two cost components—equipment acquisition and finance costs—that need to be managed separately. In particular, lease interest rates must be monitored to compare them to the interest rates available directly to the agency in the private financial markets. The spread between these rates must be constantly evaluated from an overall lease management standpoint to determine when lease refinancing would be warranted.

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## **Defense Initiative Can Improve Financial Management of Leases**

DOD's CIM initiative provides an opportunity to develop systems that meet the special information requirements of lease management. CIM's overall objective is to improve the usefulness of financial information and the efficiency of financial operations through the consolidation of DOD financial management operations and systems. This involves developing standard information requirements and data formats and eliminating the multiple information systems that currently support similar functional areas. The CIM initiative also provides an opportunity to establish central offices responsible for lease oversight and management at DOD and its components.

Under the CIM initiative, a review of information requirements according to specified functional areas is being performed to determine levels of information compatibility and redundancy. Because the Air Force's current contract management systems for ADP equipment contain the information needed to compute an implicit lease interest rate, they could be a starting point for building needed lease information into systems flowing from the CIM initiative.

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## Conclusions

Currently, it is not feasible to expand the Army's lease refinancing program DOD-wide because the overall decline in DOD's equipment lease program reduced the number and value of leases from which to select candidates for pooling and refinancing. Moreover, the Army held over 50 percent of DOD's equipment lease obligations, and its contractor reported that none of these leases were eligible for refinancing. Also, most of those leases that had assignable purchase options were eliminated from DOD's inventory of leases during the 1980s lease buyout program, and many of DOD's remaining leases do not include assignable purchase options.

The FAR does not provide specific criteria for identifying leases that should include assignable purchase options when agencies lease equipment, nor does it require documentation of the decision to exclude an assignable purchase option.

We have previously reported that if leases are used to finance equipment acquisition, a lease refinancing program has the potential to reduce costs. If leasing by DOD and its components increases in the future, pooling and refinancing may become economically viable. However, DOD and its components currently do not have designated lease management officials and central financial management systems that record and report reliable lease information, which would be needed to support a lease refinancing program DOD-wide. We also conclude that DOD components are not reporting their lease acquisition and finance costs in accordance with Title 2.

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## Recommendations

We recommend that the Administrator of General Services amend the Federal Acquisition Regulation to provide agencies with specific guidance and criteria for identifying leases that should include assignable purchase options and for documenting related decisions.

We recommend that the Secretary of Defense

- ensure that DOD's components obtain, record, and maintain the (1) lease assignable purchase option prices and dates, (2) lease stated interest rate, (3) lease commencement date, (4) purchase price offered by the lessor when the lease was awarded, (5) lease term including option years, (6) number of lease payments, and (7) lease payment amount exclusive of maintenance and service costs;
- instruct DOD components to account for and record the lease acquisition cost component separately from the lease finance cost component on

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**Chapter 3**  
**A DOD-Wide Lease Refinancing Program**  
**Similar to the Army's Is Not Feasible**

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capital leases in accordance with GAO's Policy and Procedures Manual for Guidance of Federal Agencies, Title 2; and

- design DOD's management information systems under the CIM initiative to record and report the information needed to routinely monitor lease operations and costs as well as to implement a lease refinancing program. Procedures should be established for DOD and its components to monitor lease costs—particularly the finance cost component of total lease costs—to identify cost-effective refinancing opportunities.



# DOD Equipment Lease Obligations as of September 30, 1988

Dollars in thousands

Type of equipment	Number of leases	Dollars obligated	Percent of total obligations
ADP equipment and supplies	393	\$210,909	40.98
Communication	118	160,585	31.21
Miscellaneous	83	18,836	3.66
Industrial machinery	138	16,725	3.25
Office machines	150	15,880	3.09
Subsistence	29	15,513	3.01
Vehicles, trailers, and cycles	147	14,199	2.76
Construction	63	13,453	2.61
Ships, small craft, and docks	30	7,903	1.54
Refrigeration and conditioners	5	4,478	.87
Materials handling	36	3,677	.71
Maintenance and repair shop	18	3,502	.68
Prefabricated structures	19	3,254	.63
Alarm and signal systems	19	2,962	.58
Aircraft launching and ground	2	2,320	.45
Containers and packaging	5	2,127	.41
Aircraft structural components	8	2,100	.41
Household furnishings	22	1,675	.33
Water purification	10	1,626	.32
Instruments and laboratory	12	1,464	.28
Service and trade	14	1,330	.26
Pumps and compressors	12	1,190	.23
Plumbing and heating	10	968	.19
Furnace and nuclear reactor	13	967	.19
Ship and marine	7	906	.18
Photographic	14	828	.16
Electrical and components	8	767	.15
Power distribution	7	518	.10
Medical and dental	10	464	.09
Tractors	9	417	.08
Weapons	2	390	.08
Textiles, leather, tents, and flags	6	373	.07
Vehicular components	3	372	.07
Lighting fixtures and lamps	2	280	.05
Metalworking machinery	2	237	.05
Furniture and appliances	3	221	.04
Cleaning and supplies	4	173	.03

(continued)

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**Appendix I**  
**DOD Equipment Lease Obligations as of**  
**September 30, 1988**

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<b>Type of equipment</b>	<b>Number of leases</b>	<b>Dollars obligated</b>	<b>Percent of total obligations</b>
Food preparation and servicing	4	151	.03
Chemicals and chemical products	2	134	.03
Other	20	745	.14
<b>Total</b>	<b>1,459</b>	<b>\$514,619</b>	<b>100.00</b>

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# Related GAO Products

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Lease Refinancing: Progress in Reducing Army's Equipment Leasing Costs (GAO/AFMD-90-67BR, Mar. 13, 1990).

Lease Refinancing: Observations on GSA's Proposed Master Leasing and Army's Lease Programs (GAO/AFMD-90-7, Nov. 24, 1989).

Budget Issues: Restructuring the Federal Budget—The Capital Component (GAO/AFMD-89-52, Aug. 24, 1989).

Lease Refinancing: Observations on GSA's Proposed Master Leasing and Army's Lease Refinancing Programs (GAO/T-AFMD-89-9, Aug. 2, 1989).

Lease-Purchase: Corps of Engineers Acquisition of Building in New Orleans District (GAO/AFMD-88-56FS, June 7, 1988).

Budget Reform for the Federal Government (GAO/T-AFMD-88-13, June 7, 1988).

Effective Management of Computer Leasing Needed to Reduce Government Costs (GAO/IMTEC-85-3, Mar. 21, 1985).

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