Considerations for Closed- Versus Open-End Leasing

April 2017, by Gary Scanlon - Director of National Accounts

New Federal Accounting Standards Board (FASB) rules going into effect next year will standardize all lease reporting for businesses. Companies with fleet leases will now have to report the vehicles on financial statement as "right-to-use assets" and the payments as operating expenses, regardless of the lease structure. Before the new rules, one of the benefits of open-end leasing was being able to use the vehicles without having to declare them as an asset.

While the option for that off-balance-sheet treatment goes away, businesses still have the option to use either open-end or close-end lease structures as well as capital or operating leases. However, due to rule changes, some businesses may find closed-end leases to be a more attractive alternative. This is a good time to check in with your fleet management services provider to discuss how the new rules affect your financial reporting and whether or not your current leasing structure best meets your needs.

Risk of Ownership

The primary difference between an open-end versus closed-end leasing is which party assumes the depreciation risk. The leasing company assumes the depreciation risk in a closed-end lease. Open-end leases assign that risk to the lessee.

Under an open-end leasing structure, the client keeps the vehicles for as long as it requires after a minimum term, typically 12 months, beyond which the vehicles may be turned in at any time. The vehicles are sold and any margin above the book value goes to the lessee. If the vehicles sell for less than book value, the lessee pays the difference.

Close-end leases are fixed in term and payments. At the end of the term, typically written between 12 to 48 months, the lessee returns the vehicles and walks away. If the resale market for that type of vehicle has dropped, the lessee is still free and clear unless mileage limits are exceeded or the vehicle fails to meet agreed-upon condition standards. Closed-end leases are considered less flexible because each lease typically has a set lease term and a limit to the number of miles vehicles can be driven during the lease term, although some lessors do offer unlimited mileage terms. The predictable costs of a closed-end lease simplify budgeting as the total cost of ownership is negotiated up front with little back-end risk when the vehicles are turned in. The lease rate depends on a good-faith utilization estimate by the lessee, which is why the annual mileage is built into the agreement as well as a return-condition provision. But it is important to know that a good leasing partner will renegotiate after a certain period if the reality of operations is dramatically different than the original good-faith estimate.

Another fixed-cost benefit is the ability to negotiate additional expenses into the monthly payment. Insurance and even maintenance agreements, for example, can be rolled into the lease itself so the total cost of running the fleet is much more predictable.

Determining which is best

There really is no set formula for determining which type of lease makes sense for an organization. Every business is different and operations evolve over time. The lease structure that met needs in the past may not be optimal moving forward. It is a good policy to revisit this decision periodically and more so now in light of the changes in accounting rules.

The number one question to ask when evaluating your leasing options is:

What is your cost-of-ownership risk tolerance? With an open-end lease, total cost of ownership is unknown until the resale is complete. Ownership costs also become less predictable as vehicles age, wear and tear takes a toll, and preventative maintenance turns into responsive maintenance with increased downtime.

- Is highly sensitive to budget overruns
- Negotiates "cost-plus" customer contracts that include vehicle costs
- Is converting from reimbursing employees using personal vehicles to providing company vehicles and want to lock in your costs as much as possible
- Is part of a larger parent company based in Europe where the standard for lease structure choice is the closed-end model.

Businesses with European parent companies will benefit greatly by having the US fleet on a closed-end leasing structure because it will better align the financial reporting.

One size doesn't fit all

Fleet management companies want your business. They need to earn it by partnering with you to gain an in-depth understanding of your operations and create a leasing structure that meets your needs. They should be flexible, willing to renegotiate, and have the capacity to offer different types of leases and even customize agreements.

The bottom line is the more engaged and invested your fleet management company is with you, the more likely you are to minimize your total cost of ownership and put the best possible lease in place for achieving that goal. Don’t wait for a fleet management company to contact you. Be proactive, seek out professional advice and know your options.

About the Author - Gary Scanlon

With over 39 years of experience in the Fleet Leasing business, Gary brings a considerable amount of knowledge in all aspects of the Fleet Management Industry. As Director of National Accounts for Merchants Fleet Management, Gary is charged with providing senior level consulting services to Merchants key clients. Gary also handles all contract negotiations, provides sales support to Merchants field Sales Executives, represents Merchants at industry functions, and provides assistance in the development of Merchants ancillary services.