

Leasing in Development

Guidelines for Emerging Economies

Matthew Fletcher, Rachel Freeman, Murat Sultanov, and Umedjan Umarov



 **IFC**
International
Finance
Corporation
World Bank Group



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Lessons from Emerging Economies

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Foreword

The International Finance Corporation (IFC) has been successful in introducing, leading, and implementing programs to develop leasing throughout the world. However, there are many countries whose leasing sectors have not contributed to development as much as others elsewhere. In an effort to minimize this gap in progress between countries, IFC has commissioned this manual to share experiences on leasing development based upon its leasing technical assistance (TA) activities.

By studying the approach of IFC leasing TA projects implemented to date, we hope to provide a manual that can be a useful reference throughout the world to stakeholders, lessors, lessees/SMES, governments, regulators, investors, legal/accounting, banks, international financial institutions and donors. This manual highlights which elements to look for locally, why experiences may be different between countries, and what (based on our collective experience) may be appropriate courses of action.

Examining the approach of current and past projects, this manual also aims to identify the key policy issues on leasing development. Within these policy issues, there will be certain standards that are non-negotiable—tenets that form the foundation of credibility, integrity, and success around the world. There will be other elements on these issues that are based on general principles that can be applied only in specific ways depending on local conditions. This manual should help leasing development practitioners identify key local characteristics, assess their potential impact, and, therefore, make the decisions required on which route to take.

The authors would particularly like to thank those who have contributed their time and energies to developing this manual. We would also like to congratulate those who have worked tirelessly to develop leasing around the world, showing tremendous focus and belief, as well as wish all who are embarking on leasing development projects every success in the future.

Laurence Carter
Director, Small and Medium Enterprise Department
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Chapter 1

Importance of Leasing and IFC's Role

What Is Leasing?

Leasing in its simplest form is a means of delivering finance, with leasing broadly defined as “a contract between two parties where one party (the lessor) provides an asset¹ for usage to another party (the lessee) for a specified period of time, in return for specified payments.” Leasing, in effect, separates the legal ownership of an asset from the economic use of that asset.

Leasing is a medium-term financial instrument for the procurement of machinery, equipment, vehicles, and/or properties. Leasing provides financing of assets—equipment, vehicles—rather than direct capital. Leasing institutions (lessors)—banks, leasing companies, insurance companies, equipment producers or suppliers, and non-bank financial institutions—purchase the equipment, usually as selected by the lessee, providing the equipment for a set period of time to businesses. For the duration of the lease, the lessee makes periodic payments to the lessor at an agreed rate of interest. At the end of the lease period, the equipment is either transferred to the ownership of the business, returned to the lessor, discarded, or sold to a third party. Under financial leasing, the lessee typically acquires or retains the asset.

It is important to remember during this discussion and throughout this manual that legal definitions, definitions for tax purposes, and definitions under local and international accounting standards may differ considerably in different jurisdictions. Discussion in this manual is generally directed at economic substance, which largely corresponds to international accounting treatments. This manual is a summary for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice.

¹ This manual is primarily for equipment leases. The term *asset* in this manual refers to equipment and/or vehicles.

Leasing is based on the proposition that profits are earned through the use of assets, rather than from their ownership. It focuses on the lessee's ability to generate cash flow from business operations to service the lease payment, rather than on the balance sheet or past credit history. This is why leasing is particularly advantageous for new, small and medium-size businesses that do not have a lengthy credit history or a significant asset base for collateral. Furthermore, the lack of a collateral requirement with leasing offers an important advantage in countries with weak business environments, particularly those with weak creditors' rights and collateral laws and registries, for instance, in countries where secured lenders do not have priority in the case of default.

It should be noted that, to date, IFC has focused mainly on the development of financial leasing. This is the primary stage in leasing development in most emerging and transitional economies. Operating leases (or rent) can be equally important in the long term, but for a number of reasons are generally typical of a later stage of development.

In some respects, operating leases are equivalent to "rental." In the English language, the definition of rental is arbitrary: operating leases are rental arrangements that are longer than one year. Other languages and jurisdictions may use the terms interchangeably or define them differently.

A finance lease is a contract that allows the lessor, as owner, to retain ownership of an asset while transferring substantially all the risks and rewards of ownership to the lessee.² A finance lease is also known as a full payout lease, because payments made during the term of the lease amortize the lessor's costs of purchasing the asset (there may be a residual value that usually does not exceed 20% of the cost). The payments also cover the lessor's funding costs and provide a profit. Despite the legal form of the transaction, the economic substance of a finance lease transaction is one of purchase financing rather than a mere rental.

In contrast, an operating lease is essentially a rental contract for, usually, the short-term or temporary use of an asset by the lessee. The maintenance and insurance responsibilities (and most risks associated with the ownership of the asset) remain with the lessor, who recovers the costs and profits from multiple rentals and the final sale of the asset.

Differences between Finance and Operating Leases

Table 1-1 lays out the difference between finance and operating leases. International Financial Reporting Standards state that a lease is a financial lease if it contains at least one of the features in the list on pages 3 and 4:

²These risks and rewards of ownership may be shared or otherwise allocated, such as insuring the equipment.

Table 1-1. Differences between Finance and Operating Leases

Finance Leases (or Full Payout Leases)	Operating Leases
<ul style="list-style-type: none"> ■ Risks and rewards of ownership are transferred to, and borne by, the lessee. This includes the risks of accidental ruin or damage of the asset (although these risks may be insured or otherwise assigned). Thus damage that renders an asset unusable does not exempt the lessee from financial liabilities before the lessor. ■ The goal of the lessee is either to acquire the asset or at least use the asset for most of its economic life. As such, the lessee will aim to cover all or most of the full cost of the asset during the lease term and therefore is likely to assume the title for the asset at the end of the lease term. The lessee may gain the title for the asset earlier, but not before the full cost of the asset has been paid off. ■ The lessor retains legal ownership for the duration of the lease term, though the lessee may or may not buy out the leased asset at the end of the lease, with the lessor charging only a nominal fee for the transfer of asset to the lessee. ■ The lessee chooses the supplier of the asset and applies to the lessor for funding. This is significant because the leasing company that funds the transaction should not be liable for the asset quality, technical characteristics, and completeness, even though it retains the legal ownership of the asset. The lessee will also generally retain some rights with respect to the supplier, as if it had purchased the asset directly. 	<ul style="list-style-type: none"> ■ Economic ownership with all corresponding rights and responsibilities are borne by the lessor. The lessor buys insurance and undertakes responsibility for maintenance. ■ The goal of the lessee is usage of the leased asset for a specific temporary need, and hence the operating lease contract covers only the short-term use of the asset. Further, the duration of an operating lease is usually much shorter than the useful life of the asset. ■ It is not the lessee's intention to acquire the asset, and lease payments are determined accordingly. In addition, an asset under an operating lease may subsequently be rented out. ■ The present value of all lease payments is significantly less than the full asset price.

- The lease transfers ownership of the asset to the lessee by the end of the lease term.
- The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair market value at the date the option becomes exercisable, and at the inception of the lease, it is reasonably certain that the option will be exercised.
- The lease term is for a majority of the useful life of the asset and where the title to ownership may or may not eventually be transferred.

- The present value of the minimum lease payments at the inception of the lease is greater than or equal to the fair value of the leased asset.
- The leased assets are of such a specialized nature that only the lessee can use them without major modifications.

Leases that do not have any of these characteristics are considered to be operating leases.

The Difference between Financial Leasing and Loans

From the lessee's perspective, there is only one substantive difference between a loan and a lease: with a loan, the asset belongs to the borrower, whereas with a lease, the asset belongs to the lessor.

The many similarities between a loan and a financial lease include:

- The lessee and borrower have the choice over the acquisition of the asset. The borrower and lessee (providing the terms of the lease are met) would be able to retain the asset once payments are complete.
- Over the period of both a loan and a lease, interest and capital (equipment cost) are repaid.
- Should there be default on either a loan or a lease, as long as the loan is secured, both the lender and lessor have legal rights to reclaim/repossess assets.
- The risks and costs of ownership, including maintenance and obsolescence, remain with the borrower and lessee. Also, under both a loan or a financial lease, if the asset appreciates, neither the lender nor the lessor benefits.
- The agreements are non-cancelable until either the lessor or the lender has recovered its outlay.
- The borrower or lessee can either settle the agreement (in the case of the lease) or repay the loan early.

Why Is Leasing Different from Bank Financing?

With both leasing and bank financing involving credit decisions and financial risks, the key differences are that two additional factors apply to leasing companies:

First, they have knowledge of the asset (and often the industry), and hence are lending to some degree on an asset basis. This is different from collateral-based lending, however, in that they are lending based on the ability of the asset to contribute to cash flow (either to the lessee or in case of forced sale/liquidation). Banks and other lenders tend to look at the balance sheet value of collateral.

The second is that leasing companies are more sales and service oriented—they are using their specialized knowledge to “bridge the gap” between suppliers and pur-

chasers, and the specialized knowledge of leasing companies may also give them an advantage in disposing of the repossessed leased assets. Suppliers are generally not specialists in finance or credit decisions, while lessees are not specialists in finance or equipment acquisition; leasing companies specialize in finance, credit and equipment acquisition and disposal (equipment dealing). In effect, both the supplier and the lessee are “outsourcing” certain portions of their business to a service provider that also happens to have a certain capacity to borrow and lend money.

Financial Leases and Hire Purchase

In some countries, a distinction is made between lease and hire-purchase transactions. A hire-purchase transaction is usually defined as one where the hirer (user) has, at the end of the fixed term of hire, an option to buy the asset at a token value. In other words, financial leases with a bargain buyout option at the end of the term can be called a hire-purchase transaction.

Hire-purchase is decisively a financial lease transaction, but in some cases it is necessary to provide the cancellation option in hire-purchase transactions by statute. That is, the hirer has to be provided with the option of returning the asset and walking away from the deal. If such an option is embedded, hire-purchase becomes significantly different from a financial lease as the risk of obsolescence gets shifted to the hire-vendor. Under these circumstances, if the asset were to become obsolete during the hire term, the hirer may off-hire the asset and close the contract, leaving the owner (the lessor) with less than a full payout from the lease.

Hire-purchase is of British origin—the device originated long before leases became popular—and spread to countries that were then British dominions. The device is still popular in Australia, Britain, India, New Zealand, Pakistan, and in several African countries. Most of these countries have enacted, in line with the United Kingdom, specific laws addressing hire-purchase transactions.

Why Develop Leasing?

Leasing provides a means for delivering increased domestic investment within economies. By developing additional financial tools such as leasing or mortgages, countries are able to deepen the activities of their financial sector by introducing new products and/or industry players.

The key benefit of leasing,³ however, is the access it provides to those that do not have a significant asset base already by enabling small enterprises to leverage off an initial cash deposit, with the inherent value of the asset being purchased acting as col-

³This manual does not address the pros and cons of leasing versus secured lending. Preferences may vary depending on a number of factors including legislative framework, cost, level of financial market development, availability of diverse financial instruments, etc.

lateral. These small businesses are a portion of the population that do not have other assets that can act as collateral for loans or other types of secured lending within countries where unsecured lending is not an option. By developing leasing, smaller scale entrepreneurs can become more economically active by enabling access to finance and, subsequently, access to income-producing assets. Also, leasing offers an important advantage in countries with weak business environments, particularly those with weak creditors' rights and collateral laws and registries, for instance, in countries where secured lenders do not have priority in the case of default.

Leasing is an instrument that allows participants to manage or allocate risk. One considerable advantage is that, where feasible, leasing often allows participants to allocate certain risks (for example, residual value risk) to those parties that are best able to bear that risk.

Leasing in Emerging Economies

Emerging economies face several challenges, including the need for investment. This is compounded by an under-capitalized banking system that is only able to offer its potential clients a limited range of products. In turn, small and medium-size companies possess insufficient collateral or credit history to access more traditional bank finance. This results in a shortage of credit available to domestic entrepreneurs.

Developing the leasing sector as a means of delivering finance increases the range of financial products in the marketplace and provides a route for accessing finance to businesses that would otherwise not have it, thus promoting domestic production, economic growth, and job creation.

In addition, many developed countries suffer from underdeveloped or imperfect legal institutions. Although in principle secured lending and leasing should be roughly equivalent in terms of risk, in many jurisdictions experience has shown that legal

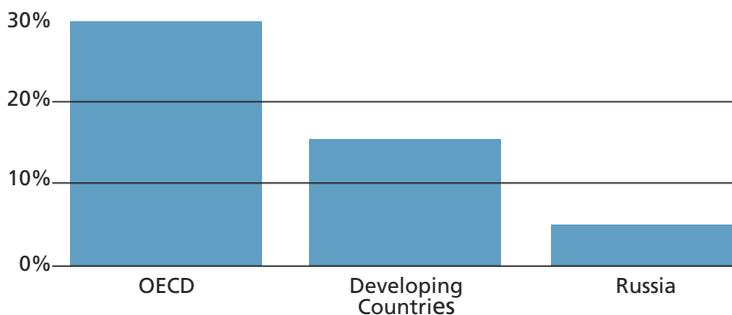


Figure 1-1. Leasing as Share of Investment in Fixed Assets

Source: IFC Russian Leasing Development Group, 2002.

ownership is recognized by all participants, especially courts, more readily and consistently than secured lending. This can reduce the risk to lenders (lessors) considerably. The value of this advantage of leasing should not be underestimated, particularly in more challenging environments.

Figure 1-1 shows the role leasing plays in emerging economies and in developed economies, and the room for growth in the use of leasing in emerging economies. The chart shows that leasing can provide a valuable additional source of finance within these markets.

The effect of leasing can be further accelerated and strengthened where the in-country conditions allow for investment by IFC and other international financial institutions, with these institutions recognizing the positive effects of leasing and introducing medium-term finance into markets where no alternative currently exists.

In many markets, discussion of leasing often focuses on “large-ticket” leasing, cross-border structures, or tax implications. While these are also important, any discussion of leasing should be kept as broad as possible and consider the effects for all businesses, including small and medium-size enterprises.

Stakeholder Arguments for Developing Leasing

A key consideration in developing leasing is identifying the goals of stakeholders, and their objectives for the development of leasing markets.

Broadly, stakeholders are those individuals or groups who either are actively involved in developing leasing locally or may be affected by the development of the leasing sector. Key stakeholder groups include government, banks, non-bank financial institutions, existing or potential lessors, existing or potential lessees, SMEs, equipment manufacturers, and the professional services sector, that is, lawyers and accountants, donors, and technical assistance providers.

In order to help target discussions with these stakeholders, this manual tries to identify objectives for each stakeholder group, and demonstrate how leasing can help achieve these objectives (see table 1-2).

Table 1-2. Stakeholders, Objectives, and How Leasing Can Help Achieve Stakeholder Objectives

Stakeholder	Possible Objectives	How Leasing Can Help Achieve Stakeholder Objectives
<p>Government</p>	<ul style="list-style-type: none"> ■ Domestic production ■ Industrial diversification ■ Capital investment ■ Government budget ■ SME development ■ Infrastructure improvements 	<ul style="list-style-type: none"> ■ Leasing aids the development of local processing and production. While manufacturing equipment may come from overseas, this equipment enables domestic processing of locally produced raw materials, thus replacing imported items. ■ Leasing lowers the overall costs of economic development. ■ Leasing provides a diversified source of capital (equity, debt, tax revenue) ■ Leasing further contributes to the development of domestic financial markets. ■ As leasing develops, there will be increased domestic liquidity through access to global markets. ■ For reasons listed below (see Lessees/SMEs), the development of leasing aids the growth of the domestic SME sector. ■ Leasing can help increase the levels of public transport and the depth of communications networks, and allow municipal authorities the means to acquire quality construction and maintenance equipment.
<p>Lessors (including banks)</p>	<ul style="list-style-type: none"> ■ Risk management/reduction ■ Leasing market development ■ Product portfolio diversification ■ Customer base expansion 	<ul style="list-style-type: none"> ■ The lessor maintains legal ownership of the asset. ■ The lessor is able to exert greater control over the investment. ■ The lessor can monitor assets more easily. ■ Lessors can actively apply specialized knowledge, such as equipment specialization. ■ Leasing provides not just an opportunity to extend product lines, but also to deepen the organizational structure. ■ In some cases, leasing may allow businesses to access both lease financing and additional bank financing without increasing their collateralized debt. ■ Leasing can provide additional marketing channels for financial services.

Stakeholder	Possible Objectives	How Leasing Can Help Achieve Stakeholder Objectives
Lessees/SMEs	<ul style="list-style-type: none"> ■ Access to finance 	<ul style="list-style-type: none"> ■ No/low collateral required. ■ The cost of lease finance is competitive with traditional credit, given the increased security held by lessors and the low transaction costs of processing a lease. ■ Leasing also offers matched maturity of assets/liabilities, since debt in emerging countries is often limited to short-term maturities. ■ Islamic compliance: in Muslim countries, leasing is seen as an interest-free product and considered the same as a rental. In Islamic finance, “ijara” is a kind of leasing, and especially relevant within the Middle East and North Africa.
	<ul style="list-style-type: none"> ■ Access to equipment and production assets 	<ul style="list-style-type: none"> ■ Leasing increases flexibility and diversification of financing sources. ■ Leasing enables investment in equipment that can modernize production and improve productivity and profitability. ■ Leasing reduces maintenance cost, since equipment is newer. ■ Due to reduced upfront costs, leasing frees up capital for other business needs.
	<ul style="list-style-type: none"> ■ Ability to plan ■ Timeliness and flexibility ■ Negotiability 	<ul style="list-style-type: none"> ■ Leasing enables companies to match income and expenditure. ■ Leasing also has advantages of a quick decision-making process, flexibility, and negotiability. This is in large part because the lessors operate in a less-regulated, more proprietary environment than bankers or traditional lenders. It may also owe something to the fact that, since leasing is a comparatively new development, lessors have to be fast and flexible to claim this as their unique selling proposition. ■ Leasing deals may make less use of the restrictive covenants that appear in more traditional forms of lending. ■ Where lessors have asset knowledge or relations with suppliers, lessees may “outsource” certain tasks (such as negotiating with suppliers), reducing costs and risks. ■ Independence from bank borrowing: through leasing, SMEs have alternative funding opportunities and are able to use a mix of funding options to finance their businesses.

Stakeholder	Possible Objectives	How Leasing Can Help Achieve Stakeholder Objectives
Equipment Manufacturers	<ul style="list-style-type: none"> ■ Expanded market base for products ■ Increased purchase options for clients 	<ul style="list-style-type: none"> ■ Leasing allows access to new equipment, by providing businesses with a mechanism to purchase equipment without incurring significant upfront costs. ■ Development of the leasing sector opens up significant after-market products and services for equipment manufacturers. ■ Leasing often provides an effective marketing channel for equipment, as leasing companies are also interested in increasing sales. ■ Effective leasing companies may bear some of the burden of dealing with inexperienced equipment purchasers, thus reducing costs and improving efficiency.
Legal/Accounting	<ul style="list-style-type: none"> ■ Lessors/banks may be clients of professional services companies ■ Tax planning and accounting opportunities ■ Systems development opportunities 	<ul style="list-style-type: none"> ■ In terms of compliance, professional advisors should be contracted by lessors to ensure that all agreements comply with local legislation and permit the lessor to utilize tax or other benefits. ■ Lessors, in order to reduce transaction costs and because of the nature of leasing, will aim to utilize credit management systems for the monitoring and control of their lease portfolios. Professional advisors have an excellent opportunity to assist in the development of business processes and systems.
Investors	<ul style="list-style-type: none"> ■ Increased ability to invest within a country ■ Development of financial sector ■ Growth in investee company opportunities 	<ul style="list-style-type: none"> ■ Improved credit scoring and processing systems can be applied across all elements of the finance sector; from leasing through to banking, thereby allowing the whole sector to take a more prudent and controlled approach to finance. ■ Leasing improves the local investment climate for all companies, increasing opportunities for investment and reducing/allocating risks more efficiently. ■ The development of non-bank lessors increases competition within the financial sector; introducing the need for finance companies to reduce transaction costs, improve business and credit management, and source funding at cheaper levels. This has the effect of reducing the cost of finance throughout the sector at the same time as increasing its level of sophistication and ability to optimize risk. ■ As lessors develop, they may expand to issuing commercial paper and to securitizing lease receivables, which can assist in deepening the securities market and creating new investment products.

IFC's Role in Leasing

IFC's Vision for Leasing Development

Leasing development TA projects within IFC fall under the wider umbrella of financial sector development TA. This hints at IFC's view that it is involved in the development of leasing, specifically the development of local financial industries, in an attempt to increase domestic access to finance and the flow of investment. Another motivation for IFC involvement is that in developed markets, leasing companies are generally financed with debt and/or commercial paper and securitizations. IFC can play an important role in emerging countries with underdeveloped debt markets through its financing mechanisms. An effective leasing industry also improves the prospects for investment in many other sectors, particularly in capital-intensive industries.

Based on the success of leasing development projects around the world, IFC and associated donors have identified leasing development TA projects as an effective, value-for-money means of developing local financial markets with positive, tangible, and far reaching results. Because of this success and the impact that reform and development of the leasing sector can bring to the wider economies of emerging markets, IFC is working to provide significant support and assistance to leasing development teams around the world.

IFC's Experience and Reach

Having invested in over 100 leasing companies in 50 different countries (including 35 in Europe, the Middle East and Central Asia), IFC has a long history in financing leasing programs throughout the world.

- IFC has helped establish the first leasing companies in 25 countries.
- IFC's total investment in leasing over the last 30 years has been over \$1 billion in 181 leasing investments in 56 countries (between 1977 and 2003).
- IFC has advised on leasing legislation in 35 countries.
- IFC currently manages more than \$5 million in leasing TA programs.

IFC and Leasing Technical Assistance

Many countries face structural obstacles in developing a leasing industry: the absence of clearly defined and predictable laws governing leasing transactions, unclear accounting standards, lack of an appropriate tax regime, impaired funding abilities, and the absence of an appropriate regulatory and supervisory framework. Regulations either do not exist or do not take into account the specific characteris-

tics of leasing, or their application and interpretation are uncertain because of a lack of precedent. Recognizing such weaknesses, governments have turned to IFC for help in laying out the groundwork for leasing development.

IFC usually helps countries develop a leasing industry through one or more leasing development TA projects that are supported by IFC regional technical assistance facilities. This ensures that previous experiences and best practices are taken into account in the implementation of IFC leasing development projects.

Chapter 2

Legislation, Regulation and Supervision

This chapter deals with the three elements of legislation, regulation and supervision. These are critical elements, because to make effective changes within the leasing sector, it is likely that changes will be necessary in the existing legislative framework.

This manual is intended to be a guideline in approaching all three of these elements. While based on “best practices” worldwide and IFC’s experience, the approach must also be tailored to local requirements and be pragmatic.

Legislation

In order to assist in the creation of appropriate leasing legislation, IFC has developed the following guidelines, based on IFC’s TA experience over the past five years around the world:

With any legislative change, amendments should be closely thought through to ensure that the most efficient and yet comprehensive changes are put forward.

Whether the relevant local legislation is based on Civil Code or Common Law, the development of a specific and separate leasing law may not be necessary, although this will ultimately depend on local circumstances and existing legislation. This assumes that it is possible to make additions and amendments to existing legislation, and that those amendments are not compromised by other elements of the local legislation.

All legislative changes need to be coordinated to ensure that there are no opportunities for conflict or contradiction. Experience worldwide has shown that contradictory legislation, which can be subject to widely different interpretations, is often the worst possible outcome.

Why Is a Legislative Framework Necessary?

Leasing is essentially a financial instrument that works based on its legal framework. Furthermore, its success rests on how well leasing legislation relates to legislation on finance.

Often, domestic legal frameworks are not conducive to the development of leasing. This may be due to several reasons/issues:

- There may be no leasing-specific legislation or clear definition of leasing.
- Contradictions exist between various elements of a country's legislative framework that prevent leasing from working effectively.
- Current legislation prevents the successful enforcement of leasing contracts.
- It is unclear whether lessors hold title to leased assets.
- It is unclear whether third parties can hold a security position in leased assets or have some kind of other claim on these assets.
- It may be difficult for a lessor to take possession of a leased asset when a lessee defaults. It may be unclear whether lessors can legally repossess nonperforming lease assets without costly and time-consuming court procedures or restrictive bureaucratic requirements.
- Definitions and legal implications of finance leases need to be specified in the legislation. Rules on these issues should be clear and written with users in mind.

Where there is an absence of leasing-specific legislation or where leasing legislation is imperfect, the question becomes: Can lease operations be established and function properly, or must legislation be enacted first?

Sometimes, successful leasing is done in countries without leasing-specific legislation (as in India) or where leasing legislation is not perfect. Technical assistance projects cannot hope to make national leasing systems perfect. The goal is to engineer a leasing environment that addresses the needs of lessors and lessees, and encourages the continued development and sustainability of the sector.

The framework that is developed may not solve all national issues, but should serve as a basis for developing operations that may not have previously existed or enable the continued improvement of the domestic leasing sector.

- Clarify rights and responsibilities of the parties to a lease
- Remove contradictions within the existing legislation
- Create non-judicial repossession mechanisms
- Ensure only the necessary level of leasing industry supervision and licensing

Legal Systems

In general terms, two different legal systems exist globally: those based on Common Law and those based on Civil Law. While the type of legal system (civil or common) present in the country of operations is important to how specific legislative changes are made, the essence of a lease should not be different in the two basic systems.

Elements of a Lease

This is an explanation of the elements in a lease—that is, the parties, asset, rentals, residual value, etc. This section also tries to detail the unique features of a lease as different from a regular financing transaction. In many cases, the legal distinctions between an operating and a financial lease may be unclear. While this manual focuses on financial leasing, the flexibility to allow for operating leases or elements of operating lease transactions, particularly in the long term, should be kept in mind as important tools for many economies.

Many jurisdictions will specify certain “essential elements” to a lease, particularly financial leases, that are in reality not essential. A pragmatic approach to these factors is important, since in many cases such factors depend on other elements of the legal or tax system; in other instances, such formal requirements are not serious impediments to leasing.

An important element is to retain maximum freedom of contract. It is impossible to foresee all elements of a lease that may be appropriate, and experience has shown that leasing is most effective when the parties to a lease transaction can tailor deals to suit their own needs and capabilities.

The transaction. The transaction of a lease is generally an asset-renting transaction, that is, the separation of legal ownership from economic use. The distinguishing factor between a lease and a loan is that in the latter money is lent out, while in a lease it is the asset that is lent out.

Therefore, a lease can be defined generally as a contract where a party being the owner (lessor) of an asset (leased asset) provides the asset for use by the lessee for consideration (rentals) that are either fixed or dependent on certain variables, for a certain period (fixed or flexible lease period). At the end of the lease period, subject to the embedded options of the lease, the asset may be either returned to the lessor or disposed of per the lessor’s instructions.

Parties to a lease. Both lessor and lessee (and the supplier in the three-party structures) can be legal entities as well as individuals (sole proprietors). There should not be restrictions allowing only leasing companies or other financial institutions to operate as lessors.

Two- or three-party leasing. Depending on local legislation, there will be at least two parties to a lease—the owner and the user (called the lessor and the lessee). In many jurisdictions, a third party may be required, that is, the supplier of the equipment.

The existence of the third party (the supplier), who is usually chosen by the lessee and from whom the lessor buys the leased asset upon instructions of the lessee, can be explained by the intention of lawmakers in some jurisdictions wishing to separate leasing from other forms of property hire.⁴

The argument is that in a three-party arrangement the lessor is a financial intermediary, and the lessee effectively “hires” the lessor’s money rather than the property. The lessor is seen as an investor who makes an investment by purchasing the leased asset and transferring it to the possession and use of the lessee.

If a lessor holds an asset in possession without buying the asset specifically following a lessee enquiry, the asset transfer may be considered a regular hire agreement. The third party is the distinguishing feature between the hire or rental of the asset within these jurisdictions.

While discussing three-party leasing, the International Institute for the Unification of Private Law (UNIDROIT) convention insists that finance leasing is a three-party arrangement.⁵ This convention regulates only cross-border leases, but supersedes national legislation in all countries that have signed up to the convention for cross-border leases.

Where countries accept legislation with a three-party structure—legislation then has to address the notion of “secondary leasing”—it remains the right of the lessor to lease the asset (which remains in the ownership of the lessor) after the first lease agreement has terminated or the leased asset is repossessed. If secondary leasing is not possible, the lessor will not be able to “lease the leased asset,” as in this transaction there would be no supplier from whom the lessor may purchase it initially.

⁴This is the case in most of the countries of the former Soviet Union, certain Eastern European countries, and now certain African countries.

⁵UNIDROIT is an independent intergovernmental organization based in Rome. Its purpose is to study needs and methods for modernizing, harmonizing and coordinating private and in particular commercial law as between States and groups of States. Set up in 1926 as an auxiliary organ of the League of Nations, the Institute was reestablished in 1940 on the basis of a multilateral agreement, the UNIDROIT Statute.

The leased asset. The leased asset must be non-consumable. Legislation can impose some restrictions to this general rule, for example to prohibit some articles being leased which are in limited free circulation or withdrawn from circulation (for example in some countries, land plots or natural sites cannot be leased). Therefore, anything that one cannot own or hold title to cannot be leased, because to act as a lessor one needs to buy the asset first.

Lease period. The term of lease (lease period) is the period for which the agreement of lease shall be in operation. In some jurisdictions, an essential element in a lease is the ability or potential by the lessee to return the asset at the end of the lease period (although lease terms may mean that this “right” is not likely to be exercised). It may also be necessary, depending on local jurisdictions, to include within the contract a certain period at the start of the lease where the lessee may be given a right of cancellation. Beyond this period, the lessee may be given a right of renewal. It is important to note that a lease cannot be viewed as a lease if it is possible to interpret it as a sale of an asset to the lessee.

In financial leases, it is common to differentiate between the primary lease period and the secondary lease period. The former is the period over which the lessor intends to recover its investment, while the latter is intended to allow the lessee to exhaust a substantial part of the remaining asset value. Alternatively, many jurisdictions stipulate that the disposal of the leased asset (either by sale, transfer to the lessee, or return to the lessor) must be specified in the lease contract.

The primary period is normally non-cancelable, and the secondary period is normally cancelable. Many jurisdictions restrict the minimum lease period; therefore, this must be checked in each specific jurisdiction. The minimum lease period is often related to the normal amortization period for a given asset, but in some cases it is stated as a specific time period.

Lease rentals (or lease payments). Lease rentals represent the consideration (usually monetary) for the lease transaction, that is, this is what the lessee pays to the lessor.

If the lease is a financial lease transaction, the rentals will usually be the recovery of the lessor’s principal and a certain rate of return on the outstanding principal. In other words, the rentals can be seen as bundled principal repayments and interest. In many cases, financial lease payments may include other costs such as insurance, regular maintenance, and certain taxes (such as property tax). These payments may be on a “pass-through” basis or otherwise structured.

If the lease is an operating lease transaction, the rentals might include several elements depending upon the costs and risks borne by the lessor, such as:

- Interest on the lessor's investment
- Charges for certain costs borne by the lessor such as repairs, insurance, maintenance or operation costs
- Depreciation of the asset
- Servicing or packaging charges for providing a package of the above service

Residual value. Put simply, “residual value” is the value of the leased equipment at the end of the lease term.

Residual value is generally defined as market value (at the end of the lease). But in some contexts it may mean amortized (or balance sheet) value, value for tax purposes, or carry other definitions. These values may differ significantly, and these differences may have important implications. Residual value risk is another important term used in leasing and refers to the risk that the actual (realizable) value of the leased asset at the end of the leased term will differ substantially from the estimated residual value at the inception of the lease.

Residual values become important when discussing operating leases, where the cost of the operating lease depends to a large extent on the value of the asset at the end of the lease period—the higher the residual value, the less the amount to finance and hence the cheaper to lease the asset. Residual value financial leasing has also become an important aspect of leasing in the United States, but most emerging economies and many European countries still fully amortize such leases.

Residual values are important to consider during the underwriting process. If a lessee is leasing an asset with a fast depreciation rate with the asset only achieving a low residual value after the lease period, or if in the event of a default the lessor is forced to repossess the asset during the lease, the lessor faces the risk of not being able to recover sufficient capital value from the sale or disposal of the asset. Even though this may be recoverable from the lessee (or in some cases from the supplier), it may involve lengthy legal procedures to recover the shortfall.

End-of-term options. The options allowed to the lessee at the end of the primary lease period are called end-of-term options. Essentially, one or more of the following options will be given to the lessee at the end of the lease term:

- Option to buy (buyout option) at a bargain price or nominal value (typical in a hire-purchase transaction), called bargain buyout option

- Option to buy at a fair market value or substantial fixed value
- Option to renew the lease at nominal rentals, called bargain renewal option
- Option to renew the lease at fair market rentals or substantial rentals
- Option to return the equipment

Alternatively, the lease could be completely paid out and amortized to zero, at which point the equipment is automatically transferred to the lessee. This is typically the case in developing countries or new leasing markets.

In any lease the suitable option depends on the nature of the lease transaction, as well as the applicable regulations. For example, in a full payout financial lease the whole, or substantially the whole, of the lessor's investment would be recovered during the primary lease period. Therefore, it is quite natural that the lessee should be allowed to exhaust the whole of the remaining value of the equipment. Regulation permitting, the lessor provides the lessee with a bargain purchase option to allow the lessee to complete the purchase of the equipment.

A buyout option may characterize the lease as hire-purchase. However, in many jurisdictions it is the existence of such a buyout option that distinguishes leases from hire-purchase transactions. If the lessor is interested in structuring the lease as a lease and not a hire-purchase, the lessor would be advised not to provide any buyout option but to allow the lessee to renew the lease and continue using the asset. In essence, a renewal option achieves the same purpose as a purchase, but the lessor retains his ownership as well as his reversionary interest in the equipment.

Fair market value options, either for purchase of equipment or for its renewal, are typical of operating leases. But this mechanism does no more than assure the lessee continued use of the equipment. If equipment has to be bought at its prevailing market value, it can be bought from the market rather than from the lessor. Therefore, the higher the fair market value, the less the value of the option for the lessee.

Upfront payments. Lessors may require one or more of the following upfront, instant payments from a lessee:

- Initial lease rental, initial hire, or down payment
- Advance lease rental payment
- Security deposit
- Initial fees

Typically, deposits taken upfront by lessors act as a means of verifying the lessee's ability to service the lease. Taking deposits or advance payments also reduces the difference between the market value of the (delivered) equipment and the purchase

price, which may include delivery, modification, or installation fees. This is especially relevant in countries where there is no credit bureau or credit ratings, and checking credit histories is difficult. It is also important where equipment is highly specialized and the pool of potential buyers is limited.

These deposits are usually calculated on the basis of a number of monthly payments, and may be the equivalent of several months of advanced rental fees or a percentage of the total equipment cost. The amount depends on the equipment and the financial situation of the lessee. The advance payment also reduces the amount of the purchase price that the lessor must finance. Upfront payments represent an equity stake in the asset by the lessee and avoid, as is desirable, 100% financing.

Accounting Standards and Recommendations for Amended Legislation

It should always be kept in mind that different accounting standards exist, are designed for, and are used for different purposes. Tax accounting is used as the basis for calculating taxes payable, and often differs significantly from accounting systems used for other purposes.

International Accounting Standards or IAS (and local versions of Generally Accepted Accounting Principles or GAAP) are targeted at use by “arm’s length” stakeholders, such as shareholders and creditors; IAS are designed to reflect economic substance, usually with a conservative approach.

Management accounting systems are generally used by management for internal control and performance (and are often somewhat similar to IAS/GAAP). Owners and controlling shareholders may have their own modifications and approach to reflect their own goals and concerns.

The recommendations and discussion that follow are targeted at accounting standards for third-party stakeholders, but some degree of overlap and disagreement between the systems is highly likely, since they are designed for different purposes for use by different parties.

- Use IAS-17 as a basis for the definition of local leasing legislation, including accounting for leases.
 - IAS-17 provides a useful framework and guidelines for the development of domestic leasing legislation.
 - While the application of IAS may not be common to all countries, the adoption of IAS is a target for most countries. With this in mind, using IAS-17 as the basis for local leasing legislation, it is possible to build in a quality standard for that legislation.

- Classify leasing as an investment activity and a financial service.
 - Leasing should be classified as both an investment activity and a financial service. It is important for leasing to operate on the same level playing field as other forms of credit.
 - Classifying leasing as an investment activity may result in lessors' receiving additional benefits connected with domestic investment initiatives. These could include accelerated depreciation, among others.
 - If leasing is classified as a financial service, it may be possible that the interest portion of the lease payments will not attract value-added tax (in addition to the VAT that is levied on the equipment cost).
- Determine if there is a need for a prudent and appropriate minimum lease term, that is, at least 1 year and in some countries up to 3 years minimum.
 - The requirement for licensing of non-bank financial institutions to finance leases needs to be evaluated based on country-specific factors, balancing the need for prudential sector regulations to promote sector development and prevent bureaucratic hurdles. Many emerging economies with sound financial sectors have chosen not to require licensing for leasing.
 - Similarly, supervision of leasing (as an activity) by central bank structures should be determined based on country-specific factors. If the lease is financed by an institution that is already under central bank supervision, supervision by central bank structures would be prudent.
 - While establishing minimum capital requirements for leasing institutions could help weed out inadequately capitalized leasing companies, this restriction may also inhibit the development of the leasing industry, particularly in nascent markets where it may be slow to develop. Hence, setting up obligatory capital requirements for leasing needs to be carefully evaluated in the context of the existing legal and regulatory framework and other factors.

In some cases, market forces may provide an indirect regulation of leasing companies, such as the discipline imposed by the market when the leasing company raises funds from banks or other investors.

Legal Issues

Below is a discussion of legal issues pertaining to leasing in emerging markets.

Registration of leased assets. In emerging markets, the ability to register ownership (a lien) of an asset may not be straightforward. This ability, however, could be important for leasing (or other forms of secured lending) to develop.

With a registry, anyone purchasing an asset can check that the asset is not owned by another party. If someone buys an asset without consulting the registry, they are presumed not to have purchased the asset in good faith, and thus their title to the asset is at risk. They are, therefore, obligated to check the registry prior to purchase. Registries also enable leasing companies to protect their assets in instances where lessees are subject to judicial action aimed at recovering assets.

It may be that the leasing development project has to become involved in improving or even creating such a registry. Experience has shown, however, that although asset registration may be available, it should not necessarily be obligatory for owners to register their assets.

Many countries have followed the approach of a central registry for lodging liens (not solely for registering leased assets within country) with an efficient process available for checking if assets have a lien against them. Furthermore, it is not important whether a private owner or state owns the registry, but it is important that the registry has sufficient legal status to provide such assurance. This should be accompanied by legislation that provides a mechanism for the properly documented lien holder to recover the asset from an unsecured party. As with any monopoly, if only a single registry exists, the costs of registration and lien verification should be regulated; the ultimate goal is to ensure that the cost of registration and lien verification is as low as possible (while still covering costs, of course) so as to encourage use of the registry.

Obligatory registration of lease agreements may not be necessary, as this could lead to administrative barriers, higher costs, and indirect regulation of the industry. If institutions prefer to register agreements, this option should be available.

Repossession of equipment under lease. Repossession is a key element of leasing, enabling credit providers to efficiently secure their asset and realize funds from the asset disposal. Without such ability, leasing is little different from other forms of unsecured finance.

To encourage the development of an efficient and fair repossession system, many countries have adopted the following: within the legislation, in the event of a default by the lessee, there should be scope to allow the lessee to voluntarily return the leased asset to the lessor without penalty.

Where the lessor tries to repossess the asset and the lessee disputes its grounds for repossession, the lessee should have access to the courts to challenge the repossession order. To encourage efficiency in repossession, a non-judicial process should be available either through a court order (an order issued by a judge outside of court proceedings and processed within a short time period, for example, 10 days) or a

notary writ (a writ issued by a notary which serves as a legal basis for repossession). Non-judicial mechanisms for repossession can be used in those cases where the lessee admits the default but does not voluntarily return the asset.

Where a lessor has already repossessed an asset but the lessee can demonstrate having fulfilled its obligations under the lease, the lessee will be entitled to go to court to claim damages.

“Self-help repossession” is a unilateral act by the lessor not supported by any legal process or permits. Basically the lessor, without asking or informing anybody, comes to the lessee’s premises and takes back the asset. It is important to note that this can only be done in certain common law jurisdictions, and that this repossession should be conducted in a way that does not “breach the peace” (another common law concept). In such jurisdictions, the lessor is liable for any damages. While lessors in many jurisdictions often lobby for this right, this practice could potentially be dangerous and highly problematic.

Efficiency is key for the whole process. If repossession takes too long, lessors will either resort to alternative, less equitable means of recovering assets, or not enter the marketplace to begin with. However, the process must also be balanced to prevent abuse by lessees, for example, ensuring that lessees fulfill 100% of the obligations of their lease.

Rights and responsibilities of the parties to a lease. The “freedom of contract” concept is a cornerstone of this issue. The parties should be given the maximum opportunity to provide in the contracts the full extent of their rights and responsibilities:

- ***Lessor rights and responsibilities.*** The lessor as owner of the leased asset retains the right to receive scheduled lease payments arising from the lease agreement. The lessor should, within the framework of local legislation and practice, also have the right to assign these rights to others. The lessor’s key responsibility is the obligation to deliver, at the outset, equipment that is “fit for purpose.”
- ***Lessee rights and responsibilities.*** The lessee retains the right under the lease to use the fixed asset. This is in exchange for the obligation to make scheduled lease payments, insure the asset, pay any applicable taxes, use the equipment responsibly and in accordance with local laws and regulations, and maintain it in good working order (subject to the lease agreement). It is important to highlight that the lessee, as the “operator” of the equipment, retains all responsibility and liability with respect to the operation of the equipment.

- In some situations, however, the law has to provide the framework/borders that parties should not be allowed to violate. This relates particularly to those jurisdictions which have accepted three-party leasing arrangements, and whose contractual relationships are consequently complex in character. The law should imperatively state in that situation that:
 - The lessor is not accountable to the lessee for the non-fulfillment of the sale-purchase contract except for those cases in which the selection of the supplier and the leased asset was conducted by the lessor, as well as cases when non-fulfillment of the sale-purchase contract was the result of wrongful acts (omissions) on the part of the lessor.
 - The lessee has the right to address all claims which stem from the sale-purchase contract directly to the supplier even though the lessee is not the party to that contract. As a result, the legislation imposes an obligation on the lessor to notify the supplier about the purpose of purchasing an asset.

Bankruptcy of the lessee or lessor. Where the lessee is deemed to be bankrupt and defaults on the lease, the lessor has the right to repossess the asset. The general norms of bankruptcy law apply, with the insolvent pool of assets consisting only of those that are owned by the insolvent company. What does not belong to the insolvent company should be returned to the owner (that is, the lessor). Note that in cases where the bankrupt lessee's liabilities are assumed by another party (there is no default on the lease agreement) the "successor" may retain the lessee's rights under the lease agreement. This may happen where temporary administration or wholesale purchase of a bankrupt lessee occurs, particularly where the leased asset is essential to the viability of the (former) lessee as a going concern.

Where the lessor is deemed bankrupt, this should have no effect on the lessee. The lessee, if perfectly solvent, retains the right to the use of the asset. It is important to clarify in law or regulation the procedure for asserting the right to receive lease payments in case of dispute, that is, the party to whom the lessee must make payments to avoid facing accusations of default when payments are made in good faith.

The party that acquires the lessor's assets as a result of the latter's default is able to enforce the rights of the original lessor only under the lease, that is, the receipt of lease payments. The new owners are not able to take possession of the asset for all cases in which the lessee is still meeting its obligations under the lease. The obligations and rights are simply assigned from the original lessor (in default) to a new party. This has to be supported by legislation which provides that the transfer of ownership does not lead to termination of the agreement and cannot be considered grounds for such termination.

Regulation, Supervision and Applications to Lessors

Regulation is a good idea where lessors are deposit-takers (that is, where leasing companies are effectively “banks”). Regulation would also be prudent in situations where lessors are able to take receipt of deposits. There are several key tests for public regulation by which these recommendations are guided:

- Regulations should be implemented only where there is a clear public interest. Deposit-taking institutions (generally, banking institutions) provide the best example of a clear public interest.
- Regulate the activity at an appropriate level. For example, there is often regulation of the trading of public securities (and the forms by which these securities are offered). In the case of leasing companies issuing tradable securities, it is not the leasing activity that generates the need for regulation, but the act of issuing securities.

Regulation

Non-bank, non-deposit-taking leasing institutions may not need the same level of stringent regulations as deposit-taking commercial banks, and in some cases, no specific regulation may be necessary. The necessity and level of regulations depend on a variety of factors, including the overall legal and regulatory framework, and should be assessed on a case-by-case basis. Note that the absence of regulation may affect the availability of financing or pricing of financing to a leasing company versus a bank.

Supervision

Supervision of leasing institutions would be necessary only when specific regulations have been established for leasing institutions. In such a case, existing supervisory institutions, such as banking supervisor agencies, may be able to perform such supervision. Specific leasing supervisory bodies may be necessary only in special circumstances.

IFC Approach to Regulation and Supervision

There are several tenets to IFC’s approach toward supervision of leasing (and many other activities). Good supervision and regulation are essential to a functioning marketplace, and governments are the prime defender of the public good. In addition, the government can often provide certain services for the benefit of the market. IFC experience as outlined in the Doing Business series (see *Doing Business in 2005: Removing Obstacles to Growth*, for example) also demonstrates clearly that poorly executed and designed regulations are often a major impediment to business.

Where leasing is at an early stage of its development, with a limited level of understanding as to its impact, there may be a need to regulate and supervise leasing activities. This need should be balanced by an understanding that the regulation or supervision of lessors, where previously imposed in other countries, has been in some cases counter-productive. Regulation can give external institutions the opportunity to interfere in, and could adversely affect the activities of others directly involved in, the sector. Regulation may also provide institutions with weak corporate governance the opportunity to profit from the development of the leasing sector. In some cases, regulation can give rise to corruption.

The market itself could act as the regulator for lessors in some cases, that is, the lessor's funding sources and its clients, who are well able to judge how well the company is run, rather than an external body with less understanding of the demands under which lessors operate. Companies with poor corporate governance and weak internal controls will have limited ability to raise investment in the market, and so their development and ability to do business will be restricted.

Further, supervisory groups charged with overseeing the development of leasing may find it difficult to acquire the skills and the ability to properly assist lessors in developing their internal controls. In addition, if regulation and supervision are not executed in the proper manner, this could adversely affect the competitive nature of a domestic leasing industry and in some cases introduce artificial barriers to the development of the leasing sector, including entry.

Common Types of Regulation for Non-Bank Lessors

There are two main types of regulation for non-bank lessors: minimum capital requirements (MCR) and licensing of leasing activity. Each type calls for different considerations.

Minimum capital requirements. The imposition of MCR for financial organizations means that companies need to retain a proportion of their assets as liquid to satisfy any immediate demands placed upon their business, thus limiting their lending to a proportion of their net asset value. The imposition of MCR for non-bank lessors acts as a form of regulation and requires supervision of the companies affected. This policy does not cover deposit-taking lessors.

Factors to consider in imposing minimum capital requirements for lessors. Clear distinction has to be made between the activity of the lessors and banks, insurance companies, etc., and the necessity of imposing MCR with this regard.

Establishing MCR is a necessary prerequisite for the deposit-taking institutions to meet their liabilities in case of default within the framework of the Basel accords on issues such as capital adequacy ratios. For such institutions, it is important that liabilities are met to avoid any negative implications for depositors.

Other factors Lessors conduct ordinary entrepreneurial activity and are not deposit-taking institutions. Their default is harmful only to their stakeholders. In this respect, lessors are in the same position as any other company, with banks financing lessors the same as any other borrower regardless of MCR.

The establishment of MCR, depending on the amount of MCR, could affect the development of the leasing services, as many companies might be excluded from the market. For instance, problems may arise when a lessor is interested in financing micro-leases, but does not have the necessary amount of capital required by legislation.

In practice, it may be difficult to determine the “right” threshold for the MCR. There are companies that specialize in micro-leasing as well as those that finance mainly “big ticket” transactions. In most jurisdictions, sub-lease provisions within the legislation envisaged for a lessor apply equally to the sub-lessor. This creates potential difficulties for a lessee/sub-lessor to transfer an asset subject to a sub-lease, as the MCR would also apply to sub-lessors, which in most cases are SMEs without sufficient capital.

Licensing of Leasing Activity. Leasing has not typically required licensing in many countries for the following reasons:

- Usually, licensing is necessary only for those activities that can cause considerable public loss, are detrimental to public safety, or cannot be regulated by any other method. Leasing companies are not deposit-taking institutions, and their bankruptcy would not influence the economy in the same way bankruptcy of a bank would.
- In case of the lessor’s default, there is no risk for the lessees. The lessees can continue the existing lease agreement with the new owner of an asset, and legislation can provide for the protection of their rights in these cases. Only the lessor’s shareholders suffer the loss, but their loss is no different from any other company. This is an entrepreneurial risk that is mitigated through the mechanisms of corporate and shareholder control (that is, the problem is one of corporate governance and applies to any other company). As for the lessor’s creditors, employees and other stakeholders, their position is also no different from that of any other enterprise.

- Experience has shown that licensing of leasing as an administrative barrier could be an impediment for the development of this market, as it could limit not only the possibilities for local enterprises but also investments by non-resident lessors who find it easier to lease in those countries that do not license leasing.
- If there is pressure to introduce licensing of leasing because of potential abuse of the possible tax privileges (the stated reason for licensing), it should be sufficient to set clear parameters and classifications on a lease transaction for the tax authority and other regulating bodies to have sufficient definition to classify and reject non-conforming leases that exist only to capture tax advantages. Licensing of leasing typically does not create a shield against potential tax abuses.
- Issuance of a leasing license for a specific period can potentially create problems for lessors. If the law provides that the license is issued for five years, then what would the framework of operations be for a lessor whose license is due to expire prior to the expiration of the lease agreement? The legality of these agreements can thus be put in question.
- It is not clear whether a sub-lessor is entitled to transfer the leased asset in a sub-lease without a license. Taking into account that in most jurisdictions the legal status of the sub-lessor equates with that of the lessor (all provisions of the law envisaged for the lessor also extend to the sub-lessor), the former may be obliged to obtain a license prior to the transfer of a leased asset to a sub-lease.
- In those jurisdictions that impose the restriction that a lessor operate exclusively in the leasing business (or set exact proportions on the income from leasing activities that a leasing company may earn), leasing companies face the challenge of flexibly adapting to the changing market situation or otherwise fall into a non-competitive position.
- A leasing license usually does not contain many requirements that a license for securities or banking operations contains and therefore, in most cases, it is nothing but some type of “registration procedure.”
- Many developed countries only require non-deposit-taking lending institutions to file annual audited statements as good disclosure/transparency requirements.
- It should be noted that the argument is often made that “bad” leasing companies may harm the entire industry. While this may be true, it is no different for example from “bad” (incompetent) shoemakers producing bad shoes and harming the reputation of the industry. Good (effective) companies will survive and prosper, while ineffective companies that don’t adapt will inevitably be put out of business by market forces.

Subsidization of Leasing Companies/Government Funding

Experience has shown that direct subsidization of leasing companies has been harmful to the development of the leasing industry. In many countries, it is perceived that providing lease finance to certain sectors (for example, agriculture, aircraft) will provide a means to overcome the difficulties these sectors face. This is rarely effective, and may actually even negatively affect both the (market-based) leasing sector and the subsidized sector—bad money chases away good and distorts the market.

Fundamentally, this analysis is the same as for subsidized financing provided directly to any industry. Disguising the approach as “by means of leasing” does not reduce or change the inherent costs, risks, or problems. Instead, it often distorts and hides the problem. As with any subsidy, if these are determined to be needed, the negative impact should be minimized as much as possible.

Chapter 3

Accounting and Taxation of Leases

This section concerns itself purely with the treatment of finance leases, and does not cover the treatment of operating leases, which are accounted for differently. IAS-17 makes specific pronouncements about operating leases that are omitted here.

While this section essentially covers the financial treatment of leases and leasing, it has been split into two distinct parts: (1) accounting for lessors and lessees; and (2) the tax treatment of leases for lessors and lessees, as well as the effects of any tax benefits applied.

Accounting Frameworks

IFC encourages the adoption of International Accounting Standards (IAS) or International Financial Reporting Standards (IFRS). Specifically with regard to leasing development projects, experience has shown that lessors and lessees adopt IAS-17 relating to the treatment of leases. IAS provides a framework for the development of emerging markets accounting, and IAS -17 in particular forms the backbone for many suggestions made in leasing development projects.

Accounting for Leases as a Lessee

In accordance with IAS-17, the following principles should be applied in the financial statements of lessees:

- At the commencement of the lease term, finance leases should be recorded as an asset and a liability at the lower of the fair value of the asset and the present value of the minimum lease payments (discounted at the interest rate implicit in the lease if practicable, or else at the enterprise's incremental borrowing rate).

- Finance lease payments should be apportioned between the finance charge and the reduction of the outstanding liability (the finance charge to be allocated so as to produce a constant periodic rate of interest on the remaining balance of the liability).
- The depreciation policy for assets held under finance leases should be consistent with that for owned assets. If there is no reasonable certainty that the lessee will obtain ownership at the end of the lease, the asset should be depreciated over the shorter of the lease term or the life of the asset.

Under IAS, accounting for the lease transaction is based on the economic substance of the transaction rather than the legal form of it. Essentially in a lease the lessee is buying the asset from the lessor, but rather than paying cash for the asset, the lessee is financing the purchase with a loan from the lessor.

This means that lessees will:

- Record a fixed asset on their books
- Depreciate that asset
- Record a payable representing their future lease payments
- Recognize interest expense as part of the lease payment each period because they have essentially received a loan to purchase this asset from the lessor

The interest that is expensed on the income statement will be calculated from the amount of the loan that is still outstanding each period. This means that each period when a payment is made, a part is a payment of interest and the rest is the reduction of the lease payable itself.

With a finance lease, lessees must write the asset, if purchased, on their books. The lessee will then recognize a lease liability for the sale price of the asset, as this represents the money borrowed from the lessor (seller). The sales price is calculated as the present value of all of the payments to be made under the lease agreement using the lowest rate of interest.

Although this treatment sounds complicated, and can often look different from regular loan financing, in mostly practical terms they are identical or extremely analogous. Lease liability should, in most circumstances, be identical to loan principal outstanding (for the lessor, the net investment in a finance lease is equivalent to the value of the loan, that is, principal outstanding).

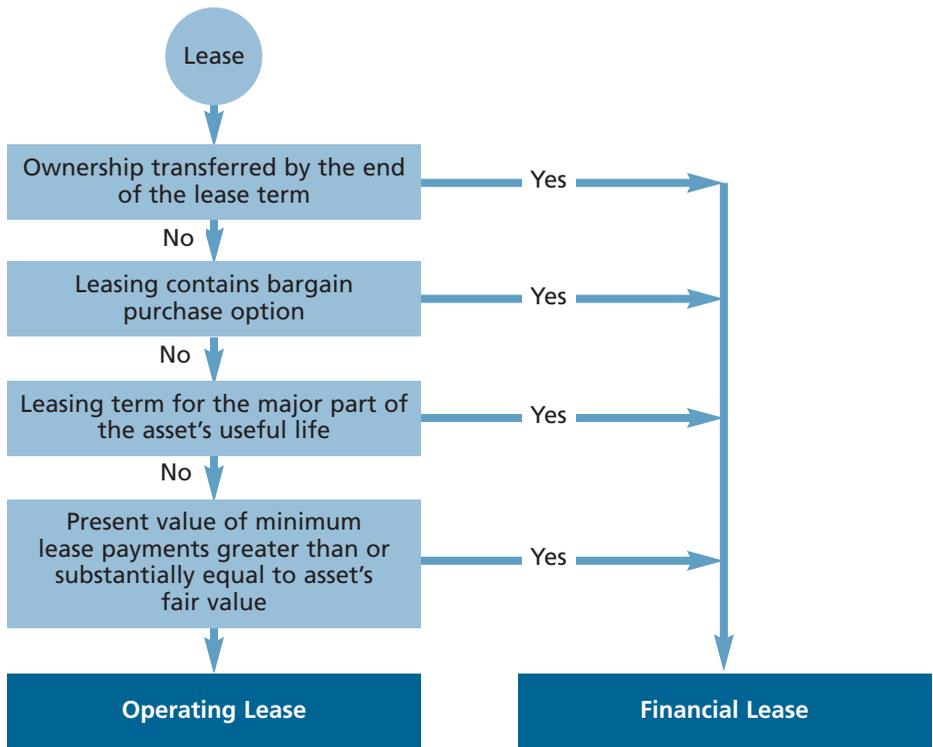
After the asset is written on the books, the company must depreciate this asset over its “useful life,” which is equal to the amount of time that it will benefit from this asset (either the useful life or lease term, depending on the terms of the lease). Also, the lessee must make a lease payment and recognize the interest expense each period.

The journal entry will consist of cash paid, interest expense, and a reduction of the lease liability. The three numbers are calculated as follows:

$$\begin{array}{r}
 \text{Annual lease payment (the same each period)} \\
 \hline
 - \text{Interest expense (beginning value of lease liability} \times \text{interest rate)} \\
 \hline
 = \text{Reduction of the lease liability for the period}
 \end{array}$$

As a result of this entry, the lease liability will be reduced and the amount of interest expense in future periods will decline each year. While the accounting for the lessee is fairly straightforward for finance leases, we need to initially determine whether the lease is an operating or a finance lease (see figure 3-1).

Figure 3-1. Determining If the Lease Is Finance or Operating



Apart from the criteria described in chapter 1, additional indicators of situations which individually or in combination also support classification as a finance lease are:

- If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee.
- Gains or losses from the fluctuation in the fair value of the residual fall to the lessee (for example in the form of a rent rebate equaling most of the sales proceeds at the end of the lease).

- The lessee has the ability to continue the lease for a secondary period at a rent which is substantially lower than market rent.

While we are not discussing operating leases, their treatment is often very simple, with the rent (lease payment) either being fully expensed in the case of the lessee, or recognized as income in the case of the lessor. In operating leases, the asset is almost always recorded on the balance sheet of the lessor.

Finance Leases

If the lease is a finance lease, the lessee will account for this transaction in two parts: the acquisition of a fixed asset and the obtaining and repayment of a loan. This means that the asset itself is going to be transferred from the books of the lessor to the books of the lessee.

The lessee also must account for the loan (or financing) part of this transaction. This is done as if the lessor is financing the purchase for the lessee. As a result of this loan, part of the amount paid by the lessee at the end of each period will be interest expense on the amount loaned, while the remainder will be the reduction of the lease payable principal.

Calculating the Value of the Leased Asset

When accounting for a lease, the lessee must initially determine the amount at which the asset will be recorded in its books. This is in essence what the selling price of the asset would have been if the lessee had paid cash for the item instead of financing the purchase.

The amount that will be capitalized as a fixed asset on the balance sheet of the lessee is the present value of the minimum lease payments (discussed below) using the lower interest rate (by using the lower interest rate we get a higher Present Value [PV]). Technically, we use the lower of two specific interest rates:

- Implicit rate in the lease (if known by the lessee)
- Market rate (or incremental borrowing rate if it is given)

Exception to the value of the leased asset. There is one exception to the rule of the recorded amount of the leased asset. If the fair market value of the leased asset is lower than the present value of the MLP, the asset will be recorded at its fair market value in the lessee's books. This approach is a reflection of the conservative nature of IAS; any eventual "gain" over the book value would usually be recorded only upon disposal of the leased asset.

Minimum Lease Payments

The minimum lease payments include all amounts the lessee is obligated to pay to the lessor over the life of the lease. The main items that are included in the MLP are:

- The annual (or monthly) lease payment
- Any required purchase price or bargain purchase option included in the lease
- Any amount of residual value that is guaranteed by the lessee (or by a party that is related to the lessee)

Please note that transaction costs, maintenance costs and any taxes on the leased item are not included in the calculation of the PV of the MLP. For the lessor, in addition to the above, the MLP includes amounts guaranteed by third parties.

Recording the Lease–Lessee Journal Entries

Once the lessee has determined the capitalized (recorded) amount of the asset, the following journal entry will be made:

<i>Dr</i>	<i>Fixed Asset</i>	<i>amount calculated as selling price</i>
<i>Cr</i>	<i>Lease Liability</i>	<i>amount calculated as selling price</i>

The selling price is recorded as the liability because this is the amount of money that the lessee would have needed to pay immediately to purchase the asset for cash. The difference between this amount and that which the lessee will pay in cash over the life of the lease will be interest expense. As with bonds, the interest expense is not recorded as a liability because at this point it is actually not owed to the lessor.

Once the lease is recorded on the books, the remaining journal entries will relate to the annual lease payments (and recognition of interest expense) and the depreciation of the asset.

Depreciation of the Leased Asset

Since there is now an asset recorded on the books of the lessee, it must be depreciated just like any other owned asset. The main issues, as always, are the calculation of the depreciable amount and the determination of the useful life. The depreciable amount will be equal to the cost paid by the lessee (as calculated above) minus any expected salvage or residual value.

A finance lease gives rise to a depreciation expense for depreciable assets as well as a finance expense for each accounting period. The depreciation policy for depreciable leased assets should be consistent with that for depreciable assets that are owned, and the depreciation recognized should be calculated on the basis set out in IAS-16

(property, plant and equipment) and IAS-38 (intangible assets). If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the shorter of the lease term or its useful life.

The depreciable amount of a leased asset is allocated to each accounting period for the duration of expected use on a systematic basis consistent with the depreciation policy the lessee adopts for depreciable assets that are owned. If there is reasonable certainty that the lessee will obtain ownership by the end of the lease term, the period of expected use is the useful life of the asset. Otherwise, the asset is depreciated over the shorter of the lease term or its useful life.

The sum of the depreciation expense for the asset and the finance expense for the period is rarely the same as the lease payments payable for the period, and it is therefore inappropriate simply to recognize the lease payments payable as an expense in the income statement. Accordingly, the asset and the related liability are unlikely to be equal in amount after the inception of the lease.

Reducing the Lease Liability

In the entry that was made at the inception (start) of the lease, the lessee also recorded a lease liability on the books representing the present value of the amount that will be paid in the future to the lessor. This liability will need to be reduced over the life of the lease so that when the last payment is made, the lease liability is reduced to zero.

Note that if there is a bargain purchase option, the lease liability will be equal to the amount of the bargain purchase option after the last lease payment is made.

The amount of the liability is less than the cash value of all of the lease payments to be made over the life of the lease because we calculated it by using the present value of the annual lease payments. As previously stated, the difference between these two amounts is the total amount of interest that the lessee will pay over the life of the lease. This interest expense will be recognized over the life of the lease because part of each cash payment is going to be considered as interest.

The interest expense is calculated as the remaining balance in the lease liability account (this is the amount of the loan that is still outstanding and is therefore the amount on which the lessee needs to pay interest) multiplied by the interest rate that was used to calculate the net present value (NPV) of the MLP:

$$\begin{array}{l}
 \text{Beginning balance of the lease liability at the start of the period} \\
 \times \text{ Interest rate used to calculate the NPV of MLP} \\
 \hline
 = \text{ Interest expense}
 \end{array}$$

The difference between the interest expense and the amount of the annual cash payment (the amount of the cash payment is going to be constant over the life of the lease) is the reduction of the lease liability:

$$\begin{array}{r}
 \text{Annual lease payment} \\
 - \text{Interest rate as calculated above} \\
 \hline
 = \text{Reduction of the lease liability for the period} \\
 \hline
 \end{array}$$

The journal entry to record this is as follows:

<i>Dr</i>	<i>Interest Expense</i>	<i>amount calculated above</i>
<i>Dr</i>	<i>Lease Liability</i>	<i>balance</i>
<i>Cr</i>	<i>Cash</i>	<i>amount paid</i>

Note that if the first lease payment is made on the date when the lease is entered into, the entire amount of that first payment is a reduction of lease liability. This is true because no time has passed since the lease was entered into and therefore no interest has accrued. It is important to look at the date the lease is entered into and the date of the first payment—if these are the same, the first payment should be treated as a reduction of the lease liability. In the example below, all of these calculations are made and the journal entries are given. Let us assume the following facts:

- \$20,000 for 5 years (payments on January 1, starting on the first day of the lease)
- 10% incremental borrowing rate
- Asset life 10 years
- Ownership transfers at the end of the lease

The present value of the lease payments is \$83,398. This is calculated by taking the present value of the \$20,000 annual lease payments at a 10% borrowing rate (see table 3-1 for the calculations).

Table 3-1. Calculation of Annual Interest Expense and Reduction of Liability

December 31	Cash Paid (interest payable)	Interest Exp. (liability x 10%)	Reduction of Principal	Liability Balance
Purchase				83,398
2001	20,000	0	(20,000)	63,398
2002	20,000	6,340	(13,660)	49,738
2003	20,000	4,974	(15,026)	34,712
2004	20,000	3,471	(16,529)	18,183
2005	20,000	1,818	(18,182)	-
TOTAL	100,000	16,602	83,398	-

Table 3-1 gives us all of the information required to record the journal entries over the life of the lease (see figure 3-2). Note that as the lease progresses, the amount of interest expense decreases. This is because the lessee is paying down the amount of the principal on the lease, and the amount due for interest is therefore also lower because the interest is calculated using the decreasing lease liability.

Figure 3-2. Recording the Lease: Lessee Journal Entries for Year One

January 1, 2001				
	Dr	Asset	83,398	
		Cr	Lease Liability	83,398
<i>To record the acquisition of the asset through a lease at the present value of the minimum lease payments.</i>				
	Dr	Lease Liability	20,000	
		Cr	Cash	20,000
<i>To record the initial payment due at the signing of the lease.</i>				
December 31, 2001				
	Dr	Depreciation Expense	8,340	
		Cr	Accumulated Depreciation—Leased Asset	8,340
<i>To record depreciation over the 10 year life of the asset.</i>				
	Dr	Interest Expense	6,340	
		Cr	Interest Expense	6,340
<i>To record the interest that has accrued during the year on the outstanding principal.</i>				
January 1, 2002				
	Dr	Lease Liability	20,000	
	Dr	Interest Payable	6,340	
		Cr	Cash	20,000
<i>To record the second lease payment, recognizing the payment of the accrued interest at 12/31/01.</i>				

The Current Liability on the Balance Sheet

In the presentation on the balance sheet, the amount that should be recorded as a current liability is only the amount by which the lease liability will be reduced in the upcoming year. This is because the amount that will be paid as interest in the upcoming year does not meet the definition of a liability on December 31. This interest will become a liability only with the passage of time and is not recorded as a current liability at the end of the year. It is still recorded as a long-term liability, and not a short-term one. In the example above, this means that the current lease liability that should be reported at the end of 2002 is \$15,026.

Front-End Fees and Other Miscellaneous Income/Expenses

The treatment of front-end fees and miscellaneous expenses is often different between jurisdictions, and sometimes between companies and auditors (front-end fees are often a percentage of the lease finance amount, and usually charged at disbursement or contract inception; a “typical” amount might be 1%).

Front-end fees are sometimes expensed at lease inception by lessees, and sometimes amortized over the life of the lease. While either treatment is acceptable, the latter has the effect of delaying recognition of unrecoverable expenses. On the other hand, it may better reflect the cost of financing (over the term of the lease). For lessees, this difference is likely immaterial.

For lessors, the income is sometimes recognized at inception, and sometimes over the life of the lease. The former treatment probably better reflects the cost of arranging the finance, since for the lessor, the costs associated with the income (e.g., legal fees, sales staff time, etc.) typically occur at lease inception (and few costs aside from finance occur over the life of the lease). Also, since front-end fees are rarely refundable, it is true income. Some auditors and accountants take the view that the income should be recognized over the life of the lease, on the basis that this approach is more conservative. While neither approach is perfect, the issue is of considerably more importance to leasing companies, for whom front-end fees might be an important component of income and provide far better matching of income and expenses.

Lease Disclosures of the Lessee

In accordance with IAS-17, lessees must make the following disclosures within the notes to the financial statements:

- The carrying amount of the asset
- A reconciliation between the total minimum lease payments and their present value

- The amount of minimum lease payments at balance sheet date and the present value thereof, for (1) the next year; (2) years 2 through 5; and (3) beyond five years
- Contingent rent, recognized as an expense
- Total future minimum sublease income under non-cancelable subleases
- General description of significant leasing arrangements, including contingent rent provisions, renewal or purchase options, and restrictions imposed on dividends, borrowings, or further leasing

Accounting for Leases as a Lessor

As with the lessee, the lessor also must make a determination of whether the lease is a finance lease or an operating lease. The accounting by the lessor for an operating lease is the same as the accounting for the lessee, except that it is rent revenue rather than rent expense. Please note that to calculate the cash amount of the annual payment, the lessor simply takes the fair value of the leased item divided by present value factor. The latter is the table factor for an annuity for the number of periods at the desired rate of return.

IAS-17 suggests that finance leases transfer substantially the risks and rewards of ownership of the asset to the lessee. The lease is seen as a financing arrangement with the lease rental effectively repayment of principal and the lessor receiving finance income from the lease. The leased asset is therefore recorded in the books of the lessor as a receivable, and not a fixed asset.

The IAS-17 income recognition requirement states that subject to prudent consideration, the recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on the lessor's net investment with respect to the finance lease. The method used should be applied consistently to leases of a similar financial character.

At the inception of the lease (that is, when the agreement or commitment is made), a finance lease is recorded as a receivable at an amount equal to the net investment in the lease. The net investment in the lease is the PV of:

- MLP
- Any unguaranteed residual value accruing to the lessor

Although this calculation may look complicated, net investment in lease is analogous, if not identical, to principal outstanding, particularly for amortizing loans (leases where periodic payments are constant). The assumption is that the periodic rate of return (that is, the interest rate if the lessor is applying the concept of interest rate) embodies the risk and financing costs for each lease. This is entirely analogous to a bank loan and the method that a bank uses for accounting for its loans. The more

complicated approach—calculating the implied constant periodic rate of return—is necessary only where the interest rate is not specified or is not used internally. Usually, this occurs only when lease repayments are irregular or fluctuating.

Any initial direct costs incurred by lessors, other than manufacturer or dealer lessors, are included in the finance lease receivable. Finance income is recognized so as to produce a constant periodic rate of return on the lessor's net investment in the lease. Manufacturer or dealer lessors recognize selling profit or loss in accordance with their policy for outright sales. The lessor will need to do the following:

- Remove the fixed asset from his or her books.
- Recognize revenue from the sale of the asset.
- Recognize a gain or a loss on the sale.
- Record a receivable.
- Record interest revenue each time a payment is received from the lessee.

For the lessor the accounting is similar to the lessee's treatment. However, the company will recognize a lease receivable for the cash value of the lease and revenue for the present value of the lease. The difference between these two numbers is the amount of deferred interest income that the company will recognize over the term of the lease. The lessor also recognizes the cost of goods sold for the book value of the leased (sold) asset.

If the book value of the asset is equal to the PV of the lease payments, it is a direct financing lease and there is no gain or loss on sale. However, if these numbers are different, it is called a sales-type lease and the lessor will recognize a gain or loss equal to the difference. The remainder of the lease accounting is principally the same as the lessee. For the lessor to account for the lease as a finance lease, there are three criteria that must be met:

- The lease must be accounted for as a finance lease by the lessee.
- There is a reasonable assurance that minimum lease payments are collectible.
- There are no uncertainties regarding the costs to the lessor associated with the lease.

If all the criteria are met, the lessor will account for the lease as a finance lease. If any are not met it will be an operating lease, accounted for in the same manner as for the lessee.

In addition to operating leases, this manual will not cover sales-type leases (leases where the lessor makes profits on the sale of the asset and on the financing to the lessee). This is because the majority of emerging market leases will be of the direct financing variety, where the lessor just profits on the financing of the asset; that is, PV of the MLP is equal to the carrying value of the leased asset (where the PV of MLP > CV of the leased asset, it is a sales-type lease). Consequently, in a direct financing lease

there is no profit recognized on sale. This is because the PV of the asset on the lessor's books is the same as the fair value (FV) of the MLP. The lessor has only one profit from this transaction: the interest income received over the life of the lease (see figure 3-3).

Figure 3-3. Recording the Lease: Lessor Journal Entries for Year One

January 1, 2001				
	Dr	Lease Receivable	100,000	
		Cr	Sales Revenue	83,398
			Unearned Interest Income	16,602
<i>To record the sale (lease) of the asset.</i>				
	Dr	Cost of Goods Sold	83,398	
		Cr	Fixed Assets	83,398
<i>To remove the asset from our books and to recognize the cost of goods sold. The combination of this journal entry with the previous one will give us no profit on the sale of the asset, as the revenue and COGS amounts are the same.</i>				
	Dr	Cash	20,000	
		Cr	Lease Receivable	20,000
<i>To record the initial collection due at the signing of the lease.</i>				
December 31, 2001				
	Dr	Unearned Interest Income	6,340	
		Cr	Interest Income - Lease	6,340
<i>To record the interest that has accrued during the year on the outstanding principal.</i>				
January 1, 2002				
	Dr	Cash	20,000	
		Cr	Lease Receivable	20,000
<i>To record the second lease payment, recognizing the payment of the accrued interest at 12/31/01.</i>				

Accounting for the Costs of the Lease

There are two types of costs associated with the creation and execution of leases—direct costs and indirect costs. The source of direct costs is negotiating and closing the lease, inspection and valuation of collateral and security deposits, the preparation of documents, and finders' fees; these costs are capitalized and recognized as a reduction of interest rate implicit in the lease. The source of indirect costs is advertising, servicing an existing lease, establishing and monitoring credit policies, and administrative expenses; these costs are expensed.

Lease Disclosures of the Lessor

IAS-17 specifies disclosures about leases, in addition to disclosures required by other standards. The lessor will need to disclose any contingent rentals that are included in any income statements that are presented. These contingent rentals are those that have been recognized as revenue in the current period on the expectation that some event will occur in the future. Specifically,

- Reconciliation between gross investment in the lease and the PV of MLP
- Gross investment and PV of MLP receivable for the next year, years 2 through 5 combined, and beyond 5 years
- Unearned finance income
- Unguaranteed residual values
- Accumulated allowance for uncollectable lease payments receivable
- Contingent rent recognized in income
- General description of significant leasing arrangements

Tax Treatment of Leases

It is tempting to avoid the subject of taxation and leasing, as well as other “indirect” issues affecting leasing, such as regulation and accounting. As previously noted, many countries have followed the approach of avoiding selection of one form of finance over another, solely for tax purposes, to avoid regulation, or to show different accounting results. However, that is not always possible. While leasing is essentially not complex, it can have profoundly different effects depending on the local context. This has been true from the inception of leasing and is demonstrated by the different levels of leasing in different markets. In some, the desire is to increase leverage without showing the “true” or comparable balance sheet, thereby boosting apparent returns (known as off-balance-sheet financing). In other markets, leasing is subject to less regulation than other forms of lending, thus reducing costs for leasing companies. Finally, tax treatment greatly affects the cost of financing.

The box below on leasing taxation aims to highlight the impact of some of the tax benefits that may be attached to leasing. Tax benefits are provided by governments for policy reasons, whether to increase investment in the SME sector or to increase the amount of value-added within a country by boosting the domestic processing and service sectors. Tax benefits may arise in various forms and affect the treatment of key financial elements to produce what is hoped to be a positive beneficial effect for the companies involved and hence the economy.

Leasing Taxation

There should be a level playing field in terms of the tax effects of domestic credit offerings, and leasing should be competitive with other forms of credit; that is, the decision to lease an asset should be tax neutral when compared against the decision to take on other forms of bank credit.

However, governments retain the right to attach preferential tax treatments to leasing in the interests of domestic development. Thus, any tax benefits should be moderate, as the overendowment of preferential tax treatments on leasing may cause distortions in domestic markets and ultimately a negative effect on the general financial sector.

A government may introduce certain measured preferential tax treatments, should its policy be to encourage investment by stimulating the leasing sector domestically. However, the main reason to provide preferential treatment should be to increase domestic investment, not to stimulate the leasing sector. Furthermore, experience has shown that the introduction of any preferential tax treatment should be for a limited time period, and that period should be published at the time of introduction to enable the sector to plan accordingly. Ultimately, the whole tax system must be considered. In many cases, some tax benefits are given to offset other disadvantages, and this approach may be pragmatic and effective. Judgments will therefore have to be made in situ as to what is appropriate.

Key elements include:

- VAT
 - VAT on import
 - VAT on delivery
 - VAT on lease payments
- Customs duties on the importation of equipment
- Income tax
 - Deductibility of lease payments/accelerated depreciation
 - Lessor profits

This manual examines the impact of some of the benefits that can be introduced, how these work, and what can be recommended.

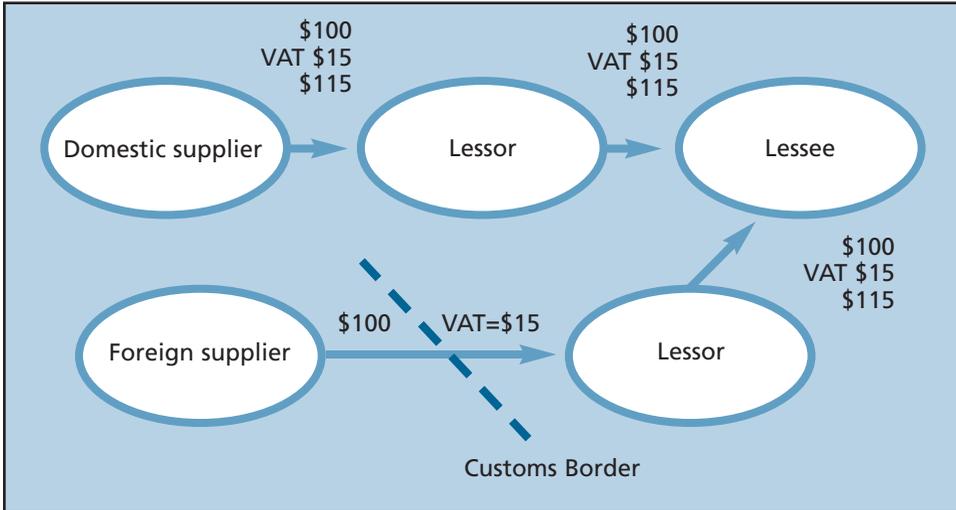
- Value-added tax: VAT is levied at a set percentage for each country (for example, 14% in South Africa, 15% in Kazakhstan and 17.5% in the United Kingdom) on applicable items. Leasing is affected by VAT in several respects. VAT can be levied at the applicable rate for:
 - Importation of equipment: VAT can be levied on the customs value of equipment brought into a country (see table 3.2 and figure 3.4).
 - Delivery: VAT is levied on the turnover of products or services (see table 3.2 and figure 3.4).
- Lease payments: Where leasing is deemed to be as service (not a financial service), it may be levied on the interest portion of the lease payment under existing leasing legislation.

Table 3-2. Effect of Removal of VAT on Importation of Leasing Equipment

Policy	Effect
<p><i>Remove VAT on importation of equipment.</i></p>	<p>Significant</p> <p>Issue: In many cases, VAT charged on foreign equipment purchases cannot be offset against domestic output VAT. The equipment is therefore automatically more expensive when domestic lessors or dealers import foreign equipment.</p> <p>Solution: Governments may choose to make the importation of certain classes of foreign equipment VAT exempt, thus stimulating capital investments in some priority sectors of the economy. This would have a significant effect on the importation of foreign-made equipment, along with reducing customs duties.</p> <p>Pros: Good for improving the quality of domestic processing equipment and increasing a country's processing capacity and productivity.</p> <p>Cons: May benefit only those companies/groups with assets sufficient to buy foreign goods in the first place. Potentially open to abuse, depending on assets allowed to be imported without VAT.</p> <p>Conclusion: Depending on local government policy and the application of certain controls, experience has shown that this can be a useful tool. Leasing companies should receive similar treatment as other companies, subject to the discussion below.</p>

Figure 3-4. Process of VAT Levy and Removal on Importation of Equipment

(a) *Levy of VAT*



(b) *Removal of VAT*

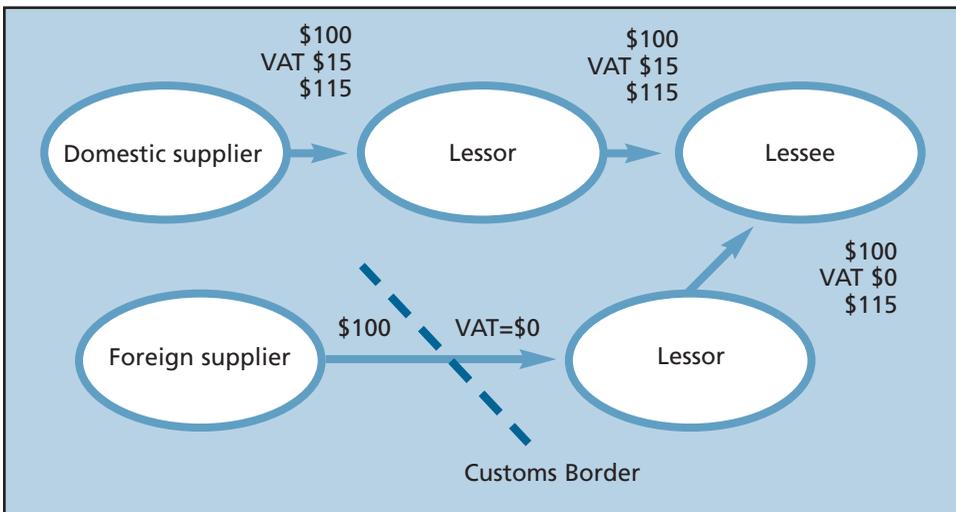


Table 3-3. Effect of Removal of VAT on Delivery of Leased Equipment

Policy	Effect
<p><i>Removal of VAT on delivery.</i></p>	<p><i>Significant</i></p> <p>Issue: Governments may decide to introduce a policy making equipment sales involving leasing exempt from VAT, with no VAT being charged on the final sale of the equipment. This differs from the usual practice of allowing companies to offset input and output VAT.</p> <p>Where the policy of VAT exemption is passed, this effectively breaks the chain of VAT reclamation and means the last link in the chain (normally the dealer) is unable to offset the input VAT (paid on the purchase of the equipment) successfully.</p> <p>Many countries have followed the approach of allowing corporations to reclaim the VAT payable on assets (as well as VAT rated products and services) used in their businesses.</p> <p>Pros: Making VAT reclaimable aids businesses by allowing them to offset this with output (sales) VAT payable. Non-paying VAT businesses (micro businesses) are able to lease without incurring VAT that they might not already have.</p> <p>Cons: By removing VAT on delivery the VAT reclaim/offset chain is broken, which severely and adversely affects local equipment suppliers.</p> <p>Conclusion: VAT should be reclaimable by businesses rather than removing VAT on delivery.</p>

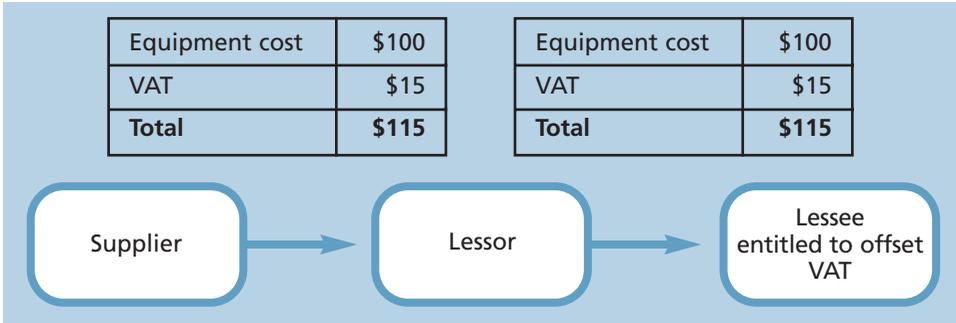
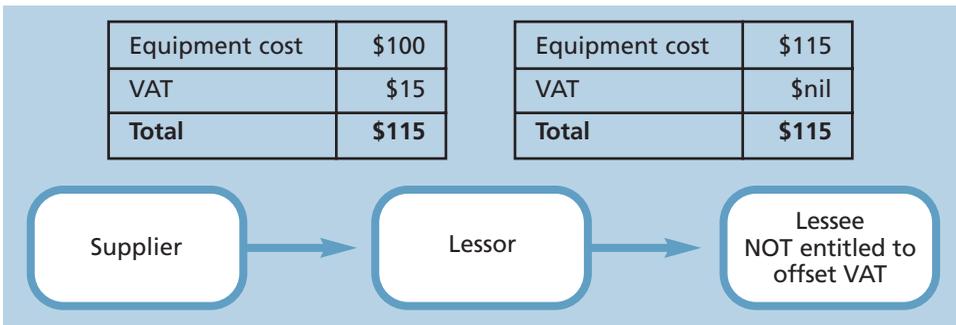
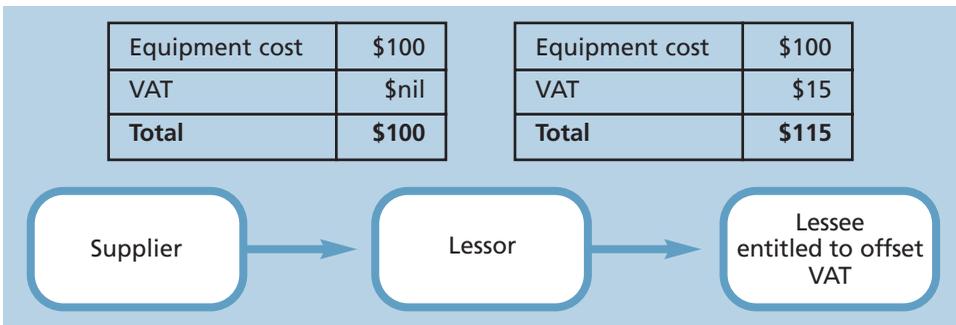
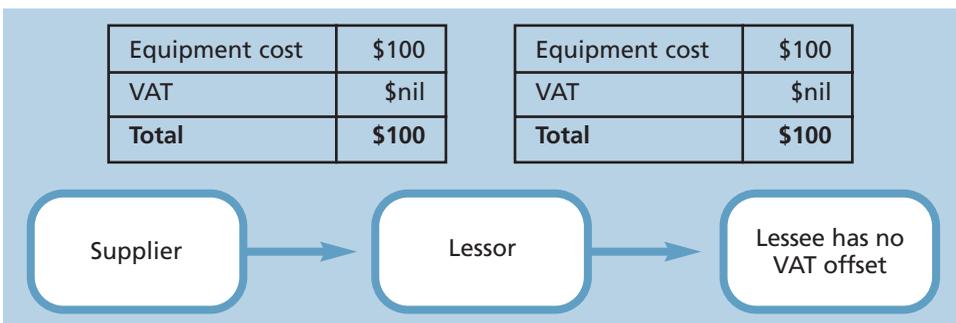
Figure 3-5. Four Approaches for Applying VAT to Leasing Equipment*(A) Both equipment sale-purchase (import) and lease are VAT levied.**(B) Equipment sale-purchase (import) is VAT levied but leasing is VAT exempt.**(C) Equipment sale-purchase (import) is VAT exempt but leasing is VAT levied.**(D) Both equipment sale-purchase (import) and lease are VAT exempt.*

Figure 3-5 shows options that many countries have followed in levying VAT on equipment. The logic is that if VAT is levied at the sale of the equipment, it should be levied within the whole chain and the offset is available. Where the policy of VAT exemption is passed, this effectively “breaks the chain” of VAT reclamation and means that the next link in the chain is unable to offset the input VAT (paid on the purchase of the equipment).

Some countries exempt leasing from VAT as a financial service (option B). This means that the whole lease payment is exempted and a problem exists for the lessee, who is unable to offset. The equipment effectively costs the same for the lessee, but this is even worse for the lessee than when leasing is VAT levied because there is no offset for the lessee.

In option C, there is an exemption of VAT similar to the “Remove VAT on importation of equipment” section. However, this recommendation will not have an impact if there is no exemption of leasing itself (see table 3-4). Therefore, this option must be coupled with another exemption of the transfer of the asset from the lessor to the lessee—otherwise it will not change anything.

Therefore, options A and D are recommended for the following reasons:

- If there is a VAT on sales (import) charged, the transfer of equipment must also be VAT levied.
- If there is no VAT on sales (import) charged, the transfer of equipment must not be VAT levied as well.

Customs Duties

Leased equipment may be eligible for either a partial or a full customs duty allowance. These expenses and the apparatus surrounding customs control may form a significant barrier to access to imported equipment and curtail the opportunity to acquire potentially higher tech goods/attain greater productivity (see table 3-5).

Depreciation

As discussed, all business assets need to be depreciated over their useful economic life with the annual depreciation expense allowable against gross income, reducing corporate income tax. The parameters of the rate at which assets may be depreciated are often laid down within corporate or national policies.

A key benefit that is attached (by some countries) to leased assets is the opportunity to speed up the rate of depreciation. Hence the term *accelerated depreciation*, that is, to allow an increased portion to be written off against corporate income and thus further reduce the amount of tax payable (see table 3-6).

Table 3-4. Effect of Charging VAT Only on Equipment Cost

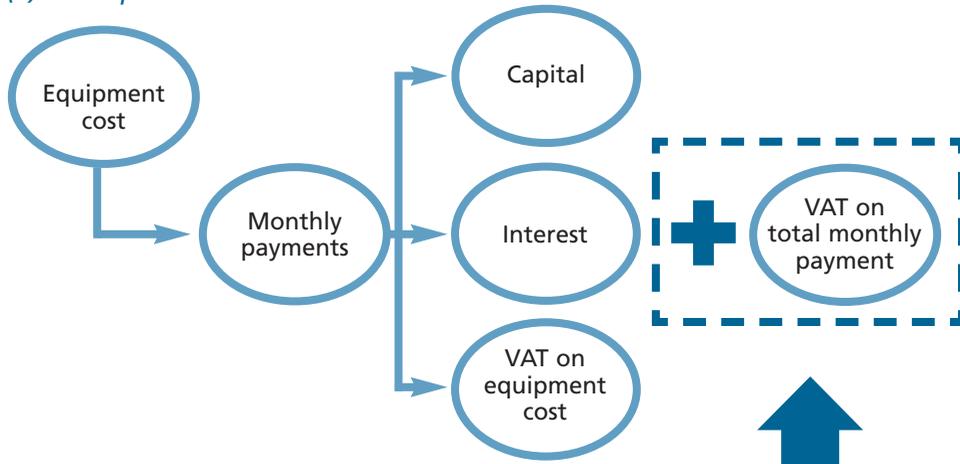
Policy	Effect
<p><i>VAT to be charged only on equipment cost.</i></p>	<p>Significant</p> <p>Issue: The monthly leasing repayment includes a portion of the capital (equipment) cost, the VAT on the capital cost and interest on the capital cost.</p> <p>Some countries where leasing is not classed as a financial service charge VAT not only on the equipment cost but also on the interest portion of the monthly lease repayment (figure 3-6a).</p> <p>This makes leases uncompetitive against other forms of finance where no VAT is payable on the repayment, for example, loans.</p> <p>Where a country classifies leasing as a financial service, VAT will not be levied on the interest portion of the lease payment (figure 3-6b).</p> <p>This effectively makes leasing equal to the tax treatment of loans where no VAT is payable on repayments.</p> <p>Pros: Provides a level playing field for leasing vis-à-vis loans and the tax treatment.</p> <p>Cons: None, except as with all VAT/tax offset capabilities this reduces the government's ability to raise tax revenue.</p> <p>Recommendation: This is an important aspect of tax legislation to ensure that leasing has a level playing field with other credit providers.</p>

Table 3-5. Effect of Waiving Import Duties for Certain Leased Assets

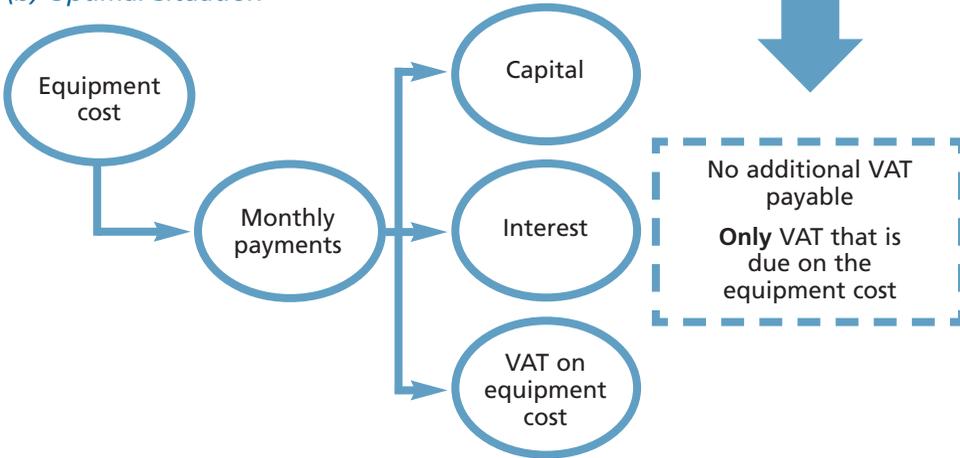
Policy	Effect
<p><i>Allow certain leased assets to be excused import duties.</i></p>	<p>Significant</p> <p>Though it would have a significant effect on the importation of foreign-made equipment, duty exemption is probably not an essential introduction for stimulating leasing. The treatment of leasing should not be different from that applied to other importers.</p> <p>Pros: Good for improving the quality of domestic processing.</p> <p>Cons: May benefit only those companies/groups with assets sufficient for buying foreign goods at all. Potentially open to abuse, depending on assets allowed to be imported without duty.</p> <p>Conclusion: Depending on local government policy, and the application of certain controls, this can be a useful tool.</p>

Figure 3-6. Effect of Charging VAT Only on Equipment Cost

(a) *Non-optimal Situation*



(b) *Optimal Situation*



This “accelerated depreciation” allowance for leased assets thereby encourages investment in fixed assets (albeit through leasing) in order to receive any tax benefits associated. In principle, accelerated depreciation should be the same for all forms of “capital investment.” In practice, factors like balance sheet choice and depreciation policies in general need to be considered. Finally, financial leasing is a form of capital investment that is somewhat more difficult to manipulate for tax purposes, since by definition it involves longer-term finance.

Table 3-6. Effect of Allowing Leased Assets to Be Eligible for Accelerated Depreciation

Policy	Effect
<p><i>Allow leased assets to be eligible for accelerated depreciation.</i></p>	<p>Significant</p> <p>By allowing companies to accelerate the rate at which they depreciate their assets, policy makers are providing a valuable and targeted benefit to the industry.</p> <p>It is important that policy makers control which assets this benefit is attached to, and it may be prudent to announce at the outset the length of time for the benefit.</p> <p>Pros: Targeted asset-based incentive that encourages increased investment.</p> <p>Cons: Policymakers must clarify which asset classes receive the benefit because if attached only to leased assets, this discriminates against non-leased asset purchases.</p> <p>Conclusion: Experience has shown that while accelerated depreciation is an effective incentive to increased investment, the terms of the benefit should be limited and clearly stated at their introduction, with any benefit having a definite lifespan and subject to review after a set period of time.</p>

Balance Sheet Treatment for Leases

With leasing, there is a potential for either the lessor or lessee to claim “possession” of the asset. Lessors can claim legal ownership, whereas lessees have all the risks and rewards of ownership and can also justifiably claim possession. Policies vary between countries as to whether lessors or lessees can claim possession and include assets under lease in their balance sheet for tax purposes. Note that this policy applies only to tax accounting and not to financial accounting.

IAS-17 has made this issue clear for accounting purposes. IAS-17 states that the balance holder of the leased asset should be the lessee in a financial lease, and this is best practice for accounting purposes.

Experience has shown that under any lease agreement, lessors and lessees should have the right to agree as to which party will be able to include the leased asset on the balance sheet for tax purposes, and thus claim the capital allowances.

Furthermore, many countries have found that making one or the other the prescribed owner is not as progressive, and that flexibility of treatment is best recommended. The local context is important, however, and must be carefully considered.

Table 3-7. Effect of Deducting a Portion of Repayment from Gross Income

Policy	Effect
<p><i>Lessees are able to deduct a portion of their repayments from gross income, reducing corporate profits tax payable.</i></p>	<p><i>Mild to significant, depending on “portion”</i></p> <p>This allows lessees to deduct a portion, either at a minimum the interest element or more generously the entire repayment, from gross income.</p> <p>Pros: At least provides a level playing field for leasing vs. other forms of credit, and encourages borrowers to choose the lease option.</p> <p>Cons: There are no negatives in allowing interest to be deducted from gross income. However, allowing more than the interest, and especially the whole repayment, blurs the definition of finance leasing by removing some of the risks of ownership and aligning it more with operating leasing or rental.</p> <p>Conclusion: Experience has shown that only the deduction of interest from gross income should be permissible in those cases in which the balance holder for tax purposes is the lessee. Any greater benefit has shown to be unnecessary. In those cases where the balance holder for tax purposes is the lessor, a full deduction is permissible.</p>

Income Tax for Lessees

In addition to (accelerated) depreciation being deducted from gross income, reducing income tax, there have been varying levels of assistance applied to the lessee’s ability to deduct lease payments from gross income (see table 3-7).

At a minimum, lessees should be able to deduct the interest portion of their repayment from gross income (see previous accounting section). However, in certain jurisdictions policymakers have taken additional steps to allow lessees to claim the whole amount of the repayment against income (corporate profits) tax. Typically, a lessee can deduct the whole payment in cases where the lessor remains the balance holder for tax purposes of the leased asset.

Income Tax for Lessors

Regarding income tax, some policymakers have allowed lessors a very direct and beneficial allowance of not being subject to income tax (see table 3-8). While this obviously acts as an incentive for leasing, it is typically not recommended as either a prudent or sustainable benefit to be attached to leasing. In fact, the effects are likely to be highly distortionary and negative over the long term.

This policy seems prudent, as it gives lessors a significant advantage against other credit providers and does nothing to encourage them to develop or improve their business practices, while encouraging non-market-oriented development of companies. Having a section of the economy that is not subject to income tax while every other sector is does not build sustainability. If firms come to rely on this benefit or even set up and structure themselves just to benefit from this perk, the leasing sector could suffer as a result.

Table 3-8. Effect of Excusing Lessors from Income Tax

Policy	Effect
<p><i>Lessors are not subject to income (corporate profits) tax.</i></p>	<p>Significant</p> <p>This excuses lessors from paying the income tax that would normally be levied on business profits.</p> <p>Pros: Encourages use of leasing.</p> <p>Cons: Development of leasing may not reflect the real domestic demand, but rather aim to avoid payment of corporate income tax.</p> <p>Conclusion: For most countries, this benefit at best is unnecessary for encouraging the development of lessors, and at worst is damaging to the long-term sustainability and development of the sector.</p>

Cross-Border Leasing

Cross-border leasing often attracts considerable attention for several reasons. First, it often involves particularly expensive capital assets, such as aircraft. Second, the tax implications can be highly complicated. Finally, it is often (incorrectly) associated with foreign investment. In principle, no special incentives should be required, and in practice they rarely are. If the import or leasing of certain assets is desirable, it should be encouraged directly and not through cross-border leasing.

It is important to remember that internationally, assets that are leased on a cross-border basis are typically limited to assets that are actually used across borders, such as airplanes, certain rail equipment, ships, and transport vessels. Most other types of assets are simply leased domestically.

Finally, cross-border leasing should ideally have no particular advantages or disadvantages over domestic leasing. In practice, relatively small amounts of equipment are financed on a cross-border basis worldwide, although the amounts are significant in certain industries.

Glossary

Accelerated Depreciation. An accounting method that allows a company to write off an asset's cost at a faster rate than the traditional straight line method, that is, not spreading the cost evenly over the life of the asset. This includes any depreciation method that produces larger deductions for depreciation in the early years of a project's life. It often results in a larger tax deduction on a company's income statement.

Accelerated cost recovery schemes, through accelerated depreciation, may be allowed for policy and tax purposes. These schemes include double-declining-balance depreciation or sum-of-the-years'-digits depreciation. Accelerated depreciation is a method of speeding up the write-off from income of qualifying investments at a faster than normal rate. Annual tax deductions are higher in the first years and diminish in later years of the write-off.

Acceptance Letter. Generally a letter signed by the lessee signifying the equipment has been delivered; however, this will depend on the terms and conditions of delivery. The letter allows the lessor to pay the vendor. Also called Delivery and Acceptance (D&A).

Accounting Rate of Return. The interest rate earned by the lessor in a lease measured by the difference between gross rentals and the value of investment in the lease, calculated on an annual basis.

Accumulated Depreciation. A financial reporting term for a contra-asset account that shows the total depreciation charges for an asset since acquisition.

Advance Payments. One or more lease payments required to be paid to the lessor at the beginning of the lease term as part of the execution of the lease. Lease structures commonly require one payment to be made in advance. This term also refers to leasing arrangements in which the lease payment is due at the beginning of each period.

Advance Rental. Any payment in the form of rent made before the start of the lease term. The term also is used to describe a rental payment arrangement in which the lessee pays each rental, on a per period basis, at the start of each rental payment period. For example, a quarterly, in advance, rental program requires the lessee to pay one-fourth of the annual rental at the start of each consecutive three-month period during the lease term.

Amortization. The process of separating payments into their principal and interest components. An amortized loan is one in which the principal amount of the loan is repaid in installments over the life of the loan, with each payment comprised partially of interest and partially of principal.

Assign. To transfer or exchange future rights. In leasing, the right to receive future lease payments in a lease is often transferred to a funding source, in return for up-front cash. The up-front cash represents the loan proceeds from the funding source, and is equal to the present value of the future lease payments discounted at the leasing company's cost of borrowing. A lease assigned by the lessor to a funding source is called an assigned lease. The assignment of leases is a very common funding technique used by leasing companies.

Assignment. The legal transfer of title to property. The right of the lessor and lessee to transfer their rights and/or obligations under the lease agreement to third parties.

Balloon Payment. A large payment at the end of the loan allowing smaller payments to be made during the term.

Bankruptcy. An action taken by a party to legally protect its remaining assets by declaring that it cannot pay its bills. Typically, liabilities exceed assets. A common definition in the United States for bankruptcy is interest coverage less than one. A firm is generally forced into bankruptcy not when liabilities are greater than assets, but when the firm cannot make its interest payments with current earnings before interest and taxes.

Bargain Purchase Option. A lease provision allowing the lessee, at its option, to purchase the leased property at the end of the lease term for a price sufficiently lower than the expected fair market value of the property, such that exercise of the option appears at the inception of the lease to be reasonably assured.

Broker. An entity which specializes in the arranging of lease transactions between a lessor and a lessee for a fee.

Capital Allowances. Depreciation allowances on assets as allowed by income tax provisions of a country.

Capital Lease. A lease in the United States is classified as a capital lease if it satisfies any of the following: (a) The lease transfers ownership to the lessee at the end of the lease term; (b) The lease contains an option to purchase the property at a bargain price; (c) The lease term is equal to 75% or more of the economic life of the property; (d) The present value of minimum lease rental payments is equal to 90% or more of the fair market value of the leased property less related investment tax credit retained by the lessor. Such a lease is required to be shown as an asset and a related obligation on the balance sheet of the lessee.

Capitalize. To record an expenditure that may benefit future periods as an asset rather than as an expense to be charged off in the period of its occurrence.

Captive Lessor. A leasing company that has been set up by a manufacturer or equipment dealer to finance the sale or lease of its own products to end-users or lessees.

Certificate of Delivery and Acceptance (D&A). A document signed by the lessee to acknowledge that the equipment to be leased has been delivered and is acceptable. Many lease agreements state that the actual lease term commences once this document has been signed.

Civil Law. The civil law system is the most common foundation of legal systems around the world. It is an alternative to common law system and, like common law has its roots in Roman law, though civil law resembles Roman law to a greater extent than common law.

In most jurisdictions, civil law is codified in the form of civil codes, but in some it remains uncoded. Most codes follow the tradition of the Code Napoléon in some fashion, though each country may adapt its civil code to local legal tradition, as is done in Germany.

Civil law is employed by almost every country that was not a colony of the British Empire, including Continental Europe, Quebec, Louisiana, the former Soviet bloc, and much of the rest of the world.

Collateral. This refers to the security that is made available to secure finance. In leasing, collateral can be a pledge of property, bank guarantee etc., and usually refers to the leased equipment.

Common Law. Originally based on Roman law, it developed into a tradition of its own in England, from where it expanded to the United Kingdom (apart from Scotland), to the United States (apart from Louisiana), and to most former British colonies.

Common law is a system of jurisprudence based on judicial precedents rather than statutory laws. The form of reasoning used in common law is known as case-based reasoning. Common law may be unwritten or written in statutes or codes.

Common law, as applied in civil cases (as distinct from criminal cases), was devised as a means of compensating someone for wrongful acts known as torts, including both intentional torts and torts caused by negligence, and as developing the body of law recognizing and regulating contracts. Today, common law is generally thought of as applying only to civil disputes.

Cost of Capital. The weighted-average cost of funds that a firm secures from both debt and equity sources in order to fund its assets. The use of a firm's cost of capital is essential in making accurate capital budgeting and project investment decisions.

Credit References. Banks and suppliers used in the lessee's business and listed on the lease application. Lessor will contact them to check lessee payment habits.

Credit Scoring. An objective method of quantifying creditworthiness by assigning numerical values based on meeting established credit criteria.

Cross-border Leases. A lease deal under which the lessor is located in one country and the lessee is located in a different country.

Default. A condition whereby the lessee does not make the payments required by the lease contract.

Depreciation. A means for a firm to recover the cost of a purchased asset, over time, through periodic deductions or offsets to income. Depreciation is used in both a financial reporting and tax context, and is considered a tax benefit because the depreciation deductions cause a reduction in taxable income, thereby lowering a firm's tax liability.

Discount Rate. An interest rate used to bring a series of future cash flows to their present value in order to state them in current, or today's, currency. Use of a discount rate removes the time value of money from future cash flows.

Early Termination. Premature termination of the contract occurring when a party to a lease fails to meet its obligations under the lease contract, to the extent that entitles the other party (under the law or the agreement) to demand such termination.

Economic Life of Leased Property. The estimated period during which the property is expected to be economically usable by one or more users, with normal repairs and maintenance, for the purpose for which it was intended at the inception of the lease.

Effective Interest Rate. The interest rate on a lease stated on an annual basis. The rate includes the compounding effect of interest during the year.

End-of-term Options. Stated in the lease agreement, options give the lessee flexibility in its treatment of the leased equipment at the end of the lease term. Common end-of-term options include purchasing the equipment, renewing the lease or returning the equipment to the lessor.

Equipment Schedule. A document incorporated by reference into the lease agreement that describes in detail the equipment being leased. The schedule may state the lease term, commencement date, repayment schedule, and location of the equipment.

Equipment Specifications. A specific description of a piece of equipment that is to be acquired, including, but not limited to, equipment make, model, configuration, and capacity requirements.

Estimated Residual Value of Leased Property. The estimated fair value of the property at the end of the lease term.

Fair Market Value (FMV). The value of a piece of equipment if it were to be sold in a transaction determined at arm's length, between a willing buyer and a willing seller, for equivalent property and under similar terms and conditions.

Finance Lease. Finance leases transfer substantially all the risks and rewards incident to ownership to the lessee.

Full-payout Lease. A lease in which the lessor recovers, through the lease payments, all costs incurred in the lease plus an acceptable rate of return, without any reliance upon the leased equipment's future residual value.

Funding. The process of paying the manufacturer of the equipment for the equipment being placed on lease.

Funding Source. An entity that provides any part of the funds used to pay for the cost of the leased equipment. Funds can come from either an equity funding source, such as the ultimate lessor in a lease transaction, or a debt funding source, such as a bank or other lending institution.

Guaranteed Residual Value. A situation in which the lessee or an unrelated third party (for example, equipment manufacturer, insurance company) guarantees to the lessor that the leased equipment will be worth a certain fixed amount at the end of the lease term. The guarantor agrees to reimburse the lessor for any deficiency realized if the leased equipment is salvaged subsequently at an amount below the guaranteed residual value.

IAS-17. The International Accounting Standard (IAS) 17 on lease accounting was published by the IAS committee in London in September 1982 and has been updated regularly. IAS-17 prescribes, for lessees and lessors, the accounting policies and disclosure to apply to leases.

Implicit Rate. The discount rate that, when applied to the minimum lease payments (excluding executory costs) together with any unguaranteed residual, causes the aggregate present value at the inception of the lease to be equal to the fair market value (reduced by any lessor retained investment tax credits) of the leased property.

Inception of a Lease. The date of signing of the lease commitment or agreement where the property to be leased has been constructed or has been acquired by the lessor; otherwise, the date construction is completed or the property is acquired by the lessor.

Incremental Borrowing Rate of Interest. The interest rate the lessee would have to pay on a similar lease. Or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with similar security, the funds necessary to purchase the asset.

Independent Lessor. A type of leasing company that is independent of any one manufacturer, and as such purchases equipment from various unrelated manufacturers. The equipment then is leased to the end-user or lessee. This type of lessor also is referred to as a third-party lessor.

Initial Direct Costs. Costs incurred by the lessor that are directly associated with negotiating and consummating a lease. These costs include but are not limited to commissions, legal fees, costs of credit investigations, and the cost of preparing and processing documents for new leases acquired.

Insured Value. A schedule included in a lease which states the agreed value of equipment at various times during the term of the lease, and establishes the liability of the lessee to the lessor in the event the leased equipment is lost or rendered unusable during the lease term due to a casualty.

Interest. The difference between the total loan payments and original loan amount (principal). Interest is to a loan as earned income is to a lease.

Interest Expense. An amount paid to a lender in return for a loan. Typically the interest is paid out over time, accompanied by a reduction in loan principal.

Interest Rate Implicit in a Lease. The discount rate which, when applied to minimum lease payments and unguaranteed residual value, causes the aggregate present value at the beginning of the lease term to be equal to the fair value of the leased property at the inception of the lease minus any investment tax credit retained by the lessor.

Internal Rate of Return (IRR). Financial analysis technique used to assess the profitability of an investment proposal. The internal rate of return is the rate at which the cash flows associated with an investment sum to zero upon discounting. The rate thus computed is compared with the cost of capital to arrive at a judgment on the financial viability of an investment.

Lease. A contract between the owner of an asset and its user for the hire of that asset. The ownership rests with the lessor, while the right to use the asset is given to the lessee for an agreed period of time in return for a series of rentals paid by the lessee to the lessor.

Lease Agreement. The contractual agreement between the lessor and the lessee that sets forth all the terms and conditions of the lease.

Lease Expiration. The time at which the original term of the lease contract has ended.

Lease Origination. The process of uncovering (through a sales force), developing and consummating lease transactions. Steps in the process include, but are not limited to, prospecting for new lease business, pricing potential transactions, performing credit reviews, and completing the necessary documentation.

Lease Payments. Also called rentals. The amount the lessee pays the lessor in return for using the leased equipment.

Lease Rate. The equivalent simple annual interest rate implicit in the minimum lease rentals. This is not the same as the interest rate implicit in a lease, which reflects the compounding effect.

Lease Term. The fixed, non-cancelable term of the lease. Includes, for accounting purposes, all periods covered by fixed-rate renewal options which for economic reasons appear likely to be exercised at the inception of the lease. Includes, for tax purposes, all periods covered by fixed-rate renewal options.

Lessee. The user of the equipment being leased.

Lessor. The owner of the equipment which is being leased to the lessee.

Lien. A security interest on property to protect the lender in the event of lessee default.

Minimum Lease Payments for the Lessee. All the payments the lessee is obligated to make or can be required to make in connection with leased property, including residual rents or purchase options, but excluding guarantees of lessor's debt and executionary costs such as insurance.

Minimum Lease Payments for the Lessor. The payments considered minimum lease payments for the lessee, plus any guarantee by a third party of the residual value or rental payments beyond the lease term.

Net Present Value. The total discounted value of all cash inflows and outflows from a project or investment.

Nominal Interest Rate. Interest rate stated as an annual percentage without including the effect of interest during the year.

Off-Balance-Sheet Financing. Any form of financing such as an operating lease that, for financial reporting purposes, is not required to be reported on a firm's balance sheet.

Operating Lease. A lease arrangement wherein the lessor seeks to recover his investment in a lease by leasing the equipment to more than one lessee. For financial accounting purposes, an operating lease is a lease that does not meet the criteria for a capital lease or direct financing lease. Also, used generally to describe a short-term lease whereby a user can acquire use of an asset for a fraction of the useful life of the asset. The lessor may provide services in connection with the lease such as maintenance, insurance, and payment of personal property taxes.

Original Equipment Cost (OEC). The amount the lessor pays the vendor for the equipment at the beginning of the lease. Usually includes up-front sales tax.

Payment Stream. The rentals due in a lease.

Payments in Advance. A payment stream in which each lease payment is due at the beginning of each period during the lease.

Payments in Arrears. A payment stream in which each lease payment is due at the end of each period during the lease.

Present Value. The discounted value of a payment or stream of payments to be received in the future, taking into consideration a specific interest or discount rate. Present value represents a series of future cash flows expressed in today's money.

Pricing. Arriving at the periodic rental amount to charge a lessee. A lessor must factor many variables into its pricing, which may include lease term, lessor targeted yield, security deposits, residual value and tax benefits.

Primary Period. The period, in a finance lease, during which the lessor expects to recover the full capital cost of the asset, along with the calculated profit.

Purchase Option. An option in the lease agreement that allows the lessee to purchase the leased equipment at the end of the lease term for either a fixed amount or at the future fair market value of the leased equipment.

Related Parties. In leasing transactions, a parent and its subsidiaries, an investor and its investees, provided the parent, owner, or investor has the ability to exercise significant influence over the financial and operating policies of the related party.

Remarketing. The process of selling or leasing the leased equipment to another party upon termination of the original lease term. The lessor can remarket the equipment or contract with another party, such as the manufacturer, to remarket the equipment in exchange for a remarketing fee.

Renewal Option. An option in the lease agreement that allows the lessee to extend the lease term for an additional period beyond the expiration of the initial lease term, in exchange for lease renewal payments.

Repossession. A situation in which a lessor reclaims and physically removes the leased equipment from the control of the lessee, usually because of payment default.

Residual or Residual Value. The market value of equipment prevailing at the end of the lease term.

Sale-Leaseback. A transaction that involves the sale of equipment to a leasing company and a subsequent lease of the same equipment back to the original owner, who continues to use the equipment.

Salvage Value. The expected market value of an asset on the expiration of its useful economic life.

Secondary Period. Frequently optional, the period in a finance lease which follows the minimum lease period during which lease rentals are usually placed at a nominal value, as the lessor would already have recovered his investment and profit during the primary lease period.

Securitization. The process of selling lease receivables to a separate legal entity that issues stocks and bonds to investors. The investors' proceeds flow through to the company that sold the receivables, and the investors receive their returns from collecting lessee receivables.

Straight-line Depreciation. A method of depreciation (for financial reporting and tax purposes) where a capital asset is depreciated by the same amount each year over the asset's useful life. The cost (or other valuation basis) minus salvage value is divided by the number of years the asset is expected to remain useful and efficient.

Sub-lease. A transaction in which leased property is re-leased by the original lessee to a third party, and the lease agreement between the original parties remains in effect.

Substance versus Form. A concept that implies that the form of a document is subordinate to the intent of the parties involved in the document.

Sum of the Digits Method. A depreciation method for assets providing for the largest proportion of depreciation to be charged at the beginning of the asset's life, with smaller charges in later years.

Tax Written Down Value. The value of an asset after deducting the total capital allowances claimed from the cost of the asset.

Termination Value. The liability of the lessee in the event of termination is set forth in a termination schedule that values the equipment at various times during the lease term. This value is designed to protect the lessor from loss of investment. If the equipment is sold at a price lower than the amount set forth in the schedule, the lessee pays the difference. In the event the resale is at a price higher than in the termination schedule, such excess amounts belong to the lessor. The termination schedule is not the same as the casualty value schedule, insured value schedule or stipulated loss value schedule.

Third-Party Lessor. An independent leasing company, or lessor, that writes leases involving three parties: 1) the unrelated manufacturer, 2) the independent lessor, and 3) the lessee.

Ticket Size. Refers to the cost of equipment being leased. The leasing marketplace is roughly segmented into the small, middle and large ticket markets.

Two-party Lessor. A captive leasing company, or lessor, that writes leases involving two parties: 1) the consolidated parent and/or captive leasing subsidiary and 2) the lessee or end-user of the equipment.

Useful Life. The period of time during which an asset will have economic value and be usable. The useful life of an asset is sometimes called its economic life.

Vendor Leasing. Lease financing offered to an equipment end-user in conjunction with the sale of equipment. Vendor leases can be provided by the equipment vendor (manufacturer or dealer) or a third-party leasing company with a close working relationship with the equipment vendor.

Withholding Tax. Payable on the rentals received from many cross-border leases, depending on the double-taxation arrangements between the countries involved. May be prohibitively high.

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