

Leasing for Small and Micro Enterprises

*A guide for designing and managing
leasing schemes in developing countries*

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LEASING FOR SMALL AND MICRO ENTERPRISES:
A GUIDE FOR DESIGNING AND MANAGING LEASING SCHEMES
IN DEVELOPING COUNTRIES

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This manual was prepared jointly by Linda Deelen, Mauricio Dupleich, Louis Othieno and Oliver Wakelin

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FOREWORD

In order to generate and sustain jobs, small entrepreneurs, whether in industrialised or developing countries, need different types of financial products. Financial products - loans and deposit facilities, payment and transfer services, leasing and insurance - can do much to keep businesses afloat and growing, thus maintaining and creating employment. Small entrepreneurs in developing countries usually don't have access to this wide range of services, because micro-finance institutions have traditionally focussed on the provision of credit. It is only now, as the micro-finance sector is reaching a certain maturity, that some institutions are starting to experiment with new financial products for which there is clearly a market. Leasing is one of these.

The Social Finance Programme assists micro-finance institutions in launching innovative financial services and provides training courses as well as direct technical assistance to financial institutions interested in broadening their product range. This handbook is one of a series of manuals produced by the programme. The most recent one, *Making Insurance Work for Microfinance Institutions* aims to familiarise micro-finance practitioners with the complexities of offering insurance products.

Leasing for small and micro enterprises is based on experiences with micro-leasing schemes in many different parts of the world. It differs from other books on leasing because of its focus on small and micro enterprises. The book aims to help managers of NGOs and micro-finance institutions in developing countries who are contemplating starting a leasing scheme. It explains what leasing is, how to design and market a lease product, and how to deal with regulatory and fiscal issues. Legal and fiscal practices from different countries are described to illustrate general notions on the regulatory aspects of leasing. For those weighing the pros and cons of offering a lease product, this book should provide some insights.

Micro-finance institutions that want to develop viable leasing programmes will have to make a considerable investment in staff training and systems development. The difference between a "lease" and a "loan" affects the whole organisation. It means that product developers need to familiarise themselves with lease product design and pricing issues, and senior managers need to explore possible partnerships for the leasing programme. Accountants will need to be aware of the different accounting and taxation issues related to leasing, while loan officers experienced in credit evaluation will have to adjust their perspective to in order to deal with equipment finance.

I would like to thank Linda Deelen, Mauricio Dupleich, Louis Othieno and Oliver Wakelin for writing this useful manual. Sincere appreciation is extended to Marie Winsvold, James Roth and Coumba Diop for their contributions, comments and support. Special thanks are due to the Netherlands Government that provided the funding for this handbook as part of the Dutch Partnership Programme with the ILO.

The ILO would be grateful for any suggestions or exchange of experiences from those who read this handbook or use it for training purposes.

Bernd Balkenhol
Chief,
Social Finance Programme

INTRODUCTION

Leasing is not a new phenomenon, but in developing countries, initiatives to offer leasing to small and micro enterprises are still rare. This is surprising, because leasing has distinct advantages over credit. The most important of these advantages is that entrepreneurs can start using the equipment before they really own it. This means that during the period of paying lease instalments, the entrepreneur is already realising extra income through the use of the equipment.

Another advantage is that leasing has no (or very few) collateral requirements. This is a feature that can open doors for many potentially successful entrepreneurs who see their loan applications turned down because of a lack of collateral. Yet another advantage is that the risk of fund diversion – a very real risk for micro-finance institutions – is averted in leasing, since the funding provided goes directly to the purchase of equipment without even passing through the hands of the lessee.

It is true that leasing schemes require new systems and special training of staff. These extra efforts which leasing demands can lead financial institutions to question — sometimes rightly — whether they can offer leasing on a viable basis. Uncertainty about the legal basis for leasing, as well as about taxation, can also discourage financial institutions from developing a lease product. This handbook tries to present the reader with a complete picture of the pros and cons of leasing to small and micro enterprises, including the risks for the financial institution.

This handbook is divided into eight chapters.

Chapter 1 introduces the essential basic principles of a lease operation.

Chapter 2 presents the life cycle of a lease from the moment an entrepreneur selects a piece of equipment to the transfer of ownership at the end of the lease term.

Chapter 3 focuses on marketing the lease product and explores ways of packaging and presenting lease products adapted to the needs of identified client groups.

Chapter 4 is on pricing, both from the perspective of the lessor and the lessee.

Chapter 5 discusses the legal and regulatory environment for leasing, including licensing and prudential requirements.

Chapter 6 deals with taxation.

Chapters 7 and 8 introduce accounting practices for different types of lease products and methods of monitoring the leasing scheme.

Those who have experience in handling leases for medium and large enterprises will know that leasing can be extremely complex, especially in the areas of contracts and taxation. They might even find some of the content of this book too simplistic. However we believe that in leasing for small and micro enterprises it is possible to avoid much of this complexity and still design a sound scheme. Of course small and micro entrepreneurs – many of them functioning outside the formal economy — have their own sets of problems, which we have described realistically.

WHAT IS LEASING?

The objective of this chapter is to:

- *introduce the basic principles of a lease operation as well as the different types of lease operations such as the financial lease and the operational lease*
- *stress the internal and external conditions that have to be in place before starting a micro-leasing scheme*
- *present the advantages of leasing over other methods of financing but also the limitations*

Leasing is a contract through which someone uses equipment owned by somebody else. The user (*the lessee*) pays specific regular amounts to the owner (*the lessor*). The important feature of leasing is that the use of the equipment is separated from its ownership. The leasing arrangement benefits both parties — the lessee generates extra income from the use of the equipment, and the owner receives income while retaining the security of ownership.

Enterprises through the world use leasing to finance vehicles, machinery and equipment. In developed (OECD) countries up to one third of private investment is financed this way¹. Leasing in developing countries took off slowly at first, but during the 1990s the leasing industry in these countries saw spectacular growth, mostly through leases to large and medium enterprises. This growth can to a large extent be attributed to improvements in the legal and regulatory environment for leasing.

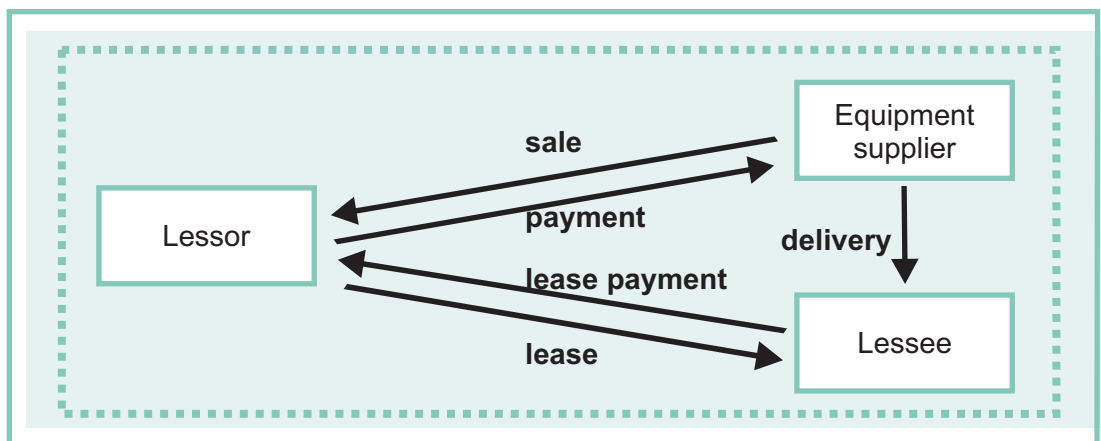
The standard lease operation

In a standard lease operation, the lessee goes to an equipment supplier, chooses the needed equipment, and negotiates the price and terms of delivery. Then, rather than approaching a bank for a loan, the lessee approaches a lessor. The lessor evaluates the lease application, and if it is approved, the two parties sign a lease contract. The lessor purchases the equipment from the

¹ *International Finance Corporation, Leasing in Emerging Markets, 1996*

supplier and leases it to the lessee for a period that is usually close to the estimated economic life of the asset. During this period (*the lease term*), the lessee uses the equipment and makes regular payments to the lessor. In many cases the lessee has the option to buy the equipment at the end of the lease term.

The standard lease operation



The elements of a typical lease are:

the lessee

The lessee is the user of the leased equipment. A lessee can be any type of enterprise, although in developing countries lessees have mainly been medium and large enterprises. Initiatives to extend leasing to micro and small enterprises are relatively new.

the lessor

The lessor is the owner of the equipment. Normally lessors are specialised private leasing companies or subsidiaries of banks or financial institutions. Sometimes manufacturers and equipment suppliers provide leasing as part of their marketing/sales activities, usually through a finance subsidiary. It is still rare for microfinance institutions or financial NGOs to offer lease products.

assets

The types of assets that can be leased range from small items (in Bangladesh the Grameen Bank leases fridges) to airplanes and satellites. Some lessors offer a standard range of items, preferring equipment with which they have experience, purchased from equipment suppliers they can rely on. Lessors also prefer equipment with a secondary resale market, so that if the lessee defaults they can repossess the item and sell it for a good price.

lease term

The lease term is the duration of the lease as stated in the lease contract. Usually the lease term is at least 80% of the economic life of the equipment. It is never longer than the useful life of the equipment. Three to five year lease terms are common.

Larger items like airplanes and ships have longer lease terms.

lease payment

Lease payments are made monthly or quarterly over the whole lease term. The amount of the lease payment depends on a number of factors: the value of the asset, the interest rate charged by the lessor, the length of the lease term, the credit rating of the lessee, the expected value of the equipment at the end of the lease term, and the options given to the client to either buy or return the equipment at the end of the lease term. Payments can be fixed for the whole lease term, or they can be variable to allow for changes in the market rate of interest.

the end of the lease option

The end of the lease option is an important part of the lease contract. Depending on the contract, the client has the option to:

- purchase the equipment
- return the equipment
- renew the lease at a significantly reduced rental
- receive a share in the profits of the equipment sale

the buy option

If the contract offers the lessee the option to own the equipment at the end of the lease term, there are different ways of setting the purchase price:

- purchase at *residual value*. This value is estimated at the beginning of the lease term, and is based on the likely market value at the end of the term.
- purchase at *fair market value*. This value is set at the end of the lease term, and must be based on independent evidence of the market value of the equipment.
- Purchase at *nominal price*, for example \$1.
- *Automatic transfer to lessee* after last lease payment is received.

Types of leasing

The word “lease” has a number of slightly different meanings, depending on the type of contractual arrangement. The meaning also can differ from country to country. Broadly, there are four different types of leasing:

A *financial lease* is a way of financing the purchase of equipment. In a financial lease, the lease term is set close to the expected economic life of the equipment. The lease payments are set so that their total over the lease term will cover the cost of the asset plus interest and profit. At the end of the lease term, the lessee usually has the right to purchase the equipment. The residual value of the equipment at the end of the lease term is of little or no significance to the lessor.

In an *operating lease* a lessee signs a contract for the short-term use of the equipment – a common example is car rentals. The lessor purchases the equipment and makes profits by renting it out to different users. The lessor bears the risk related to the residual value of the equipment, as well as the risk of obsolescence.

Hire-purchase, which is similar to a financial lease, is a way to finance the purchase of equipment. It is normally used for small items like sewing machines and fridges. In hire-purchase, part of the ownership is transferred with each payment. Upon payment of the last instalment, the lessee becomes the full owner.

Sale and lease-back is much like a financial lease, except that the client is the initial owner of the equipment. The client sells the equipment to the lessor, and signs a contract to lease back the equipment through regular payments. The lessee can use the funds freed up through the sale of the equipment as working capital.

Financial lease and hire-purchase

There can be confusion about the terms “financial lease” and “hire-purchase” because these terms are used differently in different countries. In India, for example, a financial lease can not have a buy option. Lease transactions with an option to buy will be called hire-purchase transactions. In Ghana, at the other hand, lease transactions with a purchase option are referred to as financial leases and the term hire-purchase is less used.

What are the advantages of leasing over other financing?

Leasing offers several advantages over other methods of financing. The most important advantages are:

Absence of collateral requirements

The great advantage of leasing is the absence of collateral requirements. The equipment itself serves as security because the lessor retains ownership. If the lessee is unable to make the payments, the lessor can repossess the asset. In most countries this is a relatively straightforward procedure.

Simpler evaluation

A lease can be concluded more quickly and simply than a bank loan. Rather than looking into the credit history and asset structure of the client, the leasing company only has to make sure that the client has the ability to generate sufficient cash through the leased equipment. Less detailed documentation is necessary, and the appraisal can be processed relatively quickly.

100% finance

Banks usually require from clients that they finance part of the investment from their own resources. Down payments are often up to 40%, thus reducing the amount of the loan. In a lease, 100% of the equipment value is financed and up-front security payments seldom exceed 10%. This enables lessees to retain more of their scarce resources as working capital.

Tax incentives

In many countries the tax system is conducive to leasing. The lessor, as the owner of the equipment, registers the full lease payment (principal + interest) as income but deducts the depreciation of the asset, usually on an accelerated schedule. The lessee claims the lease payment as deduction from taxable income. The lease term is usually shorter than the economic life of the equipment, so the lessee in fact “depreciates” the equipment more rapidly than if he/she had purchased it. Since both parties benefit from tax relief on an accelerated basis, overall tax payments on the lease are reduced. Chapter 6 describes in detail how different types of lease products are treated for tax purposes.

No risk of fund diversion

In leasing, the funding provided goes directly to the purchase of equipment without even passing through the hands of the lessee. This averts the risk that

the lessee might use the funds for purposes not agreed upon. It also avoids the risk that the lessee might use the credit to pay back a loan from another financial institution.

Fund diversion – the perception of the client

Clients of micro-lessors in Africa argued that they prefer leasing over loans precisely because they do not have to handle cash when taking a lease. Especially for women it can be hard to use a loan taken from a bank solely for the business purpose it was originally meant for. The pressure to spend part of it on other family needs - useful or not - is very real. A piece of equipment, however, can't be used for unbudgeted expenses.

Leasing to small and micro enterprises

In developing countries it is rare to find initiatives to lease equipment to small and micro enterprises. Most microfinance institutions and banks in these countries limit themselves to providing working capital loans in short loan cycles. However many small and micro enterprises, especially in the production and service sector, need medium-term investment finance in order to increase productivity. This is where leasing can help.

Small enterprises above subsistence level often need loans which are slightly larger and have longer loan terms than what microfinance institutions can offer. These enterprises sometimes find that they are too big for microfinance institutions but too small or informal for commercial bank loans. In any case they have difficulty providing the collateral necessary for bank finance. The simple security arrangements of leasing allow a way round this problem. Leasing enables borrowers who do not have well-developed balance sheets or credit histories to access investment finance for which they might not have been eligible.

Meeting the needs of small enterprises is one way that leasing can have an important impact on local economic development.

Setting up a leasing scheme – internal conditions

Matching of financial resources

An institution offering leasing needs to attract matching resources to finance the leasing scheme. A lessor offering leases with 2 to 3 years lease terms, needs medium term financial resources at the liability side of its balance sheet. Leasing companies are generally not deposit-taking institutions — they rely on capital markets for equity and debt. In developing countries the medium-term debt needed to finance the leasing scheme can be difficult to attract.

Human resources

An institution offering leasing needs to have the necessary staff skills in-house. Some of the skills required for leasing are different from those required for a lending scheme. Lease officers need to be able to assess the value of the equipment, its usefulness within the enterprise, the extra cash-flow it will yield, the enterprise itself, and the business environment it operates in.

Operational systems

The lessor needs to have good operational, internal control and accounting systems. Besides an information system for financial monitoring, the lessor has to keep track of the status and value of all leased equipment. Unlike banks and microfinance institutions, lessors are usually not VAT exempted. Tax administration poses extra demands on the accounting system of the lessor.

Setting up a leasing scheme – external conditions

An enabling regulatory system

Lessors will only survive and make a profit if an enabling regulatory framework for leasing is in place. This means that

- procedures for obtaining a leasing license have to be transparent.
- requirements regarding the capitalisation of the scheme should be less stringent than for deposit-taking financial intermediaries.
- procedures for lessors to repossess equipment in case of default have to be straightforward.
- the tax treatment of lessors and lessees has to be consistent and favourable to leasing.

In countries where no specific regulation for leasing exists, the regulatory framework should at least not pose impediments. (See Chapter 5 for more detail on regulatory frameworks).

Sufficient market for leasing

A big enough market should exist for leasing. This requires a critical mass of entrepreneurs in need of medium-term investment finance. A market of micro- and small enterprises all needing different types of equipment does in itself not constitute an adequate market for leasing. The lessor also needs to be sure that the equipment concerned has stable market values and adds value to the enterprises' production process. Financial institutions with experience in dealing with small and micro-enterprises, whether banks or microfinance institutions, have a comparative advantage.

Existence of equipment markets

Leasing needs reliable equipment suppliers who value the alliance with the lessor as part of their own marketing strategy. In distorted or uncompetitive equipment markets, lessors will have difficulty negotiating favourable prices and conditions with suppliers. If transport costs are high, this limits the scope for profitable leasing. Leasing also needs a second-hand market, because lessors need to be sure that they can sell repossessed equipment in a second-hand equipment market. The existence of leasing schemes can contribute to the development of such a market.

Technical support and after-sales services

One of the major challenges for lessors is the maintenance of equipment. The availability of efficient workshops and access to spare parts is essential. Technical analysis is very important in the choice of appropriate technology and suitable equipment. Most financial institutions do not have this capacity in-house, so it is important for the lessor to establish links with institutions that can provide technical assistance and recommendations.

The limitations to leasing

Limits to tax advantages

Tax advantages have played a large role in the growth of the leasing sector in developed countries. In developing countries, however, many small and

micro-enterprises do not benefit from tax advantages, either because they operate outside the formal economy or because they receive tax bills that are not based on the amount of profit they actually make.

Taxation of small enterprises in Ghana

Orlando machinery shop, an employer of 8 master metal workers and 18 trainees has leased a lathe machine from a leasing company in Ghana. Every month Mr. Orlando registers the instalment of 1 million cedis (\approx 110 USD) as an expense in his accounts. The expenses made for the leased equipment have no effects on the amount of tax Mr. Orlando pays. Like most small enterprises in Ghana, he receives a standard tax bill from the internal revenue service of 50,000 cedis each week.

Extending leasing to remote areas

Leasing companies in developing countries usually limit their operations to urban areas. Contracts between town-based leasing companies and rural small enterprises are relatively uncommon. Other factors which tend to exclude rural clients are:

- the cost of monitoring the status of the leased equipment and the financial performance of the enterprise is high when it involves travelling to the countryside
- clients with leased equipment in rural areas are far from suppliers' shops and maintenance workshops
- the cost of repossession is higher when the equipment is far from the lessor's premises

Working capital constraints

Leasing can only finance the purchase of fixed assets. It cannot directly fulfil a client's needs for working capital, although it can be argued that the lower down-payments of leasing indirectly free up working capital for the client. Lessors need to be aware, however, that lack of working capital could jeopardise their clients' capacity to generate extra cash flows through the leased equipment, and therefore their ability to keep up with lease payments.



CASE STUDY

Crystal Clear Finance (CCF) is a financial NGO working in the rural areas of Libalia. Its head office is based in the capital town of Durma Province from where it has, over the past 8 years, extended loans through a solidarity group system. 80% of its clients are based in the rural areas and involved in agricultural production as well as off-farm activities. Over the past years many of CCF's clients have complained that loan sizes available through the solidarity group system are too small for the productive investments they want to make. CCF has not extended loan sizes above 500 USD and the maximum loan term is 12 months. In order to be able to offer larger credits on longer terms, Crystal Clear Finance is contemplating to start a leasing scheme.

After studying some available literature on leasing, CCF management has decided to hire a consultant to undertake a feasibility study on micro-leasing.

Please help CCF management in writing terms of reference for the consultant that define which aspects he/she should cover in the study.



Crystal Clear Finance

Terms of Reference

Feasibility study on Micro-leasing

Background

Crystal Clear Finance is contemplating to start a leasing scheme for farmers and micro entrepreneurs in Durma Province. However, before it would start to offer micro-leasing, CCF wants to find out whether a number of internal as well as external conditions for such a scheme are fulfilled. The objective of this feasibility study is to find out whether CCF can viably offer micro-leasing. The study has to show whether there is sufficient demand for leasing, whether the regulatory environment is conducive and whether Crystal Clear Finance can establish the systems and staff requirements necessary to manage the scheme.

Main aspects to be addressed in the study

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KEY TERMS and CONCEPTS



- ✓ Buy option
- ✓ Economic life
- ✓ End of the lease option
- ✓ Fair market value
- ✓ Financial lease
- ✓ Fund diversion
- ✓ Hire-purchase
- ✓ Lease payment
- ✓ Lease term
- ✓ Lessee
- ✓ Lessor
- ✓ Matching of financial resources
- ✓ Obsolescence
- ✓ Operational lease
- ✓ Residual value

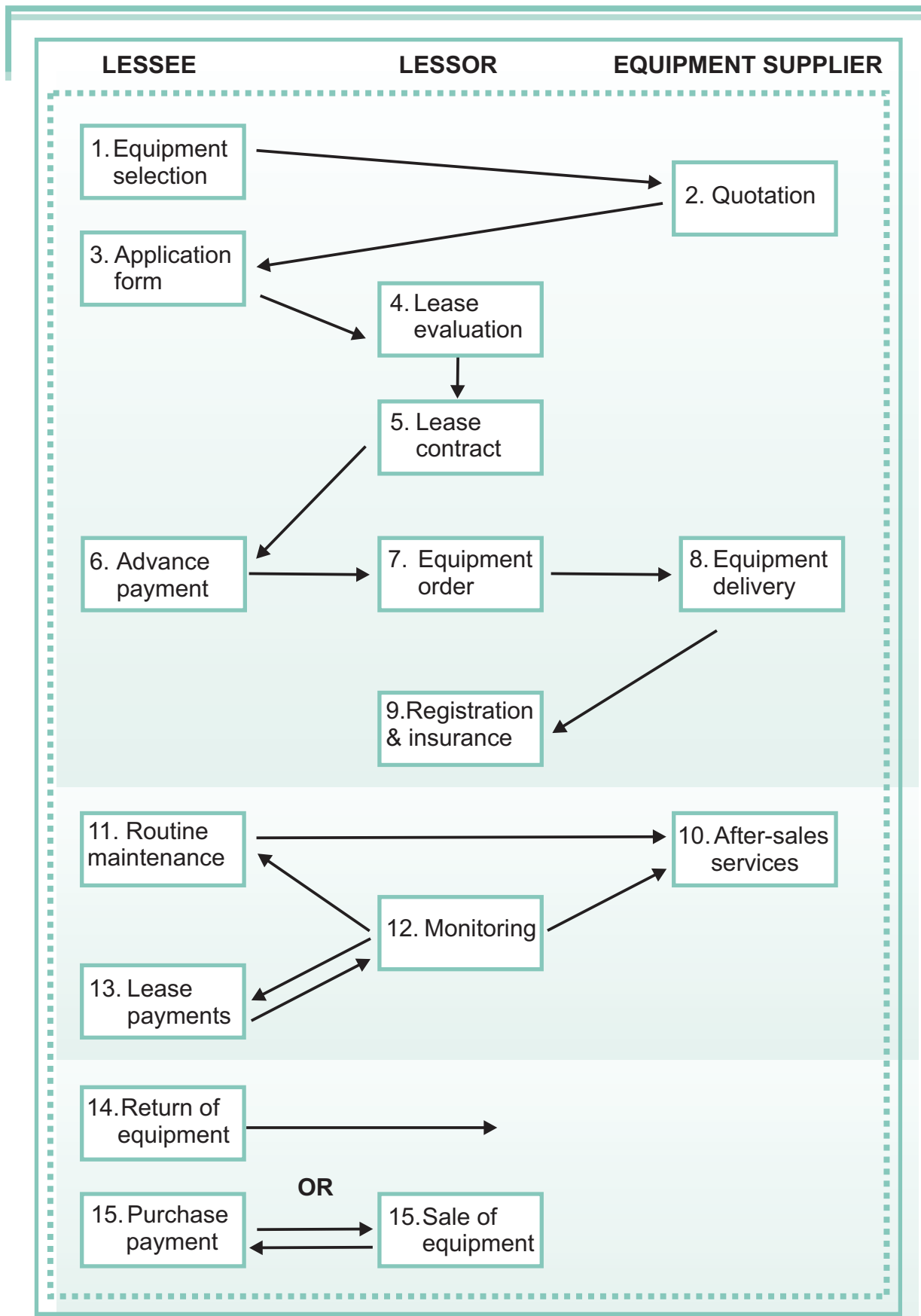
THE LEASING OPERATION

The objective of this chapter is to:

- *present the different steps of a lease operation from equipment selection to transfer of ownership*
- *introduce working methods for lessors geared to minimising the risk present in the lease operation*
- *outline the principle clauses that should feature in a lease contract*

There are 15 steps in a typical leasing operation. These steps in sequence are:

1. The entrepreneur chooses the equipment and the equipment supplier.
2. The supplier provides a quotation.
3. The lessee submits an application to the lessor.
4. The lessor evaluates the application.
5. The lessor and lessee sign a lease contract.
6. The lessee pays the advance lease payment.
7. The lessor orders the equipment from the supplier.
8. The supplier delivers the equipment.
9. The lessor registers and insures the equipment.
10. The supplier provides after-sales services as per contract.
11. The lessee maintains the equipment (routine maintenance).
12. The lessor monitors the lease operation.
13. The lessee pays instalments as per contract.
14. At the end of the lease period, the lessee either returns the equipment or exercises the option of purchase.
15. If the option is purchase, the lessee pays the agreed final sum and the lessor transfers the ownership of the equipment to the lessee.



The 15 steps in a lease operation

1. *Selecting the equipment and the equipment supplier*

In principle, the entrepreneur is in the best position to evaluate what type of equipment is needed to deliver the desired output for his/her business. The entrepreneur usually knows where to buy the equipment he/she wants, and which supplier can be trusted. In most leasing operations the entrepreneur is free to select the equipment and supplier of his or her choice.

For a number of reasons though, some lessors restrict the lessee's freedom to decide on the equipment and the supplier. One reason is that the equipment serves as collateral for the lease. The lessor therefore wants to make sure it is reliable, appropriate for the lessee's business, and likely to retain its market value for the whole lease term. Another reason is that leaving the choice of equipment to the entrepreneur means more risk for the lessor, who might not have the technical capacity to evaluate and monitor a wide range of equipment.

If the lessor chooses the supplier, there is less scope for the supplier to collude with entrepreneurs and give quotations above the real price of the equipment. Dealing with a few reliable suppliers also limits the risk of supplier-related problems like late delivery, deficient post-sale service, and unavailability of spare parts. Fewer suppliers also means volume discounts for the lessor, extended warranty periods, and improved post-sale service.

The following table shows the advantages of free choice and no free choice for the lessee.

Lessees' choice of equipment and equipment supplier

	Of equipment	Of supplier
Lessee has free choice	<ul style="list-style-type: none"> ● Lessee selects on the basis of knowledge of the production process ● Selection process is transparent in the eyes of the lessee ● Lessee is unlikely to claim non-performance of the equipment 	<ul style="list-style-type: none"> ● Lessee can build upon existing customer relationship ● Lessee can select a supplier near to his/her business ● Negotiation process is transparent in the eyes of the lessee
Lessee has no free choice	<ul style="list-style-type: none"> ● Lessor is informed about performance and market value ● Standardised evaluation and monitoring process more likely 	<ul style="list-style-type: none"> ● Better negotiating position with supplier for lessor ● Volume discounts and services for lessor ● No lessee/supplier collusion ● Reliability/availability of spare parts

2. The quotation

Before the lessee applies for a lease, he/she needs a quotation from the equipment supplier. This is a document stating that the supplier will sell the equipment to the lessor, and giving the agreed terms of the sale.

The quotation should be issued on the letterhead of the supplier, and addressed to the lessor, since it is the lessor who will purchase the asset. It should contain the following:

- the price and method of payment
- an expiry date that allows for the time involved in processing the lease application

3. *The lease application*

The lease application form should ask for a basic description of the business, including how and where the desired equipment will be used. The form should ask for information which will help the lessor decide whether the equipment will generate the increased income necessary for the lease instalments.

A lease application form normally asks for:

- The personal details of the entrepreneur.
- The address or location of the enterprise.
- A description of the business or production process.
- Number of employees.
- A description of the requested equipment, backed up by information on the quotation.
- The function of the equipment and its intended location in use.
- A list of the lessee's main assets such as land, houses, vehicles, equipment, inventories, bank accounts, and liabilities such as debts to suppliers, financial entities or third parties.
- The expected income from the business over the lease period, specifying types of products and quantities to be sold.
- Description of the market where the product is destined.
- Expected income from other activities over the lease period, including income of other family members.
- Expected business expenses over the lease period.
- Expected non-business expenses such as family expenses (necessities such as housing, food, education, health and clothing).
- Signatures of the entrepreneur and the lease officer.

Annex 1 is an example of a lease application form as used by ANED in Bolivia.

The lease application can be filled in by the entrepreneur with or without the assistance of the lessor. For the lessor, the more detailed the information the better, bearing in mind that long and complicated forms can discourage and confuse possible good clients. Ultimately the skills of lease officers to detect good entrepreneurs with good business plans are more important than the level of detail in the application form.

It is important for the lessor to visit the enterprise and verify the information provided by the lessee. Again the lease officer is crucial here — accurate verification depends on his/her experience.

4. *Evaluation of the application*

The evaluation of lease applications has two objectives:

- Screening of clients
- Tailoring of the terms and conditions of the lease to the needs of the clients

A good evaluation process works to the advantage of both the lessor and the lessee. The lessor minimises default rates, and the lessee gets a lease adapted to his/her needs and repayment capacity.

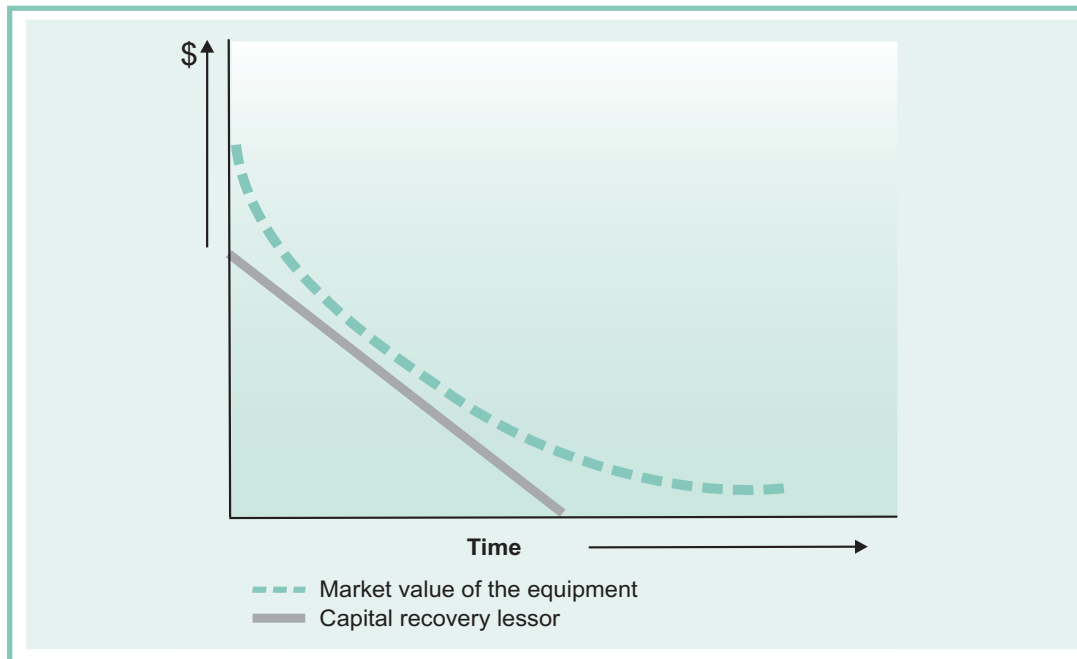
The lease evaluation has to look at three broad areas: the projected cash flows, the productive capacity of the equipment, and the market value of the equipment.

The *projected cash flows* generated through the use of the equipment are more important than the asset structure or credit history of the client. Evaluation techniques based upon the estimated inflows and outflows of cash in the enterprise are essential here. These cash flows determine the lessee's ability to pay the instalments.

The *productive capacity of the equipment* and the capacity of the entrepreneur to optimise its use is assessed. Is it the right type of equipment, will it be used in the right way and in the right place? To what extent will it increase production, save costs, improve quality or open the way for new products or services?

The *market value* of the equipment is important. If the lessee defaults, the lessor has to recover his investment by taking back the equipment and selling it or re-leasing it. At all stages of the lease period, the market value of the equipment should be higher than the total of outstanding lease payments. This is illustrated in the graph below.

Capital recovery and market value of the equipment



A good lease officer will structure the lease schedule to the repayment capacity of the client. The lease officer needs to tailor the lease to the entrepreneur's income and cash flow. There are different ways of doing this.

seasonal lease schedules

Some businesses, such as tourism, have seasonal business cycles. Farmers and farming-related rural enterprises collect most of their income during the harvest. For these clients, the lease schedule can be adapted to allow higher payments in the peak season and lower payments for the rest of the year.

stepped lease schedules

Some businesses can expect their income to increase steadily from the use of the equipment. These businesses will prefer a lease schedule with stepped payments, where the payments increase month by month or year by year by a given percentage or a given amount.

deferred lease schedules

Sometimes the equipment does not increase the income of the enterprise straight away. For example, the staff using the equipment may first need to be trained. A deferred lease schedule allows a grace period until the equipment is expected to generate income.

The internal regulations of the lessor usually set the limits to which lease schedules can be tailored to meet the expected cash-flows. Lessors who offer seasonal lease schedules, for example, have restrictions on the number of months during which off-season payments can be accepted as well as on the minimum amounts to be paid during these months.

Whatever the type of lease schedule offered, the overall yield for the lessor has to be the same. In stepped or deferred schedules, the higher payment at the end of the lease term must cover the lessor's higher interest cost at the beginning.

Once the lease officer has evaluated the lease application, he or she will prepare a report to be submitted to the lease committee. In most leasing programmes, lease applications will have to pass different levels of authorities, depending on the size of the proposed lease.

Lease applications in Bolivia

Lease applications for ANED Bolivia have to be submitted to different lease committees, depending on the size of the lease:

Regional Committee made up of at least 3 regional ANED staff, can approve operations up to USD 3,000.

Central Committee made up of managers/executives at the central level, can approve operations up to USD 10,000.

External Committee made up of outside professionals and representatives of the Board of Directors, can approve operations larger than USD 10,000.

5. *The lease contract*

Once the application has been approved by the lease committee, the lessor can offer the client a lease contract. A recommended list of clauses commonly found in lease contracts is given on page 32.

It is important for the lessee to fully understand his or her rights and obligations before signing the contract. Taking the extra time and effort to explain all the details of the contract to a client is more than justified by the reduction in later problems.

Good practice: Plain language contracts

For lessors serving illiterate or poorly educated clients, it is good practice to draft a contract in simple language, avoiding long and unnecessary legal terms.

This saves time and effort in finalising the contract, but also later on, when common problems of misunderstanding arise, for example the restrictions regarding the use of the leased equipment.

Plain language contracts also make it easier for third parties, such as rural authorities or respected people in the community, to explain the details of the contract to the clients.

Contracts that have too much small print do not cover the lessor's interests if they create future problems. Common examples are not explaining clearly the annual effective cost of the contract, or not explaining the penalties charged for late payment.

Depending on the local legal context, lessors can opt to deposit lease contracts with a public notary. The additional costs will probably be justified by greater legal certainty for the lessor.

The lease contract has to state clearly that the lessee will pay instalments according to the lease schedule, with the first instalment being made a certain number of days after the commencement date stated in the lease schedule. This date can be set in different ways:

1. The date of signing the lease contract.
2. The date when the lessor orders the equipment from the supplier.
3. The date when the client takes delivery of the equipment.
4. The date when the equipment is first installed or first used in production.

The last two options are known as turnkey leasing.

Under the first two scenarios, the lessor avoids any type of risk related to the delivery of the equipment. From the point of view of the lessee it is more logical to start the payment schedule when the equipment arrives, or when it is installed and running.

Starting date for turnkey leases

Some types of equipment only become productive long after being ordered from the supplier. There might be delays for import, assembly and testing. In such cases a lease schedule that begins on the day that the equipment becomes operational will mean a less discontented client. On the other hand, if the lessee himself or herself is in charge of the testing period, there might be an incentive to delay or not report the actual functioning of the equipment. Anticipating this, the lease contract could stipulate a reasonable and agreed-upon time of delay before the schedule starts. This will act as an incentive for the lessee to solve technical and logistical aspects of installation before the agreed date.

T

6. *The advance payment*

Most lessors require an advance payment or security deposit when the client signs the lease contract. This acts as security for the lessor before the equipment is purchased. The higher the advance payment, the less funds have to be invested by the lessor, and the sooner the lessor recovers the investment. The lessor's profit derives not only from the amount of the lease payments, but also from the time when the payments are received. Advance payments in leasing are usually in the range of 10% of the total value of the lease.

7. *Ordering equipment from the supplier*

Once the client has made the advance payment, the lessor orders the equipment from the supplier. The order confirms the sales offer in the name of the lessor. The lessor informs the equipment supplier of the lease arrangement because:

- the equipment has to be delivered to the lessee rather than to the lessor.
- in most cases the warranties and other post-sale service contracts are transferred to the lessee.

It is good practice for the lessor to ask the equipment supplier for a dated and signed order confirmation. This binds the supplier to delivering the equipment at the time and place requested. The order confirmation helps the lessor to avoid any conflict with the lessee over delays in the delivery of the equipment. It also avoids any claim by the supplier that the quotation could have expired.

8. *The delivery of the equipment*

The equipment is purchased in the name of the lessor and delivered directly to the premises of the lessee. It is good practice, especially with bigger leases, for the lessor (represented by the lease officer) to be present when the lessee checks and accepts the equipment. The lease officer can assist the lessee in case any problem arises. The presence of the lease officer also decreases the chances of future complaints that the equipment was damaged or otherwise inadequate.

On delivery, the lessee signs a delivery acceptance note, stating that:

- the equipment has been delivered with all parts and accessories, in good shape and available for use as specified in the contract.
- the equipment conforms to the specifications detailed in the contract and the application form.
- the equipment was delivered on time.
- the delivery was to the satisfaction of the client.

The client should personally sign the delivery acceptance note and not delegate this task to an employee.

Photographic record

Some lessors take photographs of the lessee with the equipment at the moment of delivery and acceptance. The photographs can be used at a later stage if problems arise, whether over the property rights of the lessor, or damage, or lack of maintenance.

The lease contract will state who is responsible for the consequences of late or incomplete delivery. It could be the lessor, or the lessee, or it could be shared between them. If the lease schedule starts from the date the lessee signs the contract, the costs of delays in delivery have to be borne by the lessee.

9. *The registration and insurance of the equipment*

Equipment such as vehicles and motorcycles are registered with local authorities in the name of the lessor. Most types of equipment are not registered with any authority — the sales documentation and the lease contract are the lessor's proof of ownership.

Good practice : Tag your asset

It is good practice for the lessor to attach a tag with the leasing company's name when the equipment is delivered. The lease contract can state that the lessee cannot take off the tag before the end of the lease term. The tag is extra proof that the equipment is owned by the lessor. This could be important especially if the enterprise later becomes bankrupt.

Three types of insurance are normally required:

Insurance against loss or damage

This is insurance against theft or against damage caused for example by fire or electrical surges. For small enterprises in developing countries, this type of insurance poses a special challenge. For the equipment to be insurable, the enterprise may have to conform to certain standards, for example minimum health and security standards. This may not be practical for small enterprises. The insurance requirements of the lease can in this way introduce new costs to the enterprise that are so high as to render the lease uneconomical.

If the lessee is a well-established enterprise, it may be sufficient for the lessor to require that the lessee insures the equipment. In such cases, the lessor should contractually bind the lessee to produce proof of payment of insurance premiums upon demand. With small and micro enterprises however, it may be more appropriate that the lessor chooses the insurance company and insures all leased equipment. In case of loss or damage, the lessor will be paid out by the insurance company. The lessor can then decide to use this payment to replace or repair the equipment or – if this is uneconomical – to cover the outstanding liability of the lessee. The practice of taking out insurance in the name of the lessor may be preferred by the client, who as an individual may not

have the capacity to insist on the insurance company carrying out its obligations in the event of claims.

Third party insurance

Normally the owner of a piece of equipment is the user, and is therefore liable if the operation of the equipment caused injury or loss to another person (third party). However in a lease agreement, the ownership and the operation of the equipment are split between lessor and lessee. Operation is the responsibility of the lessee, and it is necessary that the lease agreement explicitly absolves the lessor from responsibility for injury to third parties. While it is advisable that lessees insure themselves against third party claims, in practice small and micro entrepreneurs seldom insure themselves against such claims. They are usually incapable of paying for any damages awarded against them.

Life insurance

The lessor may consider insuring the lessee's life or insure against any disability which would make it impossible for the lessee to fulfil the lease contract. This type of insurance is affordable and available in many developing countries and has been found useful by microfinance and micro-leasing institutions.

10. After-sales service

Some equipment vendors offer an after-sales service package that they sell alongside the equipment. A lessor may insist on the lessee taking such a contract, although the lessor should be aware that this condition might discourage clients who feel that an after-sales service contract is too expensive.

Most vendors will only issue warranties and guarantees on performance of equipment as long as they or their agents maintain and repair the equipment. It is generally difficult to claim warranties where maintenance has been in the hands of people not under the control of the equipment vendor.

If there is no network of well supervised agents authorised to service the equipment and supply and fit genuine spare parts, a service contract may be a significant cost to the lessee. At the other hand, the use of fake spare parts and "bush mechanics" reduces the value of the equipment in the long run.

11. Routine maintenance

In most leasing schemes the lessee is solely responsible for the maintenance of the equipment. The lessor also has a strong interest in the maintenance, because the asset is only acceptable as the principal security for the lease as long as its market value remains higher than the outstanding balance of lease payments. Poor maintenance and incorrect use reduce the market value.

Routine maintenance is a critical factor in the reliable performance of the leased equipment, as well as its resale value. Equipment manufacturers usually supply tables showing how often various services are needed, e.g. changing oil, cleaning air and fuel filters, etc. These are known as routine or scheduled maintenance. These maintenance costs are predictable, although warranties often do not cover the costs of components fitted.

When there is unexpected failure of equipment, repairs have to be done. The costs of repairs have to be covered by the lessee. If it can be proved that failure was due to a manufacturing defect, the warranty covers the costs of repair. In developing countries, the need for repairs is more likely to be due to the equipment being inappropriate for the environment in which it is used, or poor fitting of replacement parts, or abuse of the equipment.

Experience in developing countries suggests that lessees often modify imported equipment in order to obtain the desired performance. Such modifications, especially if they result in permanent alterations to the equipment, may negatively affect the performance and the market value of the leased asset. The lease contract should therefore be explicit on procedures to be followed if any major alteration to the leased equipment is observed.

12. Monitoring the lease operation

It is advisable for the lessor to undertake regular monitoring visits to the lessee's enterprise, even if the lease instalments are being paid in time. During a monitoring visit, the lease officer can assess the state of the business and the condition of the leased equipment.

The equipment should also be monitored technically. This includes checking whether:

- the equipment is still working
- any damage has been caused to the equipment, either by factory defects or misuse by the lessee
- the equipment is being used for the purpose stated in the contract

- the equipment is not being lent or rented out to third parties
- all obligations related to the use of the equipment, such as licenses and payment of road tax are fulfilled
- insurance premiums have been paid (if the lessee is responsible for insurance)
- the tag with the name of the lessor is in place
- no modifications to the equipment have been made
- routine maintenance is being undertaken

13. *Payment of the lease instalments*

The lease contract should clearly indicate when and how lease instalments are paid. Some microfinance institutions work with cash only. One form of payment is the use of post-dated cheques, which make it unnecessary for clients or lease officers to carry cash with them. It is also a secure form of payment, because allowing a post-dated cheque to bounce is a legal offence in many countries.

14. *The end-of-the-lease-option*

As mentioned earlier, the lease contract will state what the lessee's options are at the end of the lease term. These could be one (or more) of:

- return the equipment
- purchase the equipment
- renew the lease at a significantly reduced rental
- receive a share in the profits of the equipment sale

Most financial lease contracts are geared towards the client buying the equipment at the end of the term.

For the option of the lessee receiving his/her share in the profits of the equipment sale, there is scope for misunderstanding about the price. The lease contract should therefore state that the selling price of the equipment is supported by independent (arms-length) evidence of value.

Leases in which the client returns the equipment at the end of the lease contract are referred to as operational leases. The client of an operational lease has less incentive to maintain the equipment, so maintenance and insurance issues are treated differently from those described above.

15. *The final payment*

The most common option in a financial lease is for the lessee to purchase the equipment at the end of the lease term. The lease contract will specify how the final payment is decided on. The different possibilities are:

- The final payment equals the residual value of the equipment at the end of the lease term, as defined at the beginning of the lease term in the lease contract.
- The final payment is a standard nominal price, for example 1 USD or 50 USD.
- The ownership of the equipment is transferred automatically to the lessee upon reception of the last lease payment, with no further payment.
- The final payment equals the residual market value of the equipment as defined at the end of the lease term and supported by independent evidence of arms length value.

Setting the advance payment equal to the final payment

Some lessors structure lease contracts in such a way that the final payment amount equals the security payment made by the client upon signing the lease contract. Clients appreciate this arrangement because they don't have to pay any sum of money at the end of the lease contract.

In some countries the leasing law restricts how the final payment is defined. In these countries, to be able to benefit from certain tax advantages, the lessor has to carry some of the risks related to the residual value of the equipment. In the first three methods above, the lessor carries no risk related to the residual value and therefore the lease would not qualify as a tax lease. Chapter 6 gives more details on leasing and taxation.

16. *Transfer of ownership to the lessee*

When the final payment has been concluded, the lessor transfers the ownership of the equipment to the client. For registered equipment such as vehicles and motorcycles, the transfer of ownership has to be registered with the relevant authorities.

The costs related to transfer of ownership, possibly including taxes, normally have to be carried by the lessee. It is good practice for the lessor to make a list of the costs related to the transfer of ownership and to make the client aware of these costs before the signing of the lease contract.

Clauses commonly included in a lease contract

1. The name and address of both the lessor and the lessee.
2. The identification of the equipment, including its serial and/or registration number and, if necessary, the name of the equipment supplier.
3. The schedule of lease instalments.
4. The method of payment.
5. A clause related to eventual additional collateral or security payment.
6. The starting date of the contract.
7. A clause determining how the equipment will be delivered and, if necessary, who is responsible for the transport costs for delivery.
8. A clause stating that in case of late delivery by the equipment supplier, the lessee will inform the lessor. No changes in the repayment schedule are made because of late delivery of the equipment unless by written consent of the lessor.
9. A clause stating that the lessee will sign an acceptance note that the equipment has been examined and tested and accepted upon delivery and that, therefore, no claim can be made by the lessee regarding the quality of the equipment.
10. A clause stating that the ownership of the equipment will remain with the lessor for the duration of the lease contract.
11. A clause stating that the lessee can use the equipment as long as he/she makes the periodic payments and does not breach the contract.

12. A clause either stating the exact location of the equipment or, in case of moveable equipment, a clause stating that the lessee will inform the lessor at any moment about the whereabouts of the equipment. If possible, a clause stating that the lessor's ownership tag should not be moved from the equipment.
13. A clause stating that only qualified personnel can use the equipment, according to its operating instructions for the specified purpose. No part of the equipment is to be used for other purposes.
14. A clause stating that the lessee will not make alterations to the equipment without the explicit prior consent of the lessor.
15. A clause stating who is responsible for the maintenance and servicing of the equipment and who carries the maintenance costs. Repairs and replacements will only be carried out by reputable repair shops with the explicit approval of the lessor.
16. A clause determining which party will be responsible for the payment of insurance premiums against loss or damage caused by fire, theft or accidents.
17. A clause stating that if the lessee is responsible for paying the insurance premiums, he/she will produce proof of payment of premium on demand. A clause stating that in case the lessee fails to pay the insurance premiums, the lessor shall be allowed to pay the premium and charge the costs to the lessee.
18. A clause stating that in case of loss or damage, the lessee will immediately (or within a specified number of days) inform the lessor.
19. A clause stating that insurance monies will be paid out to the lessor. The insurance monies will either be used to repair the equipment or to replace it if the lessor considers repair to be uneconomical. If the lessor considers both repair or replacement uneconomical, the monies will be used to cover the outstanding liability of the lessee to the lessor. If insurance monies are not sufficient to cover the outstanding liability, the remaining amount is still payable.
20. A clause stating that loss or damage to the equipment does not affect the continuation of the lease contract and therefore the lease payments.
21. A clause stating that during the lease term, the lessee will acquire all necessary licences, permits and permissions and will pay all registration charges and taxes related to the use of the equipment.
22. A clause stating that the lessee shall indemnify the lessor against any claim including third party claims for any loss or injury related to the equipment or its use.

23. A clause stating that the lessee shall allow the lessor at any time during the lease period to inspect the equipment and therefore to enter the premises of the lessee.
24. A clause stating that the lessee will provide the lessor with the required financial statements and allow the lessor or his/her representative to check the lessee's accounts.
25. A clause stating that the lessee has no right to either sell, pledge or mortgage the equipment without the prior written consent of the lessor.
26. A clause defining the rights of the lessee at the end of the lease term to:
 - Purchase the equipment.
 - Return the equipment.
 - Renew the lease at a significantly reduced rental.
 - Receive a share in the profits of the equipment sale.
27. In case the lease contract offers the option for the lessee to gain ownership of the equipment at the end of the lease term, a clause describing the buy option:
 - The equipment can be purchased at residual value as estimated at the beginning of the lease term.
 - The equipment can be purchased at its fair market value, defined at the end of the lease term.
 - The equipment can be purchased for a nominal price, for example 1 USD.
 - The ownership of the equipment is transferred automatically upon reception of the last lease payment.
28. A clause stating who is responsible for registration charges related to the transfer of ownership of the equipment.
29. A clause giving the lessor the right to charge penalty interest on late payment.
30. A clause stating the duty of the lessee to return the equipment to the premises of the lessor in a good state when the lessee is in default.
31. A clause stating the right of the lessor to repossess the equipment upon default of the lessee or upon breach of any other clause in the contract after prior notice.
32. A clause giving the lessor the right to enter the premises of the lessee to repossess the equipment.
33. An clause indemnifying the lessor for any damage made to the premises of the lessee caused by the repossession of the equipment.

34. A clause giving the lessor the right to charge to the lessee any costs related to the repossession of the equipment, including legal charges.
35. A clause giving the lessor the right to recover from the lessee any loss occurred when the market value of the repossessed equipment is lower than the outstanding liability of the lessee. In relation to this, a clause stating how the market value of the equipment will be defined.
36. General contract clauses related to communications and place of jurisdiction.



CASE STUDY

The consultant hired by Crystal Clear Finance to carry out a feasibility study on leasing confirmed the viability of a micro-leasing scheme. He suggests CCF to start leasing out types of equipment for which there is a big demand in the region, notably diesel generators and water pumps. In the report on the feasibility study, he makes a number of additional recommendations:

1. Although there are four different shops in Durma selling both diesel generators and water pumps, the consultant recommends Crystal Clear Finance to procure the equipment from one supplier only. In this way, CCF would benefit from volume discounts offered by the supplier.
2. Since most clients are primarily dependent on agricultural production, CCF should offer seasonal lease schedules. In the four months before the big rice harvest in Durma, lease instalments should be around 50% lower than they should be during the other 8 months of the year.
3. Crystal Clear Finance should require from all clients that they insure the leased equipment against theft or damage as well as against third party claims.

Please evaluate the recommendations made by the consultant.

KEY TERMS and CONCEPTS



- ✓ Advance payment
- ✓ Arms length value
- ✓ After-sales service
- ✓ Cash flow
- ✓ Quotation
- ✓ Deferred lease schedule
- ✓ Delivery acceptance note
- ✓ Insurance against loss or damage
- ✓ Lease committee
- ✓ Life insurance
- ✓ Routine maintenance
- ✓ Seasonal lease schedule
- ✓ Stepped lease schedule
- ✓ Third party insurance
- ✓ Turnkey lease



Application form used by ANED Bolivia

GENERAL INFORMATION OF APPLICANT:

First and Last Names:	
Identification Number:	
Date of birth: ___/___/___	Sex: Male <input type="checkbox"/> Female <input type="checkbox"/>
Occupation:	Civil Status:
Address:	
Years of Experience in the Area: ___ Years	Training Received: Yes <input type="checkbox"/> No <input type="checkbox"/> Specify Area:

SPOUSE INFORMATION:

First and Last Names:	
Identification Number:	
Date of birth: ___/___/___	Sex: Male <input type="checkbox"/> Female <input type="checkbox"/>
Number of children or dependents:	

INFORMATION ON THE BUSINESS

Please indicate the number of employees that work with you:

	Family		Non Family	
	Male	Female	Male	Female
Paid				
Non-paid				

PHYSICAL LOCATION OF THE BUSINESS

Please draw an accurate map of the address of your enterprise



PRODUCTION PROCESS

Please describe the production process.

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EQUIPMENT TO BE LEASED

Please indicate the equipment to be leased and attach quotations.

Detail		Supplier					Amount in US\$	
How often are you willing to make payments?	Annually	Every 6 months	Every 4 months	Every 3 months	Every 2 months	Monthly	Other _____	
What should be the duration of the lease? _____ years			What is the upfront payment you are willing to make?					

Please explain for what type of work the equipment will be used and why you think it will be useful.

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ASSETS

What types of assets do you own?

Type of assets	Quantity	Estimated value	Description
House in the city			
Land			
Rural property			
Machinery and/or equipment			
Inventories			
Cash/bank			
Accounts receivable			
Other			



Product							
Month 7	Quantity						
	Price						
Month 8	Quantity						
	Price						
Month 9	Quantity						
	Price						
Month 10	Quantity						
	Price						
Month 11	Quantity						
	Price						
Month 12	Quantity						
	Price						

Other Sources of Income

Detail	Value	How often do you perceive them? (please mark the correct option)						
		annually	every 6 months	every 4 months	every 3 months	every 2 months	every month	Other _____
		annually	every 6 months	every 4 months	every 3 months	every 2 months	every month	Other _____
		annually	every 6 months	every 4 months	every 3 months	every 2 months	every month	Other _____
		annually	every 6 months	every 4 months	every 3 months	every 2 months	every month	Other _____
		annually	every 6 months	every 4 months	every 3 months	every 2 months	every month	Other _____
		annually	every 6 months	every 4 months	every 3 months	every 2 months	every month	Other _____
		annually	every 6 months	every 4 months	every 3 months	every 2 months	every month	Other _____
		annually	every 6 months	every 4 months	every 3 months	every 2 months	every month	Other _____
		annually	every 6 months	every 4 months	every 3 months	every 2 months	every month	Other _____



Water			annually	every 6 months	every 4 months	every 3 months	every 2 months	every month	Other _____
Administrative Expenses			annually	every 6 months	every 4 months	every 3 months	every 2 months	every month	Other _____
Communications (telephone etc.)			annually	every 6 months	every 4 months	every 3 months	every 2 months	every month	Other _____
Advertising			annually	every 6 months	every 4 months	every 3 months	every 2 months	every month	Other _____
Transportation			annually	every 6 months	every 4 months	every 3 months	every 2 months	every month	Other _____
Debt			annually	every 6 months	every 4 months	every 3 months	every 2 months	every month	Other _____
Cost of life			annually	every 6 months	every 4 months	every 3 months	every 2 months	every month	Other _____

MARKETING:

Please mark the correct option:

How do you sell your products?	Directly to the consumer	To retailers		To wholesalers
	I use sellers and promoters	I sell through distributors		Others
Where do you sell your products?	From home	From my shop		At the market in a fixed place
	In a shopping centre	In the street (fixed place)	In the street (not fixed location)	Other:

We declare that all the information provided herein is true and authorize that ANED may verify this information, my financial standing with the credit bureaus and financial institutions. We will freely accept the denial of our application in case of alteration or misdoing, bad will or financial incapacity. We also accept to provide ANED with any information it requires during the application process or the duration of the lease.

Signature of the Husband

Signature of the Wife

MARKETING THE LEASE PRODUCT



The objective of this chapter is to:

- analyse the needs and preferences of the potential clients of a leasing programme
- present ways of reaching potential clients
- explore the options of the lessor to offer either a broad or a narrow range of equipment and associated services
- discuss possible partnerships between lessors, brokers, suppliers and buyers

Market research

Like any product, a lease product must meet the needs of the customer. The lessor has to accurately define the target client market, and design a product which meets that market's need more competitively than available alternatives.

For an institution already experienced in small and micro enterprise financing, the challenge of diversifying into leasing is the acquisition of knowledge of equipment and markets. Generally speaking, it is advisable to set up leasing programmes in well-known markets and to restrict leases to a narrow range of equipment. This strategy may narrow the market range, but it has more chance of success. Of course there must be enough lease customers for a threshold volume of business.

Before committing to introducing a lease product, the lessor has to undertake market research to confirm that there is sufficient demand. The following questions should be explored:

In what sector and with what equipment is there enough leasing business?

A lease product is offered to a market rather than an individual. The lessor has to make sure that the market as a whole has enough potential to service lease

instalments. If there is sufficient market potential and one lessee defaults, there will soon be another client to lease the asset after repossession.

The lessor needs to study the market and be satisfied that there is an opportunity for increased cash flows to be unlocked through leasing. *Sub-sector analysis*² is an excellent research tool for doing this. It examines the processes in a chosen sub-sector and assesses the value added, the institutions involved, the numbers of people engaged at all stages, and the volumes of business transacted. The process generates a *sub-sector map*, which allows the researcher to identify where in the sub-sector improved access to equipment is likely to have a large positive income impact.

The lessor need not undertake a sub-sector analysis if it has already been done by others. It is advisable therefore for the lessor to find out which sectors of the economy have been recently analysed. Existing high quality sub-sector studies can considerably lessen the work needed in market research.

Who are the target entrepreneurs/enterprises?

The next stage of the market research concerns likely lessees. Who are they?

- Are they new or existing businesses?
- What size are they? (turnover, asset base, wage expenditure per annum)
- Where are they to be found? What sort of premises do they operate in?
- What is their prevailing business culture?
- What legislative and regulatory environment do they operate in?
- What proportion of their business assets are in the form of equipment?

It is important for the lessor to understand whether the equipment will be used appropriately and productively. Some entrepreneurs will feel attracted to sophisticated equipment while lacking the skills to make full use of its operational capacity. In other types of businesses there might be an abundance of cheap labour, so that leased equipment would not bring about the desired savings in costs. For lessors it is necessary to understand the prevailing business climate amongst potential lessees to avoid dissatisfaction for both lessor and lessee.

² See for example : Graeme Buckley, *Understanding the informal sector using sub-sector analysis*, *Development in Practice*, Vol. 7, Number 4 - 1997

How does a client make the decision to lease?

By the time an entrepreneur approaches a lessor, he or she will have already gone through a decision-making process consisting of three basic steps:

1. The investment decision
2. The financing decision
3. The choice of lessor

1. The investment decision

The equipment used by small and micro-enterprises is either owned by the entrepreneur or by others from whom the enterprise purchases a service, e.g. photocopying, or transport. As the business grows, it reaches a point where the entrepreneur decides to invest in his or her own equipment. The entrepreneur then begins to collect information about how this can be done.

2. The financing decision

The most obvious way for an enterprise to possess and use equipment is by direct purchase. The two main alternatives for direct purchase are use of own funds or borrowing. The entrepreneur who does not have sufficient funds must borrow, and this entrepreneur is a potential client for leasing.

The entrepreneur will evaluate the lease option in the light of other ownership options — purchase with own cash, purchase with a loan, or a combination of own and borrowed money. These purchase options differ from leasing in an important way. Purchase bundles together possession and use of the asset and offers them as one product, whereas leasing unbundles possession and use and offers them as distinct products. In this sense a lease is quite different from a loan to acquire equipment, and is not directly comparable to it.

It is important to note here that in many developing countries entrepreneurs simply do not have a choice of financing options. In many cases small enterprises are unable to access medium-term loans from financial institutions. The leasing programme could be the only option available, and it is clear that many financial institutions in developing countries benefit from this absence of competition. But even without competition from other sources of finance, it is necessary for the lessor to understand the client and tailor the lease product to his or her needs.

3. *The selection of a lessor*

Once the entrepreneur has decided on the lease option, s/he evaluates one lease package or offer against another by looking at these factors:

content

- The types of equipment available for lease
- The lease term
- Whether or not the lessee will eventually own the equipment
- Liability of the lessee in the event of loss or damage to the equipment
- Embedded services such as technical advice and the availability of spare parts

price

- The amount of the instalments in absolute terms
- How the instalments are structured in time
- The advance payment
- Other costs related to using the equipment, such as repairs, maintenance, and insurance

competitiveness

- Flexibility in the terms of the lease contract
- Flexibility in the design of the lease schedule
- Free choice in selecting the equipment and equipment supplier
- Simplicity of procedures
- Quality of service from the lease officer
- Promptness of equipment delivery

The lessee will choose the optimal cost-value lease which corresponds most closely with his or her needs, preferences and financial capabilities. In designing the lease contract, therefore, the lessor is advised to make the effort to find out, understand and appreciate what values the lessee attaches to the various elements in the contract.

In practice, lessees will compare the lease option with any other financing alternatives available. The product designer must therefore be well informed

about these alternatives, and be capable of defining exactly the differences between them and the lease offer. Chapter 4 shows how the pricing of leases can be compared to the pricing of alternatives such as loans.

Comparing leasing with other financing options: an approach used in Kenya

An institution about to start a micro-leasing scheme in Kenya invited 10 small entrepreneurs to a workshop in order to see how potential clients would view the scheme. The various options for acquiring equipment were explained to the entrepreneurs:

- direct purchase with own funds
- taking out a loan and purchasing outright
- hire-purchase
- leasing

The periodic payments for each option were worked out realistically, taking into account tax, real rates of investment, and upfront costs.

A roleplay followed, where one entrepreneur acted as a potential buyer of equipment and the others were invited to advise him on what options to take or leave. All the arguments for or against each option were recorded. Each participant was then asked to consider all the options and to present their decision as if they were the potential investor. This exercise gave both the institution and the participants an overview of how competitive the proposed lease would be.

What type of equipment should be leased?

Leases are more attractive to clients when the clients can select the type, make and model of equipment they want to lease. For a number of reasons, though, lessors restrict the freedom of choice of their clients. In general, the lease product designer prefers equipment that attracts large numbers of lessees without unduly increasing the risk and cost associated. Dealing in equipment that can easily be sold, for example, reduces residual value risk for the lessor. The decision matrix facing the lease product designer is illustrated below.

Types of equipment to be leased: general or specific

Importance of equipment knowledge increases this way	Industry specific	General purpose
	Wide range	Wide range
	Industry specific	General purpose
	Narrow range	Narrow range
	Importance of market knowledge increases this way	

General purpose equipment vs industry-specific equipment

Dealing in general-purpose equipment is one way to reduce residual value risk and increase market size and density. Office equipment, for example, is useful to a wide range of businesses, so the lessor can, if need be, quickly find a buyer for it. With such general purpose equipment the lessor can have a large number of clients within a small geographical area, and hence reduce operational costs. General purpose equipment usually has a well-developed market, and estimates of actual resale price can be set to a fair degree of accuracy. The lessor therefore faces less uncertainty, although this also means that in some countries there is a greater opportunity for the lessee to abscond with the equipment, or for theft (real or alleged). In these circumstances the prospect of tracing and recovering the equipment is much lower.

One disadvantage of dealing in general purpose equipment is that lessors have more difficulty gaining in-depth knowledge about clients' business opportunities, since the types of businesses their clients operate may be very diverse. Knowledge of clients' markets is necessary to confirm that each lease

will generate the necessary increase in cash flow. Lack of this knowledge increases the lessor's exposure to loss through non-performing leases. By focusing on a given industry the lessor can get to know the clients' particular market, and this in turn results in a reduction in problem leases.

The very definition of leasing suggests that the success of a lease depends on the value in use of the leased equipment. It is equally important that the equipment has a high value in exchange. Therefore the ideal equipment for leasing has a high use value (its ability to generate the cash flows needed to service the lease) as well as a high exchange value (a ready re-sale market). Unfortunately, value in exchange does not always coincide with value in use, especially in developing countries where imperfections in market information can be pronounced.

Dealing in industry-specific equipment (which has high use value) will almost always mean a reduced secondary re-sale market for the equipment simply because the information on equipment sales does not reach potential clients. Industries that are attractive to lessors will be those that serve young and growing markets. In these markets competition is less intense, so the prospects for successful realisation of the cash flows needed to service the leases are good. But such industries will usually not have large numbers of small entrepreneurs engaged in them, and so there will be a smaller market in which to sell the leased assets readily if the need arises.

Wide range of equipment vs narrow range

Expanding the range of equipment increases the depth of service to clients. This means that one client may take out leases for more than one piece of equipment, thereby increasing the market size available to the lessor. The risks associated with this strategy are higher, though, since a broader equipment knowledge is required. Restricting the range of equipment allows the lessor to source equipment from a single supplier, and so claim volume discounts, warranties, and credit, all of which contribute to lower costs of leases to the client.

Whatever the choice of equipment range, it is desirable that the equipment accepted as eligible for leasing should be:

- Identifiable – It is important that every single piece of the leased equipment is described in the lease contract in such a way as to be readily distinguishable from other equipment. This can be done through serial numbers, registration, non-standard fittings, or visual branding.
- Technically appropriate for the job, its capacity well matched to the intended output and materials available to the business.

- Reliable in performance over the life of the lease. This depends in part on ready availability of affordable spares, repair and maintenance services.
- Within the price range prescribed in the leasing programme.
- Capable of holding up its market value, at least for the term of the lease.

Can second-hand equipment be leased?

In developing countries, the lessor may come under pressure to lease used equipment. The principal advantage of used equipment lies in its lower acquisition cost, which could enable lessors to offer shorter-term leases than for new equipment. In developing countries, where it is often difficult to raise medium term finance cheaply, this can be a significant contribution to reducing risks associated with mismatches between assets and liabilities. The lessor who deals in used equipment in developing countries is likely to have a wider market because of the lower costs of the leases.

If used equipment is to be offered on lease, it must be subjected to a thorough technical assessment to establish its reliability in performance, its estimated residual life and its likely fair market value. There must therefore exist in the lessor's environment credible, independent and affordable capacity for doing such assessment correctly. Where leased items are of low unit value, this may be challenging, since the cost of assessment must be loaded onto the acquisition price of the asset. For lessors dealing in industry-specific equipment, technical assessment is not so challenging since the value-adding capacity of the equipment will be known to a fair degree of accuracy.

Full service lease vs net lease

It will by now be clear that for a lease contract to run its cycle smoothly, a number of inputs are needed — insurance, maintenance, service and supply of spare parts. Different arrangements may be made for accessing and paying for these services. At one extreme there is what is known as a full service lease. Here all the services associated with the lease are procured and paid for by the lessor, and bundled into the lease price. At the opposite end is a net lease, where all services are procured and paid for separately by the lessee. There are a number of variations between these extremes. The appropriate lease to offer depends on the client's preferences and the technical and institutional capabilities of the lessor.

Bear in mind that leases become less directly comparable to loans the more they are bundled with other services. Financial institutions usually prefer the net lease, arguing that the technical aspects of the full service lease stretch too far away from their core business. However when dealing with small and micro entrepreneur clients, the lessor may find it prudent to take responsibility for certain inputs such as insurance, because these clients are often in a weak position to access them competitively.

Reaching potential clients

Once lease offers are designed and ready, a marketing effort is necessary to attract potential clients. There is a wide range of alternative marketing approaches, with some approaches being more effective in specific circumstances. The effectiveness of different approaches in the marketing of leasing to small and micro enterprises has not been studied extensively. We can however highlight some special challenges that are known about communicating effectively with small entrepreneurs.

Advertising through radio

This is an effective tool because many entrepreneurs in developing countries listen to the radio. Their listening patterns need to be studied before committing to specific slots. In many developing countries, specialised radio programmes provide advice on running small enterprises, and they are particularly popular with operators of small and micro enterprises. Advertising in, or sponsoring such programmes is likely to be effective.

Advertising through equipment suppliers

Lessors can ask equipment vendors to provide information about the lease programme to potential clients. Equipment suppliers are often the first point of contact for a potential client of the leasing programme, so it is strategic for a lessor to keep as many suppliers as possible fully informed about the programme. The lessor can leave brochures and other documents with the suppliers for potential clients to take home.

Word of mouth

Word of mouth is probably the most important marketing mechanism in developing countries. Existing clients are a source of both positive and negative information about a leasing programme. Ensuring a high degree of

satisfaction with the leasing service among existing clients and actively converting them into advocates for the service is perhaps the surest way for the leasing programme to take off successfully. It may be advisable for the lessor to set up a reference system so that potential customers are referred to existing lessees for firsthand testimonies, both about equipment and the lease programme itself.

Good service and advice

A lessor can provide valuable service and advice to the lessee beyond the lease itself. For example the research that the lessor carries out can be very helpful to the lessee. It can indicate which subsectors in the economy can support new income. Assistance with the selection of equipment type, make and model also adds value for the lessee, as do specifications of the maintenance schedule for the equipment. The lessor may also assist with advice on the operation of the equipment and on potential buyers for the SME's output. The quality of this kind of service is a value-added input to the client's business.

Extension workers, microfinance institutions and NGOs

Development workers such as government extension officers, NGO and MFI field staff can be important advocates of the leasing programme because they often are in close contact with small and micro enterprises, especially in rural areas. Lessors are advised to run campaigns to keep such people well informed about the leasing programme.

Monday sensitisation seminar

A micro-lessor in Tanzania used to advise any prospective client to attend a "Monday sensitisation seminar", conducted for at least an hour every Monday morning. During these seminars a staff member would introduce the procedures and conditions of the lease programme. On average around 30 prospective clients would attend the meeting. Clients can either fill in an application form on the same day or take the documentation home for further study.

Source: Pinder, C., SELFINA Tanzania, 2001

Partnerships

To market a profitable lease product, a lessor might look for certain partnerships with other institutions, both financial and non-financial. Lessors can establish mutual beneficial working relations with equipment suppliers, with investors, or with NGOs. Leasing companies based in urban centres might link up with microfinance institutions that have a strong rural presence. Common partnerships in leasing are broker-lessor relationships, leveraged leasing and supply chain leasing.

Broker-lessor relationship

Lessors based in urban centres might decide to work with brokers who are already working in localities where the lessor intends to penetrate the market. A broker in this sense means any organisation or individual that arranges lease transactions between lessees and lessors for a fee. The broker provides some of the services in the lease transaction, but does not retain the lease transactions in his own portfolio. The role of the broker depends on the arrangement between the lessor and the broker. Brokers can be involved in marketing the lease product, screening potential clients, arranging for the equipment with the manufacturer and in collecting and monitoring lease payments. In some cases, brokers also take part in the risk and in the profit of the deal.

A microfinance institution might consider taking on the role of broker in partnership with a leasing company. From the perspective of the lessor, the microfinance institution can offer:

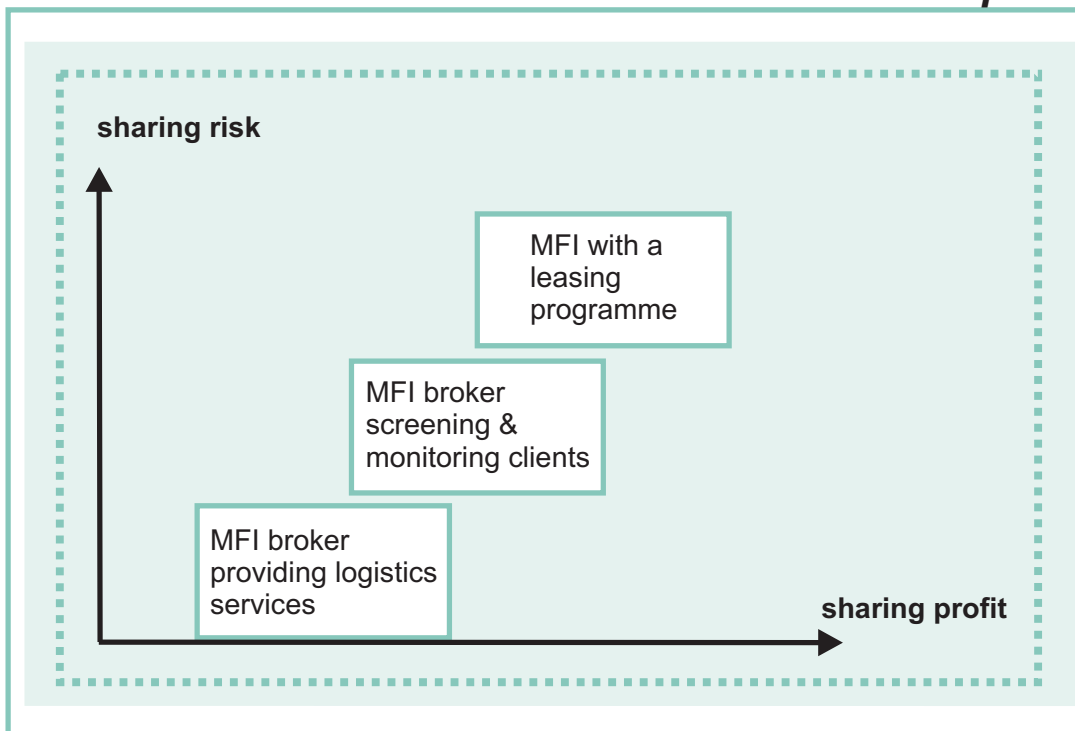
- staff used to dealing with small clients and their problems
- cost-effective evaluation and monitoring systems
- clients with good credit histories

The microfinance institution may simply provide logistic services for the lessor such as collecting lease payments in the area where it operates. This service may be provided without the institution taking part in the risk and the profit.

The microfinance institution might prefer to become much more involved, for example evaluating lease applications and monitoring leases on behalf of the lessor. In this case, the microfinance institution should take some of the risk and share in the profit associated with the leases. Brokerage services can be compensated for by a percentage of the lease amount as initial fee per transaction, plus an interest spread paid in arrears as the client is making the

lease instalments. While in such an arrangement the risk taken by the microfinance institution might still be limited, it does provide an incentive to carry out thorough lease evaluation and monitoring. The more the broker shares in risk and profit, the closer it should be involved in screening and monitoring of clients.

The MFI as a lessor or a broker: different options



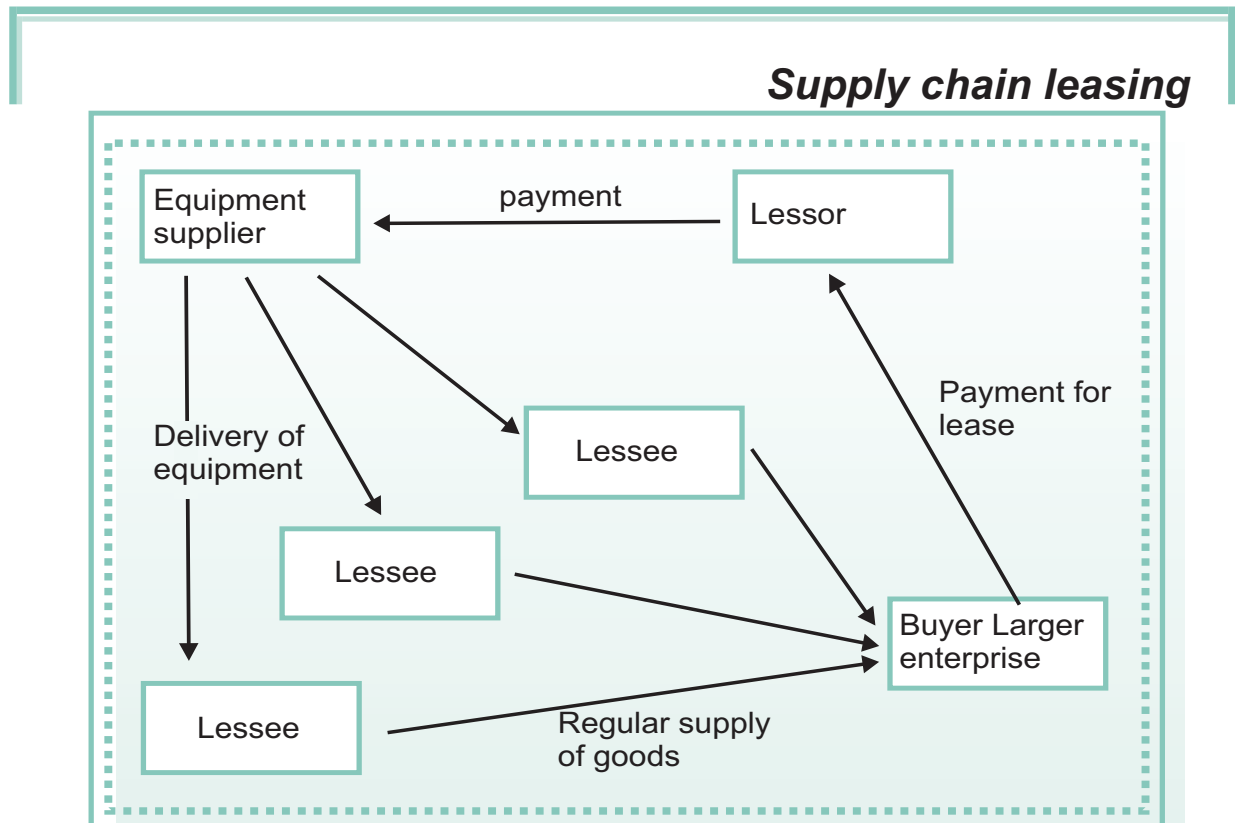
Leveraged leasing

Leveraged leasing is a way for lessors to overcome capital constraints by accessing capital from investors. In a leveraged lease, the lessor puts up some of his or her own money to purchase the asset and borrows the rest from a lender. The lender is given a mortgage on the asset and an assignment of the lease and lease payments. During the lease term, the lessee makes payments to the lessor, who in turn pays back the lender. If the lessee defaults the lender has the first right on the proceeds coming from a repossession of the equipment. Although the concept of a leveraged lease is simple, the contractual arrangements between the three parties are often complex. Because of these complexities and because of the fact that both the lessor and the lender have to evaluate the lease application, leveraged leases are usually

done with larger lease sums. This kind of partnership would not be of much interest to micro-lessors who have to minimise their evaluation and operational costs.

Supply chain leasing

Supply chain leasing is a mechanism conceived to specifically target industries where numbers of small enterprises produce inputs on a regular and predictable basis for larger companies further down the supply chain. This model assumes that both the small enterprises and their customer have a strong interest in increasing investment in productive capital and in maintaining their commercial linkage. A lessor can take advantage of this relationship between supplier and buyer.



The basic principles of this approach are:

1. The lessor offers leased equipment to the small enterprises that have established relationships involving regular deliveries to a larger company.
2. The lessees undertake to supply a minimum quantity of goods/services to the larger company — sufficient to cover the value of the lease payments.

3. The company monitors the lessees, deducting and assigning lease instalments directly to the lessor from payments of goods/services supplied by the lessee.
4. In the event of default, the lessor has a call not only on the leased asset itself, but also on any outstanding payment (typically 60 or 90 days supply) that the company owes the lessee.

This model has several advantages:

Firstly, the willingness of the lessees' customer to participate in such a scheme, which usually means incurring extra administrative costs, can itself be taken by the lessor as a confirmation of the market for the lessees' products/services, and hence of the viability of lessees' businesses.

Secondly, by undertaking the administration of lease payment collection within its own financial systems, the lessees' customer significantly reduces the lessor's overhead costs. The lessees' customer is also in a privileged position to monitor the performance of lessees' businesses since it should become aware of problems in output long before default occurs. Finally, the lessees' incentives against default are increased by the prospective penalty of losing payments owed by the lessees' customer.

**CASE STUDY**

While making preparations to start leasing out diesel generators and water pumps on a pilot basis, Crystal Clear Finance is approached by MEGA Leasing, a commercial lessor based in Libalia's capital city Libumba. Since MEGA Leasing doesn't have a branch office in Durma, it would like to enter a lessor-broker agreement with CCF. On the basis of this agreement, Crystal Clear Finance would arrange leases for MEGA Leasing in Durma Province with a minimum lease size of 1,000 USD and a maximum lease size of 10,000 USD. CCF would evaluate lease applications and collect and monitor lease payments but it would not have to finance the leases. MEGA offers a fee of 2% of the lease amount paid up-front plus 10% of the interest spread paid in arrears. Crystal Clear Finance would not take part in the risk as long as losses over each 6 months period remain lower than 5% of the average outstanding lease portfolio. CCF would have to cover 50% of the losses made exceeding 5% of the average outstanding portfolio.

Please advise CCF management whether they should enter an agreement with MEGA Leasing or whether they should set up their own leasing scheme.

KEY TERMS and CONCEPTS



- ✓ Embedded services
- ✓ Financing decision
- ✓ Full service lease
- ✓ General purpose equipment
- ✓ Industry specific equipment
- ✓ Investment decision
- ✓ Lease broker
- ✓ Leveraged lease
- ✓ Net lease
- ✓ Re-sale market
- ✓ Serial number
- ✓ Sub-sector analysis
- ✓ Supply-chain lease

PRICING THE LEASE PRODUCT

The objective of this chapter is to:

- introduce the basics of Net Present Values as a way of comparing the cost of a lease with the cost of a loan
- present ways for lessors to calculate yields
- discuss different types of risks that can affect the pricing of leases and the viability of a leasing scheme

Pricing from the lessee's viewpoint

The subject of pricing of leases should be approached both from the perspective of the lessee and from the perspective of the lessor. For the lessee, the pricing of the lease is one of the biggest factors in deciding whether or not to take up a lease offer. The price has to be set in such a way that the lessee finds the lease option competitive when compared to other ways of financing the equipment.

Net present values

Lessees can compare the costs of different financing options through *Net Present Value (NPV) analysis*. NPV analysis enables one to find a common standard when comparing options with different parameters. One may want to compare, for example, the price of a two year loan with 24 instalments with the price of a 3 years lease with 18 instalments and a purchase option. The reader interested in a full understanding of NPV analysis is encouraged to refer to a good finance textbook. The following is a brief introduction.

The principle of present value analysis is that the value of an investment lies not just in the amount of money paid, but the time it is payable. 100 USD spent today is of greater value than 100 USD spent a year from now. If the rate of interest is 10% per annum, paying 100 USD at the end of the year can be converted to the same as paying at 90.91 USD the beginning of the year (the present value).

The general formula for calculating the present value of an amount paid or received in the future is:

$$PV = FV (1+r)^{-N}$$

Where:

PV	=	Present value
FV	=	Future value
r	=	Annual discount rate
N	=	Number of years

In this case, the present value of:

100 USD spent at the end of the year = $100 \times (1 + 0,10)^{-1} = 90.91$ USD.
90.91 USD is said to be the present value of 100 USD paid one year hence.

The discount rate used in present value analysis should be the interest cost of borrowing.

For a lease, the present value of future payments by the lessee can be compared with the outright purchase price of the leased asset, or with the present value of the instalments of a loan.

Cost factors – outflows and inflows

When working out the net present value of a lease, the various payments or “outflows” should be included:

- The advance payment
- The lease instalments
- The purchase price on expiry of the lease contract

Lease clients might benefit from tax relief when they can deduct the lease payments from their pre-tax income. Tax relief constitutes an “inflow” of net present value.

Net present value can similarly be calculated for the option of taking out a loan to purchase the asset. In this case the inflows and outflows are:

- The equity contribution (outflow)
- The loan instalments (outflow)
- Tax relief due to depreciation of the asset (inflow)
- Tax relief on interest payment (inflow)

The present value of a lease may now be compared with that of a loan. If the net present value of the lease exceeds the net present value of the loan, the lease is clearly more expensive than the loan.

Example of Net Present Value (without tax relief)

An entrepreneur wants to buy a piece of equipment worth 4,000 USD.

The entrepreneur's financing option 1 is to make an own funds contribution of 1,000 USD and take out a bank loan worth 3,000 USD for three years with an interest rate of 12% (yearly instalments to be paid in arrears).

Financing option 2 is to lease the equipment over a period of 3 years with annual instalments of 1,500 USD payable at the end of each year and a purchase price at the end of the lease term of 800 USD.

NPV Analysis Option 1 (loan)

Year	Equity contribution	Loan instalment	Discount factor	Present value
0	1,000		1	1,000
1		1,360	$1/(1.12)$	1,214
2		1,240	$1/(1.12)^2$	989
3		1,120	$1/(1.12)^3$	797
Net present value:				4,000

Note that the NPV is the same as the original amount. This is because the discount rate used in present value analysis is the interest rate of borrowing. On this basis the present value of a loan is simply the amount of the loan, whatever the repayment schedule.

NPV Analysis Option 2 (lease)

Year	Lease instalment	Purchase price	Discount factor	Present value
1	1,500		$1/(1.12)$	1,339
2	1,500		$1/(1.12)^2$	1,196
3	1,500	800	$1/(1.12)^3$	1,637
Net present value:				4,172

In this example option 1 is cheaper and it would be a logical choice for the entrepreneur to make an own funds contribution of 1,000 USD and to take the 3,000 USD loan. Of course, the final decision of the entrepreneur might depend on other factors than costs. The entrepreneur might for example be attracted by the absence of advance payments or by certain extra services offered by the lessor.

Example of Net Present Value including tax relief

An entrepreneur wants to buy a piece of equipment worth 10,000 USD.

Financing option 1 is to take out a bank loan worth 10,000 USD with 10% interest for four years (yearly instalments to be paid in arrears). Tax payable on profits is 30%. The entrepreneur uses straight-line depreciation of the asset over a period of four years.

Financing option 2 is to lease the equipment over a period of 4 years with lease payments of 2,800 USD each year, payable annually in advance.

NPV Analysis Option 1 (loan)

In NPV calculations that include tax benefits, the discount rate has to be corrected for tax relief on interest payments. If it is assumed that tax payments arise in the same year as interest charges, then the after-tax cost of interest can be calculated as:

$$r(1-t)$$

r = the interest rate
 t = the tax rate

In this example the annual interest rate is 10% and the tax rate is 30%. Therefore the discount rate to be used is $10\% \times (1 - 0,30) = 7\%$.

If the entrepreneur chooses to purchase the equipment, she/he will benefit from capital allowances. In this simplified example, the entrepreneur depreciates the asset over four years according to a straight-line schedule. Every year an amount of 2,500 USD will be booked as depreciation costs on the profit and loss statement. The tax relief on this depreciation will be:

Year	Amount of depreciation	Tax saving on depreciation
1	2,500	750
2	2,500	750
3	2,500	750
4	2,500	750

The net present value can now be calculated as follows:

Year	Loan instalment	Tax relief on interest	Tax relief depreciation	Discount factor	Present value
1	3,500	300	750	$1/(1,07)$	2,290
2	3,250	225	750	$1/(1,07)^2$	1,987
3	3,000	150	750	$1/(1,07)^3$	1,714
4	2,750	75	750	$1/(1,07)^4$	1,469
Net present value					7,460

The discount rate used in present value analysis is the interest rate of borrowing, which in this example is $10\% \times (1-0,30) = 7\%$. So the same answer can be derived by deducting the tax relief on depreciation from the cost of the loan:

$$10,000 - (750 \times 1/(1,07)) - (750 \times 1/(1,07)^2) - (750 \times 1/(1,07)^3) - (750 \times 1/(1,07)^4) = 7,460.$$

NPV Analysis Option 2 (lease)

If the entrepreneur decides to lease the equipment, he/she can usually not take capital allowances since the asset is registered on the balance sheet of the lessor (see chapter 6 on taxation). At the other hand, he/she can deduct the full amount of lease payments from income before tax. This way, the NPV of the lease instalments minus tax relief would be:

Year	Lease instalment	Tax relief on instalments	Discount factor	Present value
0	2,800		1	2,800
1	2,800	840	$1/(1,07)$	1,832
2	2,800	840	$1/(1,07)^2$	1,712
3	2,800	840	$1/(1,07)^3$	1,600
4		840	$1/(1,07)^4$	(641)
Net present value:				7,303

In this case leasing is cheaper than taking out a bank loan. Again, the final decision of the entrepreneur will depend on both costs and other considerations.

It is important to note that the above examples are simplified and based upon certain assumptions, including:

- the tax rate remains the same over the years
- tax payments arise in the same year as interest payments
- the entrepreneur is able to benefit from tax relief

Pricing from the lessor's viewpoint

For the lessor, each lease has to be individually profitable. The lessor wants a desired minimum return on capital invested, and will establish rates accordingly. The amount of capital invested by a lessor in a lease equals the purchase cost of the equipment. Through the lease payments the lessor has to recover this investment and also realise a return on the investment. This return is referred to as the lessor's yield or profit. It has to cover the operational costs of the leasing programme as well as the interest expenses on the lessor's debt and a net profit.

The yield of an individual lease transaction is determined by:

the sources of income:

- Lease instalments
- Advance payments
- Income from sale of equipment at the end of the lease period

but also:

- Capital allowances (tax relief on depreciation)
- Tax relief on interest paid

and the sources of expenditure:

- Purchase cost of the equipment

but also:

- Profit tax on lease rentals
- Capital gains tax on the income from sale of equipment at the end of the lease period
- Interest cost of finance

Different lessors use different methods to calculate yields. The simplest way is to calculate yields on a pre-tax basis. In this method neither taxation nor interest cost of finance are taken into account.

Calculating yields on an after-tax basis is more complicated. In after-tax yield calculations, both the effect of tax relief and the taxes paid on income are taken into account. The project yield is influenced not only by the amount but also by the timing of these tax inflows and outflows. Since taxation has a considerable influence on the profitability of the lease programme, most lessors consider after-tax yield calculations to be more accurate.

The formula used is:

$$\text{Lease payment} = \frac{\frac{\text{NI}}{1 - (1 + \text{pi})^{-n}}}{\text{pi}}$$

where

NI = the net investment made by the lessor

pi = the periodic yield

n = the number of lease payments.

In this case the Net Investment of the lessor is 400 USD. The periodic yield is 16%/12 months is 1.3333% per month. Therefore the lease payments should be:

$$\frac{\frac{400}{1 - (1 + 0,013333)^{-6}}}{0,013333} = 69,81 \text{ USD}$$

With a business calculator, the same result can be obtained by entering:

END (signifying that lease payments are made at the end of each month)

16 I/YR (signifying that the interest rate per annum is 16%)

6 N (signifying that there are 6 payments)

12 P/YR (signifying that payments are monthly)

400 PV (signifying that the present value of the net investment is 400 USD)

The result of this entries will give a PMT (payment) of **69,81 USD**.

Example of a lease with an advance payment

Consider a lease arrangement with an advance payment as follows:

Equipment cost: 400 USD

Advance payment: 50 USD

Term: 6 months, paid in arrears

The lessor wants to realise a yield on this lease of 16% on an annual basis. How much should the monthly lease payment be?

The formula used is:

$$\text{Lease payment} = \frac{\frac{\text{NI}}{1 - (1 + \text{pi})^{-n}}}{\text{pi}}$$

where

NI = the net investment made by the lessor

pi = the periodic yield

n = the number of lease payments

In this case we can simply deduct the advance payment from the Net Investment made by the lessor. The net investment is 400 USD – 50 USD = 350 USD. The periodic yield is the same as in the former example: 16/12 months is 1.3333%. Therefore the lease payments should be:

$$\frac{\frac{350}{1 - (1 + 0,013333)^{-6}}}{0,013333} = 61,09 \text{ USD}$$

With a business calculator, the same result can be obtained by entering :

END

16 I/YR

6 N

12 P/YR

350 PV

The result of this entries will give a PMT (payment) of **61,09 USD**.

Example of a lease with a residual value

Consider a lease arrangement with a residual value as follows:

Equipment cost: 400 USD

Advance payment: 50 USD

Residual value: 60 USD

Term: 6 months, paid in arrears

The lessor wants to realise a yield on this lease of 16% on an annual basis. How much should the monthly lease payment be?

In this case we have to convert the residual value that will be received after 6 months into a present value. The present value of 60 USD after six months is:

$$60 \times (1 + 0,013333)^{-6} = 55,42 \text{ USD}$$

The net investment made by the lessor is 400 USD – 55,42 USD = 294,58 USD. The periodic yield is the same as in the former example: 16/12 months is 1.3333%. Therefore the lease payments should be:

$$\frac{\frac{294,58}{1 - (1 + 0,013333)^{-6}}}{0,013333} = 51,41 \text{ USD}$$

With a business calculator, the same result can be obtained by entering :

END

16 I/YR

6 N

12 P/YR

350 PV

- 60 FV (signifying that after 6 months a “future value” of 60 USD will be received)

The result of this entries will give a PMT (payment) of **51,41 USD**.

These three simple examples showed how to calculate lease payments given a desired level of yield. Lessors who want to design lease schedules with uneven payments, or who want to calculate yields on an after-tax basis, will have to use a computer programme. With a simple spreadsheet such as the one used by ANED in Bolivia however, most types of lease calculations can be done.

Types of risks

Like all business practices, leasing is subject to a variety of risks that affect the pricing of the lease product. The main risks for a leasing business are:

- Lease portfolio risk
- Residual value risk
- Maintenance and repair risk
- Cost of capital risk
- Currency risk
- Dispute resolution and litigation risk
- Changes in tax regulations

Lease portfolio risk

This is the risk of the lessee not servicing the lease instalments as scheduled. Of course careful selection of entrepreneurs and of market sectors helps to reduce this risk, but it is difficult to tell in advance the proportion and value of leases that will be rescheduled or foreclosed. If, in pricing the leases, the lessor underestimates such cases, the lease programme may turn out to be unprofitable. On the other hand, overestimating the lease portfolio risk may lead to unnecessarily expensive leases, reduced volume of business, and possible losses.

Residual value risk

Residual value refers to the value that leased equipment is expected to have at the end of the lease term. If the purchase price for equipment at the end of the lease term is not defined beforehand in the lease contract, the residual value remains a risk factor for the lessor. If a lessor is reasonably confident that the asset will be worth say 15% of its purchase price, s/he will set the lease instalments to cover only 85% of the purchase price. At the end of the lease term s/he will attempt to sell the equipment at the highest possible price. The risk is that the equipment may realize less than the expected 15% and the lessor may suffer a loss. Of course the lessor would gain if the asset realizes more than the expected 15%.

Lessors dealing with larger lease sizes often minimize their exposure to residual value risk either through buy-back agreements with equipment suppliers or through residual value insurance. In a buy-back agreement, the equipment supplier agrees to take the equipment back at a certain price. Residual value insurance is an insurance policy stating a guaranteed residual value of leased equipment. The insurance company pays out in case less than the stated residual value is realized. Naturally, both ways of minimizing risk bring in an extra cost.

Residual value also refers to the value that can be realised upon disposal of the asset in case of default and repossession. Lessors have to make sure that this value is higher than the outstanding lease instalments during the entire lease term. Uncertainty about the market value of the equipment influences the pricing and the structuring of the lease. One way to minimise residual value risk is to deal with a narrow range of equipment in a stable resale market.

Maintenance and repair risk

Closely related to the residual value risk is the uncertainty associated with the use and maintenance of the equipment. Because lessees do not own the equipment and may not opt to own it at the end of the lease, there is a risk that equipment may be kept in a poor state of repair. If so, it will fetch less than its projected fair market value after repossession. If, on the other hand, the equipment is well maintained or underused during the lease term, this may transmit as gains to the lessor. It is understandable therefore that a lessor would want to influence the repair and maintenance regime for the equipment, and to ensure through periodic inspections and other means that this regime is adhered to. What proportion of leased equipment is abused or inadequately repaired, and what proportion exceeds expectations, can only be established from historical records that the leasing company maintains over time. Adequate provision can then be made for losses associated with this uncertainty.

Cost of capital risk

One reason why leasing is more attractive to small enterprises than purchasing with loans is that loans available to small enterprises are mostly short term in nature, rarely exceeding 18 months. Leases, on the other hand, tend to have a term of around three years, because they are linked to the economic life of the leased asset. In most developing countries, it is difficult to raise fixed-rate medium term finance cheaply, and sometimes lessors are forced to finance

leases from short-term sources of capital. This can lead to a single lease being financed by three or four serial borrowings. The rate of interest prevailing at every subsequent borrowing cannot be predicted with certainty. This affects the profitability of the lease, because the cost of capital can shift during the lease term. The lessor has to provide for such uncertainty in the pricing of the lease. An excessively pessimistic view may render leases too expensive, reduce the attractiveness of the lease programme and undermine overall profitability. On the other hand, too thin a provision may mean losses for the lessor.

Currency risk

A lessor may borrow money to capitalise the leasing programme from a source which requires repayment in foreign currency. The lessor must convert income from lease instalments into foreign currency to service the borrowing. This exposes him to loss in the event of local currency depreciation.

Dispute resolution and litigation risk

As will be explained in the next chapter, leasing is uncharacteristically high in legal hazards compared with other businesses. The separation of ownership from possession and use makes it necessary to legislate on a number of potentially contentious issues between lessor, lessee, equipment vendors and third parties affected by the operation of the leased asset. This can lead to delays in recovering expected incomes, and costs in resolving such disputes. Both delays and legal costs eat into the profitability of the lease programme. Various steps may be taken to minimise the incidence of disputes, but some disputes are sure to arise, and the costs associated with their settlements or outcomes have to be provided for. Excessive provision increases costs of individual leases, while too low provisioning can cause liquidity problems.

Changes in tax regulations

The tax regulations ruling at the time of entering a lease contract are usually pivotal in determining its profitability. Sudden changes in tax regulations may significantly affect the profitability expected from leases. The risk of changes in tax regulations happening during the term of existing leases is higher in economies where government planning does not provide medium term fiscal stability.



CASE STUDY

Mr. Tipalia, a fish farmer based in one of the villages of Durma Province, is planning to buy a water pump for his fish nursery. The price of his preferred model is 2,400 USD. Crystal Clear Finance, in the leasing business since 6 months, has offered Mr. Tipalia a lease contract. According to the lease schedule, Mr. Tipalia would have to make an advance payment of 240 USD upon signing the contract. After that, there would be four yearly lease instalments of 712 USD, payable at the end of each year. Mr. Tipalia complains to Crystal Clear Finance that it would be much cheaper for him to take out a bank loan of 2,400 USD. He claims that he would be able to obtain a three years loan at the local bank with an interest rate of 11.5%.

Is Mr. Tipalia right in saying that Crystal Clear's lease is more expensive than the local bank loan?



KEY TERMS and CONCEPTS

- ✓ Accelerated depreciation
- ✓ After-tax yield
- ✓ Capital allowance
- ✓ Capital gains tax
- ✓ Cost of capital risk
- ✓ Currency risk
- ✓ Discount rate
- ✓ Future value
- ✓ Lease portfolio risk
- ✓ Net present value
- ✓ Pre-tax yield
- ✓ Present value
- ✓ Residual value risk
- ✓ Return on equity
- ✓ Straight-line depreciation
- ✓ Yield

THE LEGAL AND REGULATORY FRAMEWORK



The objective of this chapter is to:

- explain the legal issues that would normally be covered by a leasing law
- present the prudential requirements that would commonly apply to lessors
- advise lessors how to deal with the absence of a leasing law

The legal framework

All businesses have to operate within the law, and leasing poses specific legal hazards. These hazards are especially relevant when the clients are small and micro-enterprises, because the entrepreneurs who run these enterprises often operate on the fringes of the legal system and may not be aware of the law. Lessors can therefore expect misunderstandings and disagreements with some lessees over the interpretation of the lease contract.

If a country has specific laws about leasing, there is more certainty to the lease transaction, and fewer legal hazards. In a number of countries the legal framework takes the form of a Leasing Act or a statute with an equivalent name. The Leasing Act usually covers issues like:

- the definition of leasing
- the rights and obligations of the parties
- the right of the lessor to repossess the asset
- claims on residual value
- licensing
- prudential requirements

A Leasing Act will define the regulatory authority as well as the tax regulations for both lessors and lessees (described in detail in the next chapter).

The definition of leasing

A Leasing Act will give a definition of leasing. This is important, as leases are often confused with similar financing instruments such as hire purchases or chattel mortgages. The definition may be divided into further distinctions, most importantly finance and operating leases.

Rights and obligations

The particular legal hazards of leasing derive from the fact that the ownership of an asset is separated from its possession and use. In every lease transaction there is a potential for conflict between the lessee (who has possession and use), the lessor (who has ownership), and the equipment vendor (who sells to the owner, but extends warranties to the user). The parties involved may have different perceptions of their rights over the asset and the obligations of the other parties.

The lease contract gives the lessee the right to possess and use the asset. The lessor must allow the lessee unhindered possession of and use of the asset. The contract should enjoin the lessor in such a way that hindrances will modify the lessee's obligation to make periodic payments. The lessee for his/her part has to be enjoined to use the equipment only for the purposes for which it was leased. The law concerning the supplier will be spelled out in a country's Sale of Goods Act. Such a statute usually holds the seller responsible for the saleability of the goods and their suitability for their purpose.

The rights of the lessee in Uzbekistan

In Uzbekistan, the lessee is allowed to terminate the lease agreement if the lessor either fails to make the leased equipment available to the lessee or impedes its use as laid out in the lease agreement. The lessee has the right to make demands directly on the vendor of the leased equipment in cases where either the quality or quantity of the equipment supplied does not meet the specified requirements.

Normally in the purchase of equipment, it is common for the seller to offer to the buyer warranties and guarantees on the performance of the equipment. But in a lease the buyer is the lessor, not the lessee who is going to use the equipment, and this is where the legal complications may arise. If the equipment fails to perform as promised, it may be difficult for the lessee to hold the supplier liable, since there was no purchase contract between them. In such a case there is potential uncertainty as to whether the lessee should still be held liable for lease instalment payments.

A legal framework should recognise the three party structure of leasing, and make one or other party unambiguously liable for performance and saleability. This is important not only for minimising disputes, but also for increasing the attraction and competitiveness of the leasing sector as a whole.

Implications of equipment selection by lessors in Ghana

According to the Ghanaian Finance Lease Law of 1992, a lease contract shall include “a statement as to whether or not the prospective lessee has selected the asset and selected the supplier without relying on the skill and judgement of the prospective lessor”.

“Except otherwise provided in this law or in the lease agreement, the lessor shall not incur any liability in respect of defects in or fitness of the leased asset for any particular purpose unless the lessee has suffered loss as a result of his reliance on lessor’s skill and judgement and as a result of the lessor’s intervention in the selection of the supplier or the specifications of the asset.”

Repossession

One of the main attractions of leasing is that the lessor uses the leased equipment as principal security without the need for any additional collateral. This aspect of leasing is especially important in countries where weak collateral laws and dysfunctional judiciary systems prevent lenders from lending to small enterprises.

The legal framework for leasing should assure the lessor’s right, in the event of default, to repossess and dispose of the leased asset without hindrance or delay. If this right is not clearly stated in the legal framework, a lessor might find

the lessee claiming that his or her instalments have purchased equity in the equipment. Such claims can lead to long and costly judicial procedures.

The rights of the lessor on leased equipment in the United States

In the United States the rights of the lessor on the leased assets are determined by how the lease is classified. The regulatory framework makes a distinction between “true leases” and “secured transactions”. Whether a transaction is qualified as a true lease or as a secured transaction does not depend on the labeling of the transaction by the lessor, but on the economical substance of the transaction.

In a true lease, ownership rights are with the lessor, which makes it easy for the lessor to repossess the item in case of default or bankruptcy. For the lease to qualify as a true lease, however, the transaction has to conform to certain standards. Central to these standards is that the lessor bears the risk of residual value of the equipment.

If the transaction does not conform to these standards, then the transaction is qualified as a secured transaction. In a secured transaction, the lessee is the legal owner of the equipment. In case of default of the client, the lessor still has the right to repossess the equipment since the equipment functions as the security for the credit transaction. However in case of bankruptcy of the client, the lessor – as a secured creditor - can not repossess the equipment but instead has to wait for the bankruptcy resolution to see how much it is going to be paid.

In court, a transaction is likely to be classified as a secured transaction rather than as a true lease if:

- The term of the lease more or less covers the economic life of the asset;
- The value of lease payments is equal or greater than the purchase price of the asset;
- The responsibility for loss of the asset is with the lessee;
- The responsibility for repairs of the asset is with the lessee;
- The contract is set in a way that the lessee is likely to purchase the equipment for a fixed price.

Success in leasing schemes hinges heavily upon the elimination of ownership disputes between lessor and lessee. In countries where the law provides for the registering of moveable property, lessors can enhance their claim of exclusive ownership by registering their ownership before giving up the equipment for lease. In developing countries such possibilities are limited because the only equipment that can be registered are vehicles.

Claims on residual value

Most lessees will understand that it is the lessor's right to repossess the equipment if the lessee defaults on payments. But who benefits from the sale of the equipment after repossession? Some lessees may claim that any excess over and above the outstanding lease payments is due to them. Whether this is actually so depends on the lease contract and on the regulatory framework.

If the lessee has signed a contract giving him or her a claim on residual value, there is more potential for dispute after repossession. The lessee may allege that the lessor has sold the asset for less than its fair market value, thereby depriving the lessee of income.

If the lease contract states that the lessee has a claim on residual value after repossession, some refund is due to the lessee based on the realised value of the asset, and the lessor's freedom to re-lease the asset may be greatly impaired. If the lessor re-leases the equipment, it is not actually liquidated. In such cases some agreement must be arrived at with the first lessee about what constitutes a rightful claim. This is likely to be a challenge where the leased equipment has a high value in use but a low one in exchange as is commonly the case in lucrative but not well-established business sectors.

Repossession and residual value in Ghana

The Ghana Finance Lease Law states that in case of repossession:

- (1) the lessee shall, unless otherwise stipulated between the parties, be responsible for the immediate payment of all rents due for the remaining term of the lease agreement.
- (2) the parties may, under a lease agreement, stipulate that the amount of future rents at the time of repossession shall be decreased by the fair value of the asset repossessed less any administrative costs of the lessor, including but not limited to legal and transportation costs.
- (3) The lessor shall not be entitled to recover damages to the extent that it has failed to take reasonable steps to mitigate its loss.

The lease contract

Chapter 2 included a list of clauses which normally appear in a lease contract. Such contracts will be different from country to country, depending on the country's laws. The leasing regulations in some countries define in great detail what clauses have to be put into the lease contract. The socio-economic and cultural environment also affects the wording of the contract. For these reasons there can never be such a thing as a standard lease agreement.

Each lessor has to anticipate the issues that might arise from a lease and think about how to provide for them in the lease contract. However there are some common features in all lease contracts, and the clauses listed give guidance on drafting a contract.

Licensing

The regulatory framework usually puts strict controls on how financial institutions may venture into the leasing business. If financial institutions are contemplating leasing as a new line of business, they have to study these regulations carefully. Whether a financial institution goes directly into the leasing business or sets up a subsidiary company, it has to comply with the country's licensing and other regulatory requirements.

Lease licensing in Kenya

In Kenya, financial institutions are not allowed to engage directly in trading. Where the lessor bears residual value risk, leasing may be interpreted as trading and on this basis a financial institution may not engage in leasing. Even when the institution is able to persuade the central bank that its leasing activity is purely financial intermediation and not trading, it still requires the approval of the central bank to introduce leasing.

Prudential requirements

Prudential requirements for lessors are generally less stringent than those for banks, because lessors are not usually allowed to attract deposits. Nevertheless it is in the interest of shareholders as well as lessees that there are minimum prudential requirements. This helps to maintain a stable and vibrant leasing industry.

The regulation and supervision of lessors is usually vested in a country's Ministry of Finance or Central Bank. The regulating authority will spell out certain financial and administrative requirements for all leasing companies. The most common of these are:

- Minimum capital requirements

Financial institutions and banks are required to have a minimum amount of capital. Capital requirements for leasing companies are normally lower than those for banks.

- Maximum debt to equity ratio

The debt-equity ratio compares the amount of capital borrowed by the lessor with the amount of capital injected by shareholders. It is advisable that this does not exceed 10:1, meaning that no more than 10 units of capital should be borrowed for every unit invested by the shareholders. The 10:1 maximum ratio was recommended by the International Finance Corporation after many years experience in leasing ventures throughout the world³.

³ International Finance Corporation, *Leasing in Emerging Markets*, 1996

- Standardized financial statements

Financial statements are a means by which external parties can evaluate the financial health of the lessor. To stabilise the leasing industry in the country, the regulatory authority may make specific rulings concerning the presentation of the lessor's financial statements.

- Foreign exchange and customs

Lessors need to be able to freely convert local currency into foreign exchange. This enables them to buy equipment with foreign currency while setting lease payments in local currency. It is important that any customs duty that lessors pay on imported equipment is the same or less as would be paid by the entrepreneurs if they imported the equipment themselves. Many countries have adopted favourable regulation regarding customs duty in leasing.

Where there is no Leasing Act

If a country has no laws relating to leasing, this does not mean that leasing is impossible or illegal. But it does mean more uncertainty for the lessor and lessee. The absence of a leasing statute means that there is more scope for misunderstanding and less scope for litigation. In the absence of specific legislation on leasing, the courts may try to deliver justice but may have to resort to persuasion based on indicators of ownership.

If there is no specific leasing legislation, the lease contract can be written as an agreement between lessor and lessee on whatever terms they decide between them. However the agreement will still need an appropriate legal foundation, and care will have to be taken to avoid conflict with natural justice or other existing laws. The lessor should consider the existing legislation governing credit relationships, especially those which govern the handling of securities in the form of moveable assets. The drawing up of lease contracts in environments without leasing laws requires skilled knowledge of existing laws. It is best for the lessor to hire legal counsel for this. The lease contract may very well need to be based on more than one statute.

In the absence of an appropriate legal framework for leasing, the costs of leases are likely to be higher. The cost of legal hazards will become one of the risks associated with leasing, and should be realistically estimated. A legal assessment will shed light on potential legal hazards and their likely cost. The assessment will also point to the best institutional structure in which to conduct the leasing business.

Lease contracts should be designed with a view to minimising disputes. Disputes can never be eliminated, but it is worth properly evaluating the options for resolving them when they do arise. The cost and speed with which lease disputes are resolved is a factor in the profitable and competitive provision of leasing services. If dispute mechanisms are predicted and accurately factored into leasing costs, leasing programmes become more competitive.



CASE STUDY

On the 5th of January 2000, Mr. Tipalia decided to sign a lease contract with Crystal Clear Finance for a water pump worth 2,400 USD. Upon signing the lease contract he made an advance payment of 240 USD. At the end of the first two years of the contract he paid instalments of 712 USD. Because of problems on the fish farm, Mr. Tipalia was not able to pay the third instalment. Crystal Clear Finance sent Mr. Tipalia the necessary warning letters, after which it repossessed the water pump. Crystal Clear did not incur any legal costs for this repossession. Transport costs were 30 USD. Some days later CCF was able to sell the repossessed pump to the neighbour of Mr. Tipalia for an amount of 1,000 USD.

Lease schedule

Date	Amount
05-01-2000	240 USD
31-12-2000	712 USD
31-12-2001	712 USD
31-12-2002	712 USD
31-12-2003	712 USD



Mr. Tipalia's lease contract states that:

"In case of repossession:

- (1) the lessee shall be responsible for the immediate payment of all rents due for the remaining term of the lease agreement.
- (2) the amount of future rents at the time of repossession shall be decreased by the fair value of the asset repossessed less any administrative costs of the lessor, including but not limited to legal and transportation costs.
- (3) the lessor shall not be entitled to recover damages to the extent that it has failed to take reasonable steps to mitigate its loss."

What is the amount of the outstanding claim against Mr. Tipalia?

Is there any potential conflict regarding this claim?

If yes, what could Crystal Clear Finance have done to avoid conflict?

KEY TERMS and CONCEPTS



- ✓ Claims on residual value
- ✓ Debt to equity ratio
- ✓ Leasing Act
- ✓ Licensing
- ✓ Minimum capital requirements
- ✓ Prudential requirements
- ✓ repossession
- ✓ Sales of goods act
- ✓ Secured transaction
- ✓ Three party structure
- ✓ True lease

TAXATION



The objective of this chapter is to:

- explore the two ways in which a lease transaction can be treated for profit tax purposes
- introduce the effects that value added tax can have on the pricing and competitiveness of a lease
- stress the need for lessors to carefully study all possible tax liabilities

Many countries have fiscal policies to support the growth of small enterprises. These policies set preferential rates of profit tax for small enterprises and create incentives for small entrepreneurs to make capital investments, including incentives for leasing.

For many years, developed countries have introduced tax regulations that encourage leasing. Several developing countries, particularly in the last decade, have also done so, and those countries have seen an impressive growth of the leasing industry. This is not the case everywhere, unfortunately. In some countries, tax regulations for leasing remain unattractive or unclear.

Clearly, tax incentives have a direct positive effect on lease prices. Some lease products may be treated more favorably than others, so lessors should design leases to make the most out of the tax benefits available. It is usually necessary for the lessor to consult a tax advisor.

Tax accounting is an additional administrative burden for financial institutions offering leasing, especially for those that are tax-exempt for their other activities. It is important to maintain traceable records, with clear paperwork for claims and audits. National and local tax rulings must be adhered to, as any violations could lead to a large tax bill, even several years after the event.

Profit tax

Profit tax, also known as corporate tax, is tax on the profit made by an enterprise. Profit tax rates vary per country, and sometimes vary within a country for different types or sizes of enterprise.

Corporate tax rates in South Africa

Standard corporate tax	30%
Corporations with annual turnover of less than R3 million (\approx 400,000 USD)	15% on first R150,000 (\approx 20,000 USD) 30% on amounts in excess of R150,000 (\approx 20,000 USD)
Employment companies/ labour brokers	35%

Source: Werksmans Attorneys 2002

Many countries have a tax system that reduces the overall amount of profit tax paid by the lessor and the lessee over a lease transaction. This has benefits for both lessor and lessee. Advantageous tax treatment only materialises for leases in which the lessor is allowed to register the asset on its balance sheet for tax purposes. If, by regulation, the lessee is required to register ownership of the equipment for tax accounting purposes, the tax advantage doesn't occur. Exactly who, for tax purposes, is the owner of the asset (the *fiscal owner*) depends on the lease contract and on the tax regulations of the country.

The tax advantages offered to the fiscal owner are known as *capital allowances*. They permit the fiscal owner to deduct the cost of the equipment from pre-tax income through depreciation. Often the owner can use an *accelerated depreciation schedule*, which is even more advantageous because the tax advantages can be moved forward in time.

Capital allowances: an example

A lessor buys a tractor worth 20,000 USD. According to local tax regulations, the lessor can apply 30% capital allowances on the written down value of this asset. The country's profit tax is set at 25%. The table shows the capital allowance and tax saved for the first five years:

Year	Book value at the beginning of the year	Capital allowance (30%)	Tax saved (25%)
1	20,000	6,000	1,500
2	14,000	4,200	1,050
3	9,800	2,940	735
4	6,860	2,058	515
5	4,802	1,441	360

In this example, the capital allowance deducted within the first two years (6,000 + 4,200 USD) is more than half the total investment value. In most countries, even if the tractor was bought late in the first year, the company would still be allowed to register a capital allowance of 6,000 USD.

Tax leases

A tax lease is a lease contract which permits the lessor to register the asset on his or her balance sheet. For tax purposes, the lessor is treated as the fiscal owner, and therefore may deduct depreciation from taxable income. In most cases, depreciation can be deducted on an accelerated schedule. On the other hand, the lessor has to declare the total of lease payments received (both principal and interest) as taxable income. In this sense, the fiscal treatment of a tax lease is much like the fiscal treatment of an ordinary rent.

In a tax lease, the lessee can deduct the total lease payments (principal plus interest) from taxable income. Since the lease term is usually shorter than the economic life of the equipment, the lessee in fact “depreciates” the equipment more rapidly than if the equipment had been purchased directly. Thus both parties accelerate the depreciation of the asset, and the total tax payments are lowered.

Summary: the tax lease

<p>The lessor:</p> <ul style="list-style-type: none"> deducts capital allowances from taxable income registers full lease payments as taxable income 	<p>The lessee:</p> <ul style="list-style-type: none"> deducts full lease payments from taxable income
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Non-tax leases

In the non-tax lease contract, the lessor registers the lessee as a debtor, and pays profit tax on the interest income only. On the lessee's balance sheet, the equipment is registered as an asset, and the lessor appears as a creditor, as if the lease were a normal credit operation. The lessee deducts depreciation as well as the interest part of the lease payments from taxable income.

Non-tax lease: summary

The lessor:

- registers the interest part of lease payments as taxable income

The lessee:

- deducts capital allowances from taxable income
- deducts the interest part of lease payments from taxable income

Benefits of the tax lease

Clearly, the tax lease has advantages over the non-tax lease. It is therefore to lessors' benefit to design lease products which make them the fiscal owners of the assets being leased.

In developing countries, many small clients of leasing programmes do not benefit from capital allowances, even when these allowances are in principle available to them. There are various reasons for this. The enterprise may be too small (in turnover or profit) to use the depreciation allowances, or it may not have the accounting skills required, or it may not be aware of some allowances, or it may be operating outside of the tax environment altogether. In such cases, it is better for both parties if the lessor takes the tax advantages and transfers part of the benefit to clients by means of cheaper leasing rates. Such transfers of tax benefits are more likely to happen in competitive markets.

Calculation of tax benefits for the lessor

Whether a lease qualifies as a tax lease or a non-tax lease does not influence the amount of income that a lessor makes. But it does influence the timing when the income is taxed!

The following example shows how to calculate the net present value of the tax benefit:

Equipment cost:	50,000 USD
Yield:	12%
Lease term:	60 months
Monthly payment:	1,112 USD
Discount rate:	11%
Capital allowances:	33% straight-line depreciation
Corporate tax rate:	35%
Residual value:	0 USD

The lessor has purchased the equipment in the last calendar days of year 1, while the lease agreement has started on the 1st of January of year 2.

For a **tax lease**, the income for tax purposes is calculated as follows:

Year	lease payments	depreciation	income
1	0	16,667	- 16,667
2	13,344	16,667	- 3,323
3	13,344	16,667	- 3,323
4	13,344	0	13,344
5	13,344	0	13,344
6	13,344	0	13,344
	<u>66,720</u>	<u>50,000</u>	<u>16,720</u>

For a **non-tax lease**, the income for tax purposes is calculated as follows:

Year	lease payments	principle	income
1	0	0	0
2	13,344	7,765	5,579
3	13,344	8,749	4,595
4	13,344	9,859	3,485
5	13,344	11,109	2,235
6	13,344	12,518	826
	<u>66,720</u>	<u>50,000</u>	<u>16,720</u>

The **tax savings** on the tax lease as compared to the non-tax lease is:

Year	difference in income	tax savings (35%)	NPV of tax savings (11%)
1	16,667	5,833	5,833
2	8,902	3,116	2,807
3	7,918	2,771	2,249
4	- 9,859	- 3,451	- 2,523
5	- 11,109	- 3,888	- 2,561
6	-12,518	- 4,381	- 2,600
			3,205

The Net Present Value of tax savings in the tax lease as compared to the non-tax lease is therefore 3,205 USD.

Regulations on tax leases

National tax authorities have their own rulings about what constitutes a tax lease or a non-tax lease. In the United States for example, a lease only qualifies as tax lease when the lessor bears the risk of ownership.

Features indicating whether a lease is a tax or a non-tax lease in the USA

Tax lease ⁴	Non-tax lease ⁵
The lessor maintains a 20% investment throughout the lease term	A portion of the payment is designated as interest
The remaining life of the equipment beyond the lease term must be more than one year, or 20% of the term	The lessee acquires title upon payment of stated number of payments, or automatically at the end of the lease
The lessee cannot make any loan or guarantees to the lessor	The total amount payable over the lease period adds up to a large portion of total equipment costs
No bargain purchases at the end of the lease term are allowed	A bargain purchase option can exist

⁴ from IRS Revenue Procedure 75-210

⁵ from IRS Revenue Procedure 55-540

Kenya and Argentina have similar rulings that in effect forbid full pay-out or bargain options for tax leases. In these countries, if the transfer price of the asset is not at market value, then the lease is not classified as a tax lease. In India, Bolivia, and Mexico, on the other hand, bargain options are allowed in tax leases. Tax benefits still apply even if the asset is transferred to the lessee at a nominal price at the end of the lease term.

Capital allowances in India

In India, tax-payers benefit from capital allowances if:

1. the asset is owned by the taxpayer, and
2. the asset is used by the taxpayer for the purpose of the business.

While lessors always fulfil the first condition, there has been debate about what constitutes using the asset for the purpose of the business. Indian Courts have generally taken the view that the lessor's business is hiring out assets, so that lessors are eligible to register capital allowances.

Lease taxation in Korea

In Korea, a law promoting leasing was drafted as far back as 1976. The law allowed lessors to depreciate leased assets on an accelerated schedule for tax purposes, and allowed lessees to deduct the full amount of their lease payments from taxable income. On top of that, lessors were exempted for certain customs restrictions on imported equipment. These regulations enabled leasing companies to offer investment finance on more attractive terms than the banks. The result was the growth of a vibrant leasing industry.

Capital gains tax

Capital gains tax is charged when an asset is sold for a price higher than its book value. A lessor selling an asset might be liable for capital gains tax. This could apply whether the sale is made at the end of the lease, at an early buy-out, or after repossession of the leased asset.

Let us take an example. A farmer leased a tractor worth 20,000 USD as of the 31st of December 2001. According to local tax regulations, the lessor registers 30% capital allowances on the written down value of the asset. After a two year lease period, the farmer asked for an early buy-out option. The lessor offers to sell the tractor to the farmer in January 2004 for an amount of 9,000 USD. Capital gains tax is set at 35%.

Year	Book value at the beginning of the year	Capital allowance (30%)
1	20,000	6,000
2	14,000	4,200
3	9,800	2,940
4	6,860	2,058
5	4,802	1,441

In January 2004, the book value of the tractor is only 6,860 USD. The lessor has to pay capital gains tax on the amount of $9,000 - 6,860 = 2,140$ USD. At the tax rate of 35%, the lessor pays 749 USD tax on the sale.

Capital gains tax on leases in India

In India, as in many other countries, asset depreciation is worked out according to a pooling system. All assets for which a certain depreciation rate applies are pooled together. The value of the pool is the original cost of the assets in the pool, less the allowances already deducted. The depreciation allowance is applied to the pool as a whole.

If an asset is sold and its sales price is less than the book value of the entire pool, the book value of the pool is reduced by the sales price of the asset. If the sales price of the asset exceeds the value of the pool, the book value is reduced to zero. The excess is then treated as a short-term capital gain for the purpose of income tax.

Value Added Tax

Value added tax (VAT) is a tax levied on services and goods as they are sold. Unlike profit tax, value added tax is not meant to be a tax burden for the enterprise. It is a consumption tax that is ultimately borne by the final consumer of the good or service.

VAT is charged as a percentage of the sales price of a good or service, even if the buyer of that good or service is not the final consumer. Enterprises that sell goods or services have to charge VAT to their clients and they are obliged to transfer the total amount of VAT collected to the tax authorities. However they are allowed to deduct the amount of VAT they have paid on their own business purchases from their tax liability. In this way VAT is collected fractionally, as a percentage of the value added throughout the production or distribution chain. Because leasing is a service, lessors have to charge VAT on lease payments, although in some countries leases are treated slightly differently from other services.

Usually VAT is charged over the total value of the lease payments, including the interest part. This means that lessees pay more VAT than they would have if they had purchased the equipment directly. This does not make much difference to clients who can deduct their VAT payments from their VAT liability. But for small and micro enterprises who are not VAT-registered, VAT treatment of leases does affect their costs. The total amount of VAT payable over the lease might be higher than in case of direct purchase, but it might also be more manageable, since it is normally spread over the lease term.

Problems can arise when equipment is bought on informal terms without VAT being paid. In regions where informal purchases of equipment are common, lessors have to take this into account as a market reality in order to be competitive in their pricing.

Some items and goods have a low VAT status, or may even be VAT-exempt. In many developing countries, VAT rates on agricultural equipment are low, sometimes even zero. Thus it is important for lessors who lease out equipment to find out what VAT rules apply.

VAT on leased assets

in Belgium

In Belgium a 21 % VAT, calculated on the net purchase price, is payable on moveable goods. The purchaser/lessor can deduct this tax from the VAT collected. Leasing rentals attract the same 21% VAT, and the lessee can in turn deduct this from the VAT collected (with the exception of motor vehicles, where deductibility is limited to 50%). If the lessee does not benefit from VAT deductibility, or only partially, then he will not be able to get the VAT back (or only partially). If the lessee decides to purchase the goods at the end of the contract, the lessor applies the same VAT rate of 21%.

in Turkey

In 1985 the Turkish Government enacted a leasing law that reduced the VAT rate on most leased goods from 18% to 1%. A small number of luxury items and certain commercial vehicles were the only exceptions to this regulation. On top of that, leases were exempted from other official duty, and depending on the terms of the lease, from customs tax.

These large inducements boosted the leasing industry in Turkey, which experienced a 384% growth rate between 1985 and 1996.

in Ghana

In Ghana financial leases are treated for VAT purposes as if they were a supply of goods, not services. VAT is charged over the value of the equipment but not over interest charges. The amount of VAT paid to the equipment supplier at the time of purchase is reflected in the principal component of the lease instalments but there is no VAT on the interest part charged by the lessor.

Lessors who want to reclaim VAT on the equipment they buy, must become VAT-registered and they must keep clear records of all VAT paid and received. NGOs in many countries are not VAT-registered and therefore are unable to claim VAT. Apart from that, some tax authorities have regulations concerning the minimum amount of yearly claims, which can turn out to be a problem for small institutions wanting to embark on small-scale leasing schemes.

Other taxes affecting leasing

Besides profit tax and value added tax, both lessors' and lessees' businesses are affected by other local forms of taxation and tax allowances, including stamp duty, asset duty and customs duty. Lessors have to stay up-to-date with tax regulations.

Stamp duty in Colombia

In Columbia, lessees have to pay stamp duty on leases in which the sum of lease payments exceeds 53.5 million Colombian dollars (approximately 27,000 USD). This threshold amount is annually adjusted. Stamp duty is payable on the sum of lease payments, excluding the value of the purchase option.

Source: KPMG, Leasing Taxation 2000 edition

Asset tax in Mexico

In Mexico, asset tax functions as a minimum profit tax. The tax is payable at a rate of 2% over the average value of assets, reduced by certain types of liabilities, and it is only payable when it exceeds the regular amount of profit tax. If in a particular year, income tax exceeds asset tax, the excess may be credited against asset tax paid in the previous 5 years. Asset tax is therefore only a burden for entrepreneurs who pay little or no profit tax over extended periods of time.

Customs duty in Romania

In 1997 the Romanian government adopted a favourable customs regime for assets imported under leasing contracts. Lessors who import moveable goods into Romania under leasing contracts with Romanian clients, are not charged import duties. However the lessee is bound to pay customs duty corresponding to the asset residual value at the moment of conclusion of the purchase contract. This residual value cannot be less than 20% of the asset entry value.



CASE STUDY

Mr. Snapper, fish farmer and neighbour of Mr. Tipalia, has bought a second-hand water pump from Crystal Clear Finance for an amount of 1,000 USD. Until some days before Mr. Snapper bought the pump, it was leased out to his neighbour during a period of three years.

Crystal Clear Finance is treated as the owner of leased equipment for tax purposes. It can take yearly capital allowances worth 30% of the written down value of the equipment. According to tax regulation in Libalia, capital allowances are calculated for each asset individually. The rate of profit tax in Libalia is 35%.

Is Crystal Clear Finance subject to a tax charge related to the sale of the water pump to Mr. Snapper? If yes, how much is the charge?



KEY TERMS and CONCEPTS

- ✓ Book value
- ✓ Capital gains tax
- ✓ Corporation tax
- ✓ Customs duty
- ✓ Fiscal owner
- ✓ Fiscal policy
- ✓ Non-tax lease
- ✓ Profit tax
- ✓ Risk of ownership
- ✓ Stamp duty
- ✓ Tax exempt
- ✓ Tax incentive
- ✓ Tax lease
- ✓ Value added tax

ACCOUNTING



The objective of this chapter is to:

- introduce the two different ways leases can be accounted for in the lessor's financial statements
- present examples of book entries for different types of lease transactions

The two methods of lease accounting

There are two ways for lessors and lessees to account for leases in their financial statements — as an *operational lease* or as a *financial lease*. The basic differences in accounting procedures are:

- In an operational lease, the lessor registers the equipment as a balance sheet asset. The lessor owns the equipment and “rents” it out. The accounting procedure resembles that of a rental agreement. Lease payments received are recorded as “rent revenue” on the lessor's profit and loss account, and the lessor records the depreciation of the asset in accordance with prevailing accounting regulations on depreciation.
- In a financial lease, the lessee becomes the “owner” of the equipment, and registers it as an asset on his/her balance sheet. For accounting purposes, the lessor considers the asset as “sold” to the lessee, and the lessor's balance sheet records the lessee as a debtor. The accounting procedure is similar to that of a loan.

Local accounting standards usually prescribe how leases are to be treated for accounting purposes. It is the substance of the transaction rather than how it is labelled that defines who is treated as the owner of the asset. While the criteria used in accounting standards are similar to those used for tax purposes, there might be significant differences. Equipment ownership for the same lease could very well be assigned to one party for tax purposes and to the other party for accounting purposes!

Accounting classification criteria in India

Whether a lease is accounted for as a financial lease or an operational lease in India, depends on the substance of the transaction rather than its form. Examples of situations which would normally lead to a lease being classified as a financial lease, are:

1. the lease transfers ownership of the asset to the lessee by the end of the lease term;
2. the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable
3. the lease term runs for the major part of the economic life of the asset even if title is not transferred;
4. at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
5. the leased asset is of a specialised nature such that only the lessee can use it without major modifications being made.

Source: Institute of Chartered Accountants of India

Accounting procedures: operational lease

The accounting procedures in an operational lease are best illustrated by an example. On 1st January 2002, Afro Micro-leasing purchased a piece of machinery worth 10,000 USD, and immediately leased the machinery to Johnson Manufacturers on the following terms:

1. The lease term is 3 years with annual payments of 3,800 USD paid at the end of each year.
2. At the end of the lease term, Johnson Manufacturers will return the machine to the lessor.
3. The expected residual value of the equipment at the end of three years will be 3,500 USD.
4. The lessor applies straight-line depreciation for accounting purposes. (Note: the lessor might use a different depreciation schedule for tax purposes!)

The book entries are as follows:

Journal entries in January 2002

	Debit	Credit
Leased assets	10,000	
Bank		10,000

Journal entries in December 2002

	Debit	Credit
Bank	3,800	
Rent revenue		3,800
Depreciation expense	2,167	
Depreciation		2,167

Journal entries in December 2003

	Debit	Credit
Bank	3,800	
Rent revenue		3,800
Depreciation expense	2,167	
Depreciation		2,167

Journal entries in December 2004

	Debit	Credit
Bank	3,800	
Rent revenue		3,800
Depreciation expense	2,167	
Depreciation		2,167

At the end of the lease term, the lessor might sell the asset, and the sales value might be different from its book value. Any profit made (or loss incurred) should appear as a sales revenue (or loss) on the lessor's profit and loss statement.

Let us suppose that in January 2005, Afro Micro-leasing decides to sell the machine. The sales price obtained is 4,000 USD, which is 500 USD more than the actual book value of the machinery. The journal entries are as follows:

Journal entries in January 2005

	Debit	Credit
Bank	4,000	
Leased assets		3,500
Sale of asset		500

Operational leases with uneven rentals

In most countries, accounting standards prescribe that the rental income from an operational lease is to be recognised on a straight-line basis over the lease period. If the actual payments are uneven, the lessor has to create an account for accrued rent on the balance sheet.

Take for example a three-years operating lease with payments due at the end of each year. The payment pattern is as follows:

Year	Rentals
1	2,500
2	3,000
3	3,500

Each year the lessor has to recognize a rental income of

$$(2,500+3,000+3,500)/3 = 3,000 \text{ USD.}$$

The journal entries at the end of each year are:

Journal entries end of year 1

	Debit	Credit
Rent revenue		3,000
Bank	2,500	
Accrued rent	500	

Journal entries end of year 2

	Debit	Credit
Rent revenue		3,000
Bank	3,000	

Journal entries end of year 3

	Debit	Credit
Rent revenue		3,000
Bank	3,500	
Accrued rent		500

Accounting procedures: financial lease

The treatment of a financial lease is similar to that of a loan. The lessor takes the asset off his or her balance sheet and instead registers a “lease receivable”. Since the amount of the “lease receivable” includes an interest component, the lessor has to create a contra-asset called “deferred interest” or “interest receivable”.

Let us take as an example the same equipment leased over the same term, but as a financial lease. On 1st January 2002, Afro Micro-leasing purchased a piece of machinery worth 10,000 USD. Afro Micro-leasing immediately leased the machinery to Johnson Manufacturers on the following terms:

1. Lease term of 3 years with annual payments of 4,021 USD paid at the end of each year (interest rate of 10%)
2. At the end of the lease term, Johnson Manufacturers has the option to buy the machinery for the nominal value of 1 USD.
3. During the 3-year lease term, the lessee may not cancel the lease.

Accounting regulations in most countries would require the lessor to recognise a constant annual return on their investment. To calculate the annual return, the lessor should prepare a lease schedule that splits the payments into an interest component and a principal component. The lease schedule will then be:

	Principal outstanding	Rental payment amount	Interest revenue 10%	Principal balance repaid
Dec 2002	10,000	4,021	1,000	3,021
Dec 2003	6,979	4,021	698	3,323
Dec 2004	3,656	4,022	366	3,656

Journal entries in January 2002

	Debit	Credit
Machinery	10,000	
Bank		10,000
Lease receivable	12,064	
Machinery		10,000
Deferred interest		2,064

Journal entries in December 2002

	Debit	Credit
Bank	4,021	
Lease receivable		4,021
Deferred interest	1,000	
Interest revenue		1,000

Journal entries in December 2003

	Debit	Credit
Bank	4,021	
Lease receivable		4,021
Deferred interest	698	
Interest revenue		698

Journal entries in December 2004

	Debit	Credit
Bank	4,022	
Lease receivable		4,022
Deferred interest	366	
Interest revenue		366

**CASE STUDY**

Please prepare all book entries related to the following lease:

- (1) On the 5th of January 2000, Crystal Clear Finance purchased a water pump worth 2,400 USD to lease it out on the same day to Mr. Tipalia. According to the lease schedule, Mr. Tipalia had to make an advance payment of 240 USD upon signing the contract. After that, he would have to make four yearly lease instalments of 712 USD, payable at the end of each year (12% interest annually compounded).
- (2) Upon signing the lease contract on the 5th of January, Mr. Tipalia made the advance payment of 240 USD.
- (3) Mr. Tipalia paid the first two lease instalments of 712 USD on 28 December 2000 and 28 December 2001 respectively.
- (4) Because Mr. Tipalia missed the third instalment due on 30 December 2002, Crystal Clear Finance, on the 3rd of March 2003, repossessed the water pump. Transport costs upon repossession were 30 USD.
- (5) On the 5th of March 2003, Crystal Clear Finance sold the repossessed water pump to Mr. Snapper for an amount of 1,000 USD.

Crystal Clear Finance is treated as the owner of leased equipment for tax purposes. It can take yearly capital allowances worth 30% of the written down value of the equipment.

Water pumps in Libalia are VAT exempt. Leasing of VAT exempt assets is VAT exempt.

KEY *TERMS and CONCEPTS*



- ✓ Accrued rent
- ✓ Deferred interest
- ✓ Uneven rentals
- ✓ Operational lease
- ✓ Financial lease
- ✓ Lease receivable

PERFORMANCE MONITORING

The purpose of this chapter is to:

- introduce performance indicators that can be used to measure the portfolio quality, efficiency and financial viability of the leasing scheme

Every lessor needs to know whether the leasing programme is achieving its targets and objectives. This is done by monitoring indicators, both of day-to-day activities and of overall performance. Monitoring can reveal trends that show developments over time, and so it can be used by senior management as a tool to decide on issues such as pricing, marketing and branch networks. The most important indicators relate to portfolio quality, efficiency and financial sustainability.

Indicators

1. *Portfolio at risk*

The portfolio at risk indicator is a measure of the probable losses at a particular point in time. Different financial institutions calculate this indicator in different ways.

$$\text{Portfolio at risk indicator} = \frac{\text{probable losses on portfolio}}{\text{total outstanding portfolio}}$$

Let us assume the following composition of probable losses. These percentages can be set differently, depending on the actual record of losses incurred on the lease portfolio over time.

$$\begin{aligned} \text{Probable loss on portfolio} = & 10\% \text{ of outstanding lease amounts 1 to 30 days in arrears} \\ & + \\ & 30\% \text{ of outstanding lease amounts 31 to 60 days in arrears} \\ & + \\ & 70\% \text{ of outstanding lease amounts 61 to 90 days in arrears} \end{aligned}$$

Actual losses depend to a large extent on the sale or re-lease value of repossessed equipment. Therefore the percentages used in the calculations depend not only on the institution's competence to repossess, but also on the local equipment market.

2. Growth of portfolio

To measure the growth of the lease portfolio, the growth of portfolio indicator is used. This can be measured for the organisation as a whole or for each branch office, allowing comparison between different branches.

$$\text{Growth of portfolio} = \frac{\text{Actual outstanding lease portfolio} - \text{Last year's outstanding lease portfolio}}{\text{Last year's outstanding lease portfolio}}$$

3. Income on portfolio

$$\text{Income on portfolio} = \frac{\text{Income on portfolio}}{\text{Average outstanding portfolio}}$$

In operational leases, income on portfolio consists primarily of rent revenue less depreciation expenses. However to calculate the income on the portfolio correctly, the lessor has to include other income components, notably:

- interest penalties
- sales revenues (when sales values exceed book values)
- fees and commission received from lessees

On the other hand the lessor has to deduct:

- initial costs related to the procurement of the equipment
- sales losses (when sales values are less than book value)
- fees and commissions paid by the lessor on lease transactions

In financial leases, the income on the portfolio consists primarily of interest revenue. Other possible income elements to be included are:

- interest penalties
- sales revenues
- fees and commissions received from lessees

Elements to be deducted from income are:

- initial costs related to the procurement of the equipment
- sales losses

- fees and commissions paid by the lessor on lease transactions

4. *Leases per lease officer*

This indicator can be calculated for the institution as a whole or per branch. It tells us something about the efficiency of the institution.

$$\text{Leases per lease officer} = \frac{\text{number of leases}}{\text{number of lease officers}}$$

5. *Operating costs per lease transaction*

This indicator compares the overall operating costs of the programme to the amount of new leases disbursed. It tells us something about the operational efficiency of the programme.

$$\text{Operating costs per lease transaction} = \frac{\text{Total operating costs related to the leasing programme}}{\text{Number of leases disbursed}}$$

KEY TERMS and CONCEPTS



- | | |
|----------------------------|---------------------|
| ✓ Financial sustainability | ✓ Portfolio at risk |
| ✓ Income on portfolio | ✓ Portfolio growth |
| ✓ Operating costs | ✓ Portfolio quality |
| ✓ Outstanding portfolio | ✓ Probable losses |



GLOSSARY

After-sales services	Services provided by the equipment supplier, such as the provision of spare parts or periodic maintenance
Arm's length price	The price at which two unrelated and non-desperate parties would agree to a transaction
Bargain option	A provision in the lease contract that allows the lessee to purchase the equipment at the end of the lease contract for a price that is lower than the expected market value
Capital allowances	Depreciation expenses that companies are allowed to write off for tax purposes
Deferred lease schedule	A lease contract that includes a grace period at the beginning of the lease term
Depreciation	The expense charged to write off the cost of equipment over its useful life. In straight-line depreciation the expense is charged in equal amounts over the life of the asset. In accelerated depreciation the expense is charged in decreasing amounts over the life of the asset.
Discount rate	The interest rate of borrowing that is used in Net Present Value calculations to bring the value of future cash flows back to their present value
Down payment	The part of the purchase price paid in cash up front, reducing the amount of the loan
End-of-the-lease term option	The provisions in the lease contract that define the options of the client at the end of the lease term to either buy, return or re-lease the equipment

Financial lease	A lease that has the features of a financing arrangement for the purchase of equipment. For accounting purposes, a financial lease is a lease in which the lessee registers ownership of equipment.
Full service lease	A lease that includes additional services such as insurance and maintenance
Hire purchase	An arrangement similar to a financial lease but where partial ownership is transferred to the lessee with each lease payment. Upon the last payment the lessee automatically becomes the full owner of the equipment.
Lease broker	An individual or institution that provides services in lease transactions without retaining the leases in his/its portfolio
Lease term	The duration of the lease as stated in the lease agreement
Lessee	The user of the equipment on lease
Lessor	The owner of the equipment on lease
Leveraged lease	A lease in which the lessor leverages his/her investment in the lease with borrowed funds. In case of default, the creditor has a direct claim on the lease and on the leased equipment.
Net lease	A lease that does not include other services like insurance and maintenance
Net Present Value	A method used to evaluate investments, whereby the net present value of all cash outflows and inflows is calculated using a given discount rate
Non-tax lease	A lease in which for tax purposes the lessee takes ownership of the equipment. The fiscal treatment of non-tax leases is disadvantageous compared to tax leases.



GLOSSARY

Obsolescence	A loss in the utility of an asset due to the development of improved or superior equipment
Operational lease	A lease that has the features of a contract for short-term use of equipment. In accounting terms an operational lease is a lease in which the lessor registers ownership of the equipment.
Payment in arrears	A stream of payments that is paid at the end of each period
Residual value	The real or expected value of the equipment at the end of the lease term
Sale and leaseback	A lease wherein a client sells a piece of equipment to the lessor while signing a lease contract for the same piece of equipment
Seasonal lease schedule	A payment schedule that is adapted for clients who expect their income to vary during the lease term
Security deposit	Money paid in advance of a lease transaction to protect the lessor against damage or non-payment
Stepped lease schedule	A payment schedule that is adapted for clients who expect their income to increase over the lease term
Tax lease	A lease in which for tax purposes the lessor remains the owner of the equipment. Tax leases offer fiscal advantages over non-tax leases.
Turnkey lease	A lease in which the lease schedule starts on the day the equipment is delivered and installed
Yield	The rate of return to the lessor on the investment in the lease



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