

Leasing and Factoring

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1 LEASING

In most of developing or transition economy countries, one of the major economic challenges is how to respond to the need for fixed investment to grow its real sector in a sustainable manner. Their banking system is usually under capitalized and does not have adequate source of long-term funding available in the country. Commercial banks are only able to offer a limited variety of products and services only to their clients who tend to be large and/or state-owned companies.

On the other hand, small- and medium-sized enterprises (SMEs) are given lower priority from their bankers due mainly to their limited disclosure of information, uncertain business base, unreliable financial statements, insufficient level of collateral, or poor and short credit history. SMEs may be able to obtain short-term working capital funding but it would be extremely difficult to borrow long-term equipment funding. Furthermore, even when SMEs are able to borrow long-term funding for their new equipment, interest payment particularly at the beginning of its loan period will give substantial burden to their financial situation.

Financial lease has been developed during the last twenty years to offer a new means of finance to give access to those enterprises that had been facing with the difficulties in finding suitable ways for their investment.

This chapter I will provide some basic notions on financial lease. Starting with the definition, it presents a basic structure. Secondly comparing finance lease with other similar financial means will be discussed to clarify advantages. Finally, for an efficiently functioning financial lease, a good legal framework as well as its implication on accounting and taxation will be examined.

1.1 Definition of Financial Lease

Financial lease is a medium-term financial instrument based on a contract between the owner of an asset called the Lessor and another party called the lessee who is given the right to use the asset for a specified period in return for specified payments. Assets for lease contracts are machinery or depreciable equipment. Financial leases are, in general, concluded for most of, or all, the useful economic life of the asset.

The notion of leasing is formulated on the basis that profits are generated by the usage of an asset but not from the ownership of the asset. Generated cash flow by business operations of the lessee from the leased asset covers lease payment. Thus, a lease arrangement is more

beneficial for SMEs that may not have sufficient collateral, or a long credit history with banks.

1.2 Structure of Leasing

Financial lease is a contractual arrangement between two parties, which allows One party (the lessee) to use an asset owned by the other (the Lessor) in exchange for Specified periodic payments. The lessee uses the asset and pays rentals to the Lessor, who legally owns it. The legal owner relies on the ability of the user to generate sufficient cash flows to make lease payments, rather than relying on its assets, capital base or credit history.

Leasing institutions include banks, leasing companies, insurance companies, other non-bank financial institutions and equipment producers or suppliers.

Knowledge about results of business operations generates indicators of the adequacy of prospective cash flows. This knowledge provides some form of substitute information for credit history that would otherwise not be available if formal financial statements were insisted upon.

Security for the transaction is provided by the asset itself. Thus, leasing enables borrowers without well-developed balance sheets or credit histories such as SMEs to access the use of capital equipment in cases where they would not be able to avail of and qualify for traditional commercial bank lending. In spite of its long history as a financing technique, leasing has evolved considerably only in the last several decades from being an equipment manufacturer's selling technique into a specialized financial service.

1.3 Financial Lease Compared with Other Financial Instruments

Before examining the detail of financial lease, let us take a look of the difference of financial lease with other similar financial instruments.

Financial Lease vs. Operating Lease

The financial lease transfers ownership of the asset to the lessee by the end of the lease term, whereas the ownership remains at the Lessor in the case of the operating lease.

The lessee, under the financial lease, has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair market value at the date the option becomes exercisable. The operating lease does not give any option for the lessee to purchase the asset under a lease contract. .

The lease term is for most of, or all of the useful life of the asset but an operating lease contract period may vary from a short to a long duration...

Financial Lease vs. Bank Loan

There is only one substantive difference between a lease and a bank loan. The asset belongs to the Lessor with a financial lease, whereas the asset belongs to the borrower with a bank loan.

As for the similarities, there are many between a financial lease and a bank loan. A financial lease lessee and a bank loan borrower have the choice on the acquisition of the asset, and over the period of both a lease and a loan, interest and capital are repaid.

If there is default on either a lease or a loan, both the Lessor and lender have legal rights to reclaim or repossess the assets. The risks and costs of ownership, including maintenance and repair, remain with the lessee and borrower. When the asset appreciates, neither the Lessor nor the lender benefits. The agreements are non-cancelable until either the Lessor or the lender has recovered its outlay.

1.4 Financial Lease Advantages and Disadvantages

Financial lease offers several advantages over traditional bank loan to the lessee.

Advantages and Disadvantages to Lessee

In most of developing countries, leasing could be the only available source of medium-term financing particularly for SMEs to expand their production level through making capital investment by purchasing equipment.

SMEs, in particular those who are rather new, can arrange a financial lease more easily than bank loans, the latter of which require cumbersome collateral arrangement. Leasing contracts can be arranged in a simpler and quick manner since security arrangement is not needed, and lease payment including down payment can also be flexible in accordance with the expected cash flow

Tax incentives are often available through lease financing. Lessees can offset their full lease payments against income before tax, compared to the depreciation or the interest expenses on bank loans. This may not be attractive to SMEs, since their cash flow-driven operations in informal markets are not receptive to keep such accounting records for income tax purposes.

Advantages and Disadvantages to Lessor

The purchase of the equipment is directly made by the Lessor after the Lessee has made his/her choice. This will give assurance for the Lessor that the equipment is not used for other purposes by the borrower. Simpler documentation can keep transaction costs down

and this enables leasing companies to efficiently achieve high volumes and manage their costs.

Leasing companies are usually not banks and are not under strict regulations than banks are. This enables them higher leverage than other financial institutions and liberating them from directed lending mandates by government policy. On the other hand, leasing companies have to source their funding from the more volatile and higher-costing money markets. Moreover, medium- to long-term funds may also be in short supply in the domestic financial market.

As legal owner of the asset financed the Lessor has a stronger security position whereby enforcement of security rights upon non-payment is potentially simpler, less cumbersome and less costly since no court action is required.

1.5 Promoting Financial Lease

The financial lease opens access to enterprises which may not have substantial assets or a good credit history either may be able to expand their production and offer new hiring opportunities. This may also relieve SME owners from cumbersome collateral arrangement including cash deposit as de-facto collateral to maintain better banking relationships.

By developing leasing, SMEs can be more economically active by enabling access to finance. The financial leasing also offers an important advantage in countries with weak business environments, particularly those with weak creditors' rights and poorly functioning collateral and registry system in countries where secured lenders do not have priority in the case of default.

Experience has shown that direct subsidization of leasing companies has been harmful to the development of the leasing industry. In many countries, it is perceived that providing lease finance to certain sectors will provide a means to overcome the difficulties these sectors face.

1.6 Legal and Regulatory Framework

Leasing is essentially a financial instrument that works based on its legal framework. Furthermore, its success rests on how well leasing legislation relates to legislation on finance. Often, domestic legal frameworks are not conducive to the development of leasing.

With any legislative change, amendments should be closely thought through to ensure that the most efficient and yet comprehensive changes are put forward. Whether the relevant local legislation is based on Civil Code or Common Law, the development of a specific and separate leasing law may not be necessary, although this will ultimately depend on local circumstances and existing legislation. All legislative changes need to be coordinated to ensure that there are no opportunities for conflict or contradiction.

Some of the key issues while reviewing and preparing new legislations are:

- To establish a leasing-specific legislation or clear definition of leasing,
- To reduce existing contradictions a country's legislative framework that prevent leasing from working effectively,
- To eliminate current legislation preventing the successful enforcement of leasing contracts.
- To make sure that Lessor hold title to leased assets,
- To make clear whether third parties can hold a security position in leased assets or have some kind of other claim on these assets.
- To establish Lessor right to take possession of a leased asset in case of default.

Regulation is a necessary where banks offer leasing by themselves and they should be implemented, however, only where there is a clear public interest and kept at an appropriate level.

The imposition of the minimum capital requirement (MCR) for financial organizations means that companies need to retain a proportion of their assets as liquid to satisfy any immediate demands placed upon their business, thus limiting their lending to a proportion of their net asset value. The imposition of MCR for non-bank Lessor acts as a form of regulation and requires supervision of the companies affected.

Clear distinction has to be made between the activity of the Lessor and banks, insurance companies, etc., and the necessity of imposing MCR with this regard. Establishing MCR is a necessary prerequisite for the deposit-taking institutions to meet their liabilities in case of default within the framework of the Basel accords on issues such as capital adequacy ratios. For such institutions, it is important that liabilities are met to avoid any negative implications for depositors.

1.7 Accounting Framework

International Accounting Standard (IAS) provides general rules and considerations on accounting matters. IAS-17 specifically gives suggestions for developing country accounting.

Accounting for Leases as a Lessee

At the beginning of the lease contract, finance leases should be recorded as an asset and a liability at the lower of the fair value of the asset and the present value of the minimum lease payments.

Finance lease payments should be apportioned between the finance charge and the reduction of the outstanding liability. The related finance charge should be allocated to produce a constant periodic rate of interest on the remaining balance of the liability.

Under IAS, accounting for the lease transaction is based on the economic substance of the transaction. The lessees will record a fixed asset on their books, depreciate that asset, record a payable representing their future lease payments, and recognize interest expense as part of the lease payment each period.

Accounting for Leases as a Lessor

In a same manner as the lessee, the Lessor, at the inception of the lease when an agreement is made, must record a finance lease as a receivable at an amount equal to the net investment in the lease.

1.8 Tax Treatment of Leases

Mainly for tax purposes, many countries have followed to not to allow the parties in a lease contract to opt one form of finance over another to avoid showing different accounting results. While leasing is essentially not complex, it may end up with substantially different effects depending upon the local context.

Leasing Taxation

With a view to promote investment by stimulating the domestic leasing sector, governments may introduce preferential tax treatments. The main reason to provide such treatment should be to increase domestic investment, not to give favor to the leasing sector. Furthermore, the introduction of any preferential tax treatment should be for a limited time period, and that period should be published at the time of introduction to enable the sector to plan accordingly.

Customs Duties

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

1.9 Depreciation

All business assets need to be depreciated over their useful economic life with the annual depreciation expense allowing reducing corporate income tax. A possible and practical key benefit attached to lease operation is to speed up the rate of depreciation to allow an

increased portion to be written off against corporate income and thus further reduction of the amount of tax payable.

1.10 Conclusion and Recommendations on Leasing

The role leasing plays in both emerging and developed markets have been growing rapidly, and it is considered that the growth potential of leasing can provide a valuable additional value to bring more source of finance.

Financial lease, in particular, is now well perceived to offer valuable financing resources for SMEs under the developing economy where the access to medium-term finance for their equipment investment is limited through the existing financial products.

In many markets, discussion of leasing often focuses on cross-border operations, leasing related on large projects, or tax relief type transactions. At the same time, any discussion of leasing should also pay sufficient attention to leasing for small and medium-size enterprises that are the engines of growth of each economy.

2 FACTORING

Commercial banks, usually ask their customers to submit collateral in return to their loans or credit lines. Their customers, SMEs in particular, have traditionally always been facing with the difficulties in providing sufficient collateral. In general banks approach starts from the fixed and tradable assets such as land, building, equipment and even sometimes intangible assets like their trade marks. With a limited size of operations, having relatively short history, SMEs may not be easy to find additional assets to secure against their borrowing requirements.

Generally speaking, the most popular assets for business operations are account receivables generated by the regular sales activities. When sales operations are concluded, the seller company sends its invoice to their customers who purchased their products. Both in Europe and US, the factoring or a financial mechanism by converting such invoices as legally supported financial tool to support working capital funding has always been popular.

In fact, the first factoring was born and practiced, nearly 4000 years ago, to use invoice or claim over sales as a mean to receive cash from a professional merchant who know well the seller's client. The first widespread, documented use of factoring occurred in the US colonies before the independence. During this time, cotton, furs and timber were shipped from the colonies. Merchant bankers in Europe advanced funds to the colonists for these raw materials, before they reached the continent. This enabled the colonists to continue to harvest their new land, free from the burden of waiting to be paid by their European customers.

This Chapter 2 will provide some basic notions on factoring. Starting with the definition, it presents a basic structure and players. Secondly a comparison of factoring with bank borrowing will be discussed to clarify advantages. Finally, for an efficiently functioning factoring a supportive legal framework and other key issues are discussed.

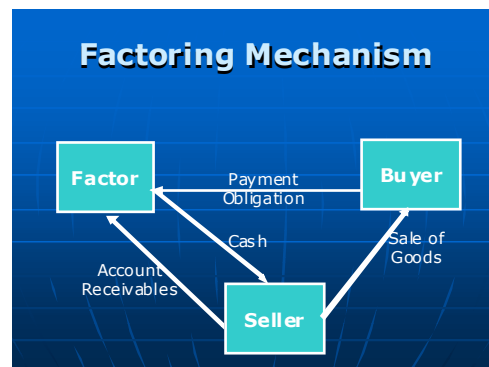
2.1 Definition of Factoring

Factoring is a type of supplier financing in which companies sell their accounts receivable to a professional institution providing factoring services and they receive cash. It is a fast and flexible method of improving cash flow of companies and providing working capital for them.

Factoring is not a loan and there are no additional liabilities on the firm's balance sheet, although it provides working capital financing. Factoring, in business practice, is offered as a comprehensive financial service that includes credit protection, accounts receivable bookkeeping, collection services and financing

2.2 Structure of Factoring

Companies recognize their account receivables as soon as the sales are committed. Such accounts receivable are presented to, purchased by a factor and receive cash at a discount. Factoring companies proceed to collect payment from the company's clients and get paid by due date of the invoice. At that time, if there is any remaining balance with the initial cashed amount by the factor will be paid to the seller company after deducting the factor's service fee and interest covering the factoring period.



The difference between this advance amount and the invoice amount adjusted for any netting effects such as sales rebates creates a reserve held by the factor. This reserve will be used to cover any deficiencies in the payment of the related invoice. Thus, even in non-recourse factoring there is risk sharing between the factor and the client in the form of this reserve account.

Under recourse factoring, on the other hand, the factor has a claim against its client (the "borrower") for any account payment deficiency. In emerging markets, most factoring is done on a recourse basis.

Reverse Factoring

Many factors will only purchase complete portfolios of receivables in order to diversify their risk to any one seller. However, this diversified portfolio approach requires factors to collect credit information and calculate the credit risk for many buyers.

One solution to these barriers to factoring is the technology often referred to as "Reverse Factoring". In this case, the factoring companies purchase accounts receivables only from high-quality buyers, i.e. large companies. The main advantage of reverse factoring is that the credit risk is equal to the default risk of the high-quality customers, and not the risky SMEs. This arrangement allows factors in developing countries to factor "without recourse" and provides low-risk loans to high-risk suppliers. Buyers, or the large companies getting supplies from SMEs, may be able to negotiate better terms with its suppliers. In addition, buyers benefit from outsourcing its account payables management to factoring companies.

The recent development in factoring sector in Japan has been focused on the reverse factoring led by large enterprises having numerous small suppliers to streamline and seek efficiency of their payable management with an extensive use of the reverse factoring (Izumi).

2.3 Factoring Compared with Bank Loans

Different from conventional bank loans, factoring does not put debt on the balance sheet and there are no loans to repay. By selling accounts receivables to a factor rather than borrowing from a bank, factoring simply converts accounts receivables into another asset, cash. Factoring can be short term or part of an ongoing financing program. New companies can benefit as well since there is no requirement for a long-term credit history.

Thus, factoring, as an alternative source of financing company's growth, eliminates many of the bank's criteria that are difficult to meet. The biggest problem with bank financing is that once a company reached their maximum credit limit, no additional funding is available from the bank.

Whereas banks lend primarily based on cash flow and collateral and establish an absolute maximum they will lend, factors provide cash based on accounts receivables. Factors primarily look at the quality of company's clients in terms of their credit worthiness and the validity of the company's invoices. This will allow factors to provide financing even if a company is new, or the credit history is weak. Because each account is evaluated individually, a factor has much more flexibility than banks when it comes to keeping up with an increase in sales.

2.4 Factoring – Advantages and Disadvantages

Factoring appears particularly important in financial systems with weak commercial laws and enforcement. Like traditional forms of commercial lending, factoring provides small and medium enterprises (SMEs) with working capital financing.

It may also be a powerful tool in providing financing to high-risk borrowers. The underwriting in factoring is based on the risks of the accounts receivable themselves rather than the risks of the borrower, the seller company. For example, factoring may be particularly well suited for financing receivables from large or foreign firms when those receivables are obligations of buyers who are more creditworthy than the seller itself.

However, unlike traditional forms of working capital financing, factoring involves the outright purchase of the accounts receivable by the factor, rather than the collateralization of a loan. The advantage of factoring in a weak business environment like those at developing countries is that the factored receivables are removed from the bankrupt seller company and become the property of the factor.

2.5 Legal Framework of Factoring

Factoring services has been known among business and finance professionals for a while in US, Europe and Japan and do not require a very specific legal framework to be promoted.

It has been rapidly growing mainly by private initiative in some of the developing and transition countries to support and complement banking services (Factor).

Table 1: Factoring Growth by Country (EUR million)

	2000	2001	2002	2003	2004	2005
Total Europe	414,383	468,326	522,851	546,935	612,504	715,486
France	52,450	67,660	67,398	73,200	81,600	89,020
Germany	23,483	29,373	30,156	35,082	45,000	55,110
Italy	110,000	124,823	134,804	132,510	121,000	111,175
Netherlands	15,900	17,800	20,120	17,500	19,600	23,300
Spain	19,500	23,600	31,567	37,486	45,376	55,515
United Kingdom	123,770	136,080	156,706	160,770	184,520	237,205
Total Americas	126,517	127,157	115,301	104,542	110,094	135,630
Brazil	12,012	11,020	11,030	12,040	15,500	20,050
U.S.A.	102,268	101,744	91,143	80,696	81,860	94,160
Total Africa	5,655	5,801	6,203	5,840	7,586	6,237
Total Asia	69,865	76,078	69,850	89,096	111,614	135,814
South Africa	5,550	5,580	5,860	5,470	7,100	5,580
PRC	212	1,234	2,077	2,640	4,315	5,830
Hong Kong, China	2,400	2,690	3,029	3,250	4,800	7,700
India	470	690	1,290	1,615	1,625	1,990
Japan	58,473	61,566	50,380	60,550	72,535	77,220
Singapore	2,100	2,480	2,600	2,435	2,600	2,880
Taipei, China	3,650	4,511	7,919	16,000	23,000	36,000
Thailand	1,268	1,240	1,274	1,425	1,500	1,640
Total Australasia	7,420	8,320	9,992	13,979	18,417	23,380
TOTAL WORLD	623,840	685,682	724,197	760,392	860,215	1,016,547

(Source: Factor Chain International)

There are, however, certain areas where policy measures to create a better business environment are expected to be introduced. Introduction of factoring laws providing regulations on registration of liens on account receivables, minimum capital requirements on factoring companies, establishment of a supervisory authority, tax treatment are some of the key issues to be further developed (Klapper).

2.6 Conclusion and Recommendations on Factoring

Factoring is a growing financing scheme not only for large corporations but also SMEs. The uniqueness of this scheme is found on the value of suppliers (or seller's) account receivables, or more precisely, the value of account payables of buyers. First of all it is not the supplier's credit risks, secondly factoring mechanism transfers their credit risks to their high quality buyers.

In fact, in most of the developing countries where credit information infrastructure like credit bureaus, credit rating agencies are not in place, large top enterprises of the country will have better access for financing. Under that circumstance, factoring may be the only source of financing for high-risk SMEs with poor credit history or no viable financial statement disclosure system.

Account receivables are not something special but they are daily operational tool of business for enterprises. Factoring may be, thus, particularly useful in countries with weak contract enforcement, and in efficient bankruptcy systems.

The reverse factoring developed by large-size buyers to seek efficiency in account payable and supplier management has already established faster and accurate payment operations to suppliers who are, in most of cases, SMEs. Thanks to advanced IT systems adopted by those large scale buyers lined up with factoring companies, this reverse factoring may also be best fit to SMEs in emerging countries.

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