# FINANCIAL LEASING AND ITS IMPLICATIONS IN TURKEY

Prepared by: Ali Orhon
Bosphorus University, Istanbul
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## Preface

Financial Leasing has always been a method for the use of assets without the requirement for a capital outlay; that is, using an asset without outright purchase.

To begin with, it is necessary to point out the fact that financial leasing, leasing finance and lease financing, all three correspond to the same concept, which is different from operating leasing.

In an environment where the industrial production investments are considerably slowing down as a result of scarce financing resources, as in Turkey, it was expected that financial leasing could be a solution for channelling capital to productive investments while attracting foreign enterprises into the country.

One of the interesting characteristic of financial leasing is that it has been introduced to the financial marketplace without any demand coming from the related parties. Although one year has passed since the enactment of the Financial Leasing Law, no practice could be realized up to now, while financial leasing is showing a growing trend in the world, even in less developed countries.

Thus, the examination of the major determinants of this phenomenon would contribute not only to the growth of financial leasing, but also to the development of the capital market by increasing the variety of the financial instruments.

The purpose of this study is, first, to fill the gap by defining the concept of financial leasing which is confused with other forms of leasing, both by the authorities and even in the Law itself, and compiling lists of pros and cons specifying the probable shortcomings that appear in certain cases. Secondly, this study will evaluate the Turkish version of financial leasing on the basis of legal, regulation, taxation, accounting and funding aspects, concentrating on the last three to a great extent, since they require further reconsideration due to the inconsistencies which appear in the structural relationship within the law, and with the other relevant subjects, besides the existence of the inequalities when compared with other forms of debt financing.

The absence of empirical data prevented to prove certain facts that are mentioned throughout the text. The high probability of irritation of the reader from the hypothetical approaches constituted another reason for the format of the study.But if sufficient data were available,it would be very much valuable to do such an empirical research.

Much of the specific content of this study is the result of interviewing and consulting businessmen and authorities in Istanbul and Ankara ,in addition to the relevant journals and books on the subject

Acknowledgements

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Finally,I am especially indebted to Nuri Uman for the freedom given to me during the preparation of this study.

The field of finance will continue to experience significant changes.It is stimulating to participate in these exciting developments,and I hope that " Financial Leasing and Turkey " will contribute to continued advances in the theory and practice of finance.

Ali Orhon Istanbul , June 1986

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## 1. The Development

### 1.1. Early History

Leasing has had a long and successful history. There is historical evidence that it was in widespread use around 5000 BC by the Sumerians and then many advanced civilizations had also applied leasing in their commercial activities.(1)

Finance leasing of land and buildings became popular in Europe in the middle ages because of the rigid systems of land laws and the restrictions on inheriting freehold property.

Railways brought the first great leasing impetus. Though they were highly active for only a short period of time, the wagon leasing companies both made a vital contribution to the rapid development of rail freight, and established the model for other forms of instalment credit.(2)

### 1.2. Modern Development

Leasing became increasingly popular for a number of reasons. The key attractions for equipment users were that it generally provided 100% finance and enabled firms to increase their overall debt-raising capacity by offering cash flow benefits and flexibility, since leasing companies tailored the pattern and size of rental payments to the specific needs of lessees. Leasing was aggressively marketed as an alternative to medium term bank loans and contractual formalities were completed with great speed by the leasing companies.

During 1970's, leasing expanded dramatically. The amount of new leasing business in both Europe and Japan grew over 800% between 1970-79. And by the end of the decade leasing was widely recognized as a primary source of equipment finance. In Europe, new asset acquired by Leaseurope members rose from ECU 11.6 billion in 1980 to ECU 19.6 in 1983. The highest growth rates were

1) Terry, Brian., Need for Leasing despite All Change. World Leasing Yearbook, 7th Edition, London: 1985, p:10

2) Ibid p:10

recorded by the Scandinavian countries, with Denmark up 390% in four years to ECU 323 million, Norway up 380% and Sweden up 650% to ECU 1.912 million. Over the five years ending March 1984 new leasing contracts in Japan increased at an average annual rate of 23% reaching Y2.326 billion (U.S.$ 9.7 bil.) in 1983-84. There has been spectacular growth of leasing in Australia, reaching an estimated 35% of all private capital expenditure on plant and equipment in 1984.(3)

## 1.3. Developing Countries

Leasing has spread gradually to a number of developing countries, following initiatives by International Finance Corporation ( I.F.C ), the private sector arm of the World Bank and several major banking and leasing groups.

The International Finance Corporation plays an important role in the development of the finance leasing industry in developing countries. It has already set up 18 leasing companies in developing countries in association with local finance houses and foreign participants. See Table 1

IFC recognizes the importance of leasing as a financial technique for small and medium sized companies, especially new or rapidly growing industrial and manufacturing firms. The IFC's basic premise is that leasing should not be at a disadvantage compared with other forms of finance and it aims to ensure that import duties, tax exemptions and investment incentives available to owner-used equipment are also available if the equipment is leased. The corporation has opened the way for leasing in many countries through negotiations with various authories. For example, through discussions with the Indian authorities IFC managed to legalize the leasing of imported equipment in that country. Leasing has rapidly developed in Korea as a result of

3) Clark, Tom., Leasing Finance, London: McGraw Hill Book Co. Limited, 1985, p:2

TABLE 1 I.F.C Investments in Leasing Companies

| | | Original IFC Investment(US$000) | | | IFC Loan | | IFC's Funds |
|---|---|---|---|---|---|---|---|
| COMPANY | COUNTRY | Date of IFC board approval | Equity | (% Total) | Own Funds | Provided by participants | as % of initial financial plan a |
| KOREA DEV.LEASING | KOREA | March 1977 | 371.00 | 10% | 5000 | 10000 | 21% |
| ORIENT LEASING | THAILAND | August 1978 | 150.00 | 15% | no | no | 4% |
| FISO LEASING | PHILIPPINES | June 1979 | 150.00 | 15% | 2000 | 3000 | 24% |
| LANKA ORIENT | SRI LANKA | May 1980 | 249.90 | 15% | no | no | 6% |
| LEASING BOLIVAR | COLOMBIA | September 1980 | 206.25 | 10% | 3000 | 6000 | 46% |
| JORDAN LEASING | JORDAN | April 1981 | 333.33 | 10% | no | no | 1% |
| SOGEWIESE | PERU | December 1981 | 137.00 | 15% | 3000 | no | 14% |
| SASEKA GOLERA | INDONESIA | December 1981 | 300.00 | 13% | 2000 | 2000 | 17% |
| AGRILEASING S/A | BRAZIL | May 1982 | 450.00 | 15% | 10000 | 20000 | 16% |
| SOFINLOC | PORTUGAL | October 1982 | 350.00 | 15% | no | no | 1% |
| INDIA LEASING | INDIA | March 1983 | 474.00 | 15% | 3000 | no | 27% |
| CO.DOMINICANA LEASING | DOMINIC REP. | May 1983 | 150.00 | 15% | 3000 | no | 1% |
| LEASING CO.of INDIA | INDIA | June 1983 | 462.00 | 15% | 5000 | no | 27% |
| UDC LTD. | ZIMBABWE | April 1984 | 409.00 | 20% | 2000 | no | 10% |
| NATIONAL DEV.LEASING CO. | PAKISTAN | May 1983 | 450.00 | 15% | 4000 | no | 19% |
| TUNIESE LEASING | TUNISIA | June 1984 | 571.00 | 10% | no | no | 20% |
| INDIA LEASE DEV.LTD. | INDIA | June 1984 | 409.00 | 15% | 5000 | no | 10% |
| INDUSTRIAL DEV.LEASING CO. | BANGLADESH | November 1984 | 250.00 | 10% | 1800 | no | [illegible] |

a The Initial Financial plan is intented to meec most of the company's requirements during its start up phase

Source:World Leasing Yearbook

legislative changes implemented in the late 1970s.(4)

International Finance Corporation has conducted a mission to examine the existing legal, accounting, fiscal and regulatory climate relevant to

a) the development of financial leasing and

b) establishing a leasing company in Turkey in collaboration with Industrial Development Bank of Turkey ( T.S.K.B ) in 1982.

1.4. Leaseclubs

While some leasing groups were establishing their own international networks, others, lacking the same resources or connections, formed leaseclubs to assist exporters of capital equipment by introducing them to lessors in other countries.

As well as being a channel for introductions, leaseclubs;

a) establish international manufacturer and dealer chains for assets such as computers, office machines and agricultural and earth-moving equipment

b) provide a forum for exchange of information on commercial and technical developments, financial and administrative systems

c) organize training courses and workshops for managers from member companies

d) exchange staff to broaden their leasing knowledge and experience.(5)

Beside these main features of leaseclubs, membership is also an excellent tool for a lessor to be connected with a worldwide organization.(6)

Further objectives of the co-operation between members of leaseclubs include joint ventures for special projects, consortium leasing, joint funding and job

4) Stanford, M., International Finance Corporation, World Leasing Yearbook, 7th Edition, London: 1985, p:3

5) Clark, Tom., Leasing Finance, London: McGraw Hill Book Co. Limited, 1985, p:2

6) Palmer R., Overseas Leasing Networks and Leaseclubs, World Leasing Yearbook, 7th Edition, London: 1985, p:35

rotation.From these goals benefits can be drawn for all members,especially for those from countries where leasing is in its early stages.

### 1.5. Infrastructure

The work of Unidroit on uniform rules for international contracts,International Accounting Standard on Leasing and OECD recommendations on taxation of cross-border leases are amongst the principal international developments after 1980s.

Leasing companies found it necessary to work closely together to promote and protect their interest and to represent their views to the authorities so with those aims national leasing associations were established in most of the countries in which financial leasing markets were active.

Regional organizations have also been established in various parts of the world to enable lessors to share their experiences,and to provide a forum for discussion with community bodies such as the EEC,and international professional organizations.

## 2. Domestic Markets

The following gives an overview of the leasing transactions among the investments during the recent years on the basis of the internal markets of each country included.

The leasing markets of the industrialized and developing nations of the world vary considerably in size and structure,from Australia,where leasing accounts for an estimated 35% of the private capital expenditure on plant and equipment.to Zambia with two entries appearing in the list of leasing companies in the World Leasing Yearbook 1985. ( 7 )

### 2.1. Industry Size

In 1984,leasing companies around the world spent

7) Clark,Tom. ,Leasing Finance,London:McGraw Hill Book Co. Limited,1985, p:3

some US$ 110 billion on new plant and equipment for leasing to their customers.This figure is made up of some US$ 70 for the United States market,US$ 30 for OECD countries and around US$ 10 in the remaining markets. ( 8 )

## North America

The figures of leasing business in North America are given in Exhibit 1.

The low level of leasing in Canada is a result of restrictions when accelerated method of depreciation allowances on leased equipment were limited to the rental income derived from the equipment.

## Europe

The annual report of Leaseurope published in September 1984 shows that 16 member leasing companies achieved a considerable growth in 1983 in a weak overall economic position.with a low level of new investment,continuing unemployement problems and internal & external deficits.New business increased by 25% over 1982,compared to a 15% growth rate previous year.( 9 )

Exhibit 2 shows the leasing in Europe.

## Asia

Leasing had gained a strong place in Asia by the beginning of the 1980s.The setting up of Asialease in 1982 and of several national leasing associations in the region led to the compilation of statistics confirming the development of leasing in Asia over the past few years.( 10 )

Exhibit 3 shows the statistics and estimate of leasing business in Asia in 1982-83.

## Australiasia

In Australiasia, only trading and merchant banks and finance companies can make leasing activities, other

8) Ibid,p:3

9) Ibid,p:3

10) Ibid,p:4

EXHIBIT 1 Leasing in North America

| COUNTRY | Currency Units/US$ | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|
| | | | (US$m) | | | |
| CANADA | 1.2[illegible] | 110[illegible] | 1200 | 1100 | 1000 | 1000 |
| UNITED STATES | [illegible] | 326[illegible] | 43500 | 55500 | 57600 | 61000 |
| TOTAL | | 339[illegible] | 44700 | 56600 | 58600 | 62000 |

1 Average 1983 exchange [illegible] used for all tables
Sources:Statistics Canada [illegible]979-82 and Equipment Lessors Association of Canada estimate for 1983 [illegible] of American Association of Equipment Lessors

EXHIBIT 2 Leasing in [illegible]rope

| COUNTRY | Currency Units/US$ | 1979 | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|---|---|
| | | | (US$m) | | | |
| AUSTRIA | 17.960 | 133 | 177 | 172 | 176 | 180 |
| BELGIUM | 51.130 | 124 | 137 | 121 | 196 | 226 |
| DENMARK | 9.145 | 54 | 58 | 75 | 254 | 286 |
| FINLAND | 5.570 | 58 | 117 | 245 | 295 | 225 |
| FRANCE | 7.621 | 2350 | 2756 | 2782 | 3346 | 4724 |
| GERMANY | 2.553 | 1058 | 1156 | 1488 | 1645 | 1919 |
| IRELAND | 0.805 | 11 | 13 | 34 | 43 | 155 |
| ITALY | 1519.000 | 741 | 1025 | 1378 | 1579 | 1759 |
| LUXEMBOURG | 51.130 | 5 | 5 | 6 | 14 | 13 |
| NETHERLANDS | 2.854 | 443 | 509 | 517 | 469 | 437 |
| NORWAY | 7.296 | 86 | 110 | 229 | 416 | 519 |
| PORTUGAL | 110.780 | | | | 6 | 44 |
| SPAIN | 143.430 | 209 | 150 | 221 | 335 | 478 |
| SWEDEN | 7.667 | 180 | 228 | 457 | 532 | 1696 |
| SWITZERLAND | 2.099 | 195 | 279 | 316 | 343 | 350 |
| UNITED KINGDOM | 0.660 | [illegible]730 | 3574 | 4052 | 4294 | 4385 |
| TOTAL | | 8377 | 10294 | 12093 | 13943 | 17396 |

Source:Leaseurope

EXHIBIT 3 Leasing in Asia

| COUNTRY | Currency Units/US$ | 1982 | 1983 |
|---|---|---|---|
| | | (US$m) | |
| CHINA | 1.977 | 40 | 70 |
| HONG KONG | 7.[illegible] | 140 | 348 |
| INDIA | 10.[illegible] | 50 | 75 |
| INDONESIA | 909.[illegible] | 94 | 297 |
| JAPAN | 220.5[illegible] | 803 | 1002 |
| KOREA | 775.80[illegible] | 211 | 461 |
| MALAYSIA | 2.[illegible] | 239 | 497 |
| PHILIPPINES | 11.[illegible] | 70 | 100 |
| SINGAPORE | 2.11[illegible] | 210 | 264 |
| SRI LANKA | 23.[illegible] | 7 | 13 |
| TAIWAN | 40.[illegible] | [illegible] | 444 |
| THAILAND | 23.[illegible] | 4 | 5 |
| TOTAL | | [illegible] | 3576 |

Source:Asialease and Natio[illegible] Leasing [illegible]ciations groups of investors are not permitted to claim investment allowances.In Australia a higher proportion of equipment is financed by leasing than in any other country.( See Exhibit 9 ) Estimates of leasing business in Australia and New Zealand are given in Exhibit 4.

Latin America

Severe investment cut-backs,hyperinflation and major funding difficulties have all contributed to big declines in various Latin American Leasing Markets in 1980s.Brazil represents the largest market.Statistics are not avaliable for Latin America leasing markets for recent years.

Worldwide

The estimate of the total expenditure on plant and equipment by leasing companies around the world in 1982 and 1983 is given in Exhibit 5.

2.2. Nature of the Markets

Various leasing facilities are available for small, medium and large industrial and commercial equipment users in all the markets.

Leasing companies have gradually enlarged their markets,and now any item of plant and equipment with a commercial purpose can be leased.Facilities range from a few dollars to more than US$ 250 million in the case of some energy installations.

Traditionally transportation and office equipment have been the most favoured assets for leasing.In many markets,commercial vehicles and motor cars and sometimes aircraft and ships have shared the leasing limelight with office and communication equipment.In Europe leasing of vehicles covers the major part of the leasing business.Plant and machinery is also a main equipment category.Furthermore medical equipment is becoming a popular investment for leasing.Exhibit 6 shows the main types of equipment leased in 1983 in those countries for which breakdowns are avaliable.

## 2.3. Regulations

The main theme in the list of recent developments in leasing markets is the study and issue of new regulations on the fiscal and accounting treatment of leasing.While,in some countries,restrictive legislation is being relaxed,in others new restrictions are being imposed;investment incentives for leasing companies are being introduced in some places and withdrawn in others;tax guidelines for the residual treatment of leased assets follow no set pattern;and some countries are adopting provisions of the international accounting standard whilst,in others,it has been decided that capitalization of leased assets by lessees is inappropriate.(11)I F.C has played a major role as adviser to government authorities in establishing regulations open to the development of leasing.

In the developed markets,the amount of regulation has been largely determined by the relative importance which authorities attach to the role of leasing in promoting industrial development and associated loss of revenue through the deferment or reduction of tax payments by leasing companies and their corporate groups.(12)

# 3. Basic Leasing Concept

## 3.1. Terminology

Over the years there have been many descriptions of leasing to meet different purposes-definitions focusing on the legal,accounting,fiscal,economic and marketing aspects of leasing transactions. They all tried to show the concept that leasing is simply a commercial arrangement whereby the owner of the property(lessor) allows another party(lessee) to use the services of the property for a specified period of time in return for the payment of rentals.

Leasing in many countries is similar to hire purchase and it is understood in different ways.

11) Ibid,p:8

12) Ibid,p:8

A hire purchase agreement is a lease which contains an option on the part of the lessee to purchase the asset.Traditionally the option can only be exercised on payment of a specified amount, which in hire purchase is usually nominal. In the financing sense it comes under the general heading of instalment credit for a wide range of equipment from office machinery to oil refineries and aircraft.In other countries the two concept are very different indeed and should not be confused.

Confusion is caused because leasing definitions reflect different legal interpretations and tax treatments around the world.First a distinction must be made between a long term financial lease and short-term operating lease.Secondly, it is important to differentiate between a lease with a purchase option and a lease containing no chance for the lessee to acquire the title;between a lease under which the tax depreciation benefits and investment incentives flow to the lessor and a lease under which the lessee is the recipient and so on.

The most crucial point in evaluating financial leasing is to recognize it as a financing activity. As long as this major fact is perceived,the separation between financial leases and other forms of leases will be easier to reach the real concept of what the financial lease is.

The lessor is frequently a bank or finance company and,usually the leasing business is conducted through a subsidiary.There are a large number of independent leasing companies in the US,Europe and Japan run privately without banking affiliations, and some are financed on the stock exchange.A third category of leasing companies are the subsidiaries established by business corporations for utilizing the excess surplus funds separately from the main business.(13)

13) Terry,Brian.,Need for Leasing despite All Change, World Leasing Yearbook,7th Edition,London:1985,p:10

The lessees range from industrial corporations, transport companies and service businesses to all kinds of governmental bodies.The common factor is that they pay lease rentals at regular intervals.

The value of the equipment at the end of the lease contract is known as residual.It is highly important for the lessee to know his position with this residual because it has a profound effect on the cost of the transaction.

## 3.2. Finance versus Operating

There are two types of leasing arrangement; a finance lease and an operating lease.

IAS 17 classifies finance lease as
" the lessor transfers to the lessee substantially all the risks and rewards incident to ownership of an asset. Title may or may not eventually be transferred."(14)

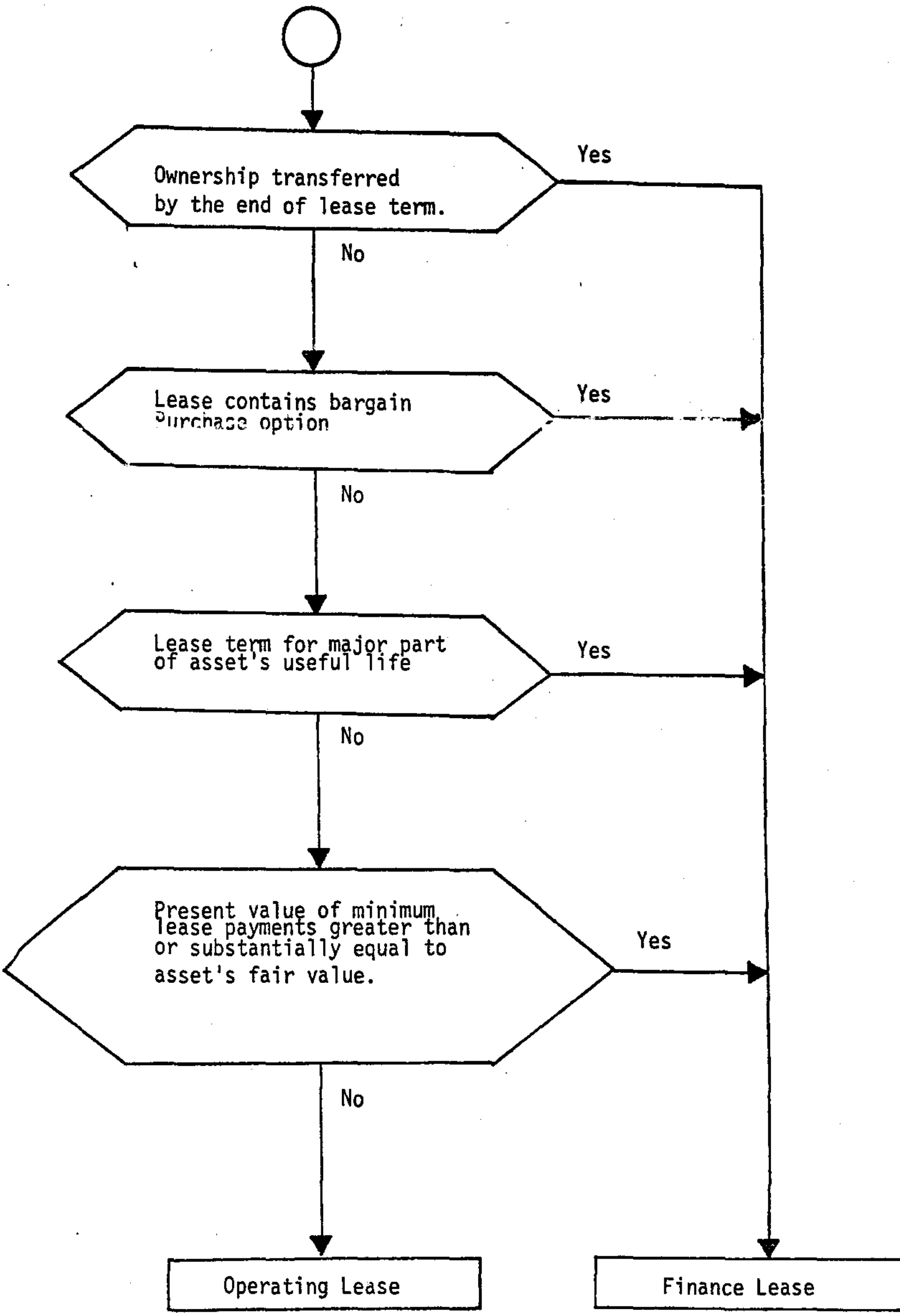
In a finance lease,the rentals payable during the non-cancellable lease term are normally sufficient to enable the lessor to recover the capital cost of the equipment(including associated expenses)and,additionally provide a return on funds invested.
Under IAS 17,an operating lease is any other lease other than a finance lease.The following chart figures out the suggested IASC approach to the classification of a lease.

For purposes of analysis,it is convenient to divide all leasing contracts into two broad categories
- financial and operating lease:

The finance lease: Here,the leasing company will act simply as a financing institution.The lessee will specify the equipment needed,and act as the lessor's agent in the matters of ordering it,inspecting it and maintaining it.The lessor is simply interested in the equipment as his legally owned asset,to which he has recourse if the lessee fails to pay his rentals.
Typically,payments under a financial lease are spread over a period of time equal to the major portion

14) Clark,Tom.,Leasing Finance,London:McGraw Hill Book Co. Limited,1985, p:18

IASC Chart for Classification of a Lease.



of the useful life of the asset acquired. During this initial term of the lease, the contract is noncancellable by either party, that is, the lessee is irrevocably committed to continue leasing the asset.

Operating lease: Here, the leasing company purchases the equipment, and leases it out to the lessee, but at a rate and term which does not cover cost, interest and profit of the lessor. To fully amortise and writedown the equipment on the books, further lease terms have to be written; it may only be necessary to write one secondary term or, many terms may be written. Or the lessor relies on the residual value of the equipment to recover the balance of the net investment and to earn a profit. That is, the leasing company relies on its expertise to remarket the asset after the primary term, which is a thing a bank or any other financing company will not undertake. Computers are frequently leased under operating leases.

The importance in distinguishing between the operating lease and the financial lease frequently extends beyond the convenience to the lessee of using the equipment for a short period of time without having to pay its entire capital cost.

Financial leases appear in many forms as; lease with no purchase or renewal options, lease with nominal purchase option, lease with advance rentals and nominal purchase option, lease with initial rental and nominal purchase option, lease with substantive purchase option, lease with advance rentals and substantive purchase option, lease with residual sharing arrangement, lease with stepped rentals, lease with security deposits and substantive purchase price. (15)

The most common standard rental structures have been illustrated, but there are innumerable possibilities. For example, rentals may be stepped but descending instead of ascending. They can also ascend and descend in the same leasing facility. The creative lessor

15) Ibid, p: 16

can structure lease rentals to meet almost any situation.

It will be useful to observe the residual value treatments because of its cost impact on lease payments liable by the lessee.

There are four main approaches:

a) Retention of the whole of the residual value by the lessor.

The options available to the lessee are limited to acquiring the asset at a fair market value or to continuing the lease for a secondary term at a fair market rental.

b) A residual sharing arrangement with no purchase option.

The lessee is usually granted an option to sell the leased asset on behalf of the lessor after the expiry of the lease term and receive a proportion of the net sales proceeds. Thus, the lessee is able to build up an equity position in the leased equipment during the lease term.

c)A Substantive Purchase Option

In some countries a nominal purchase option is not allowed. The substantive option price may be negotiated or more usually, a genuine estimate at the inception of the lease of the residual value at the end of the lease term. The extent to which the residual value taken into account by the lessor in calculating the rentals will depend on the likelihood of the option being exercised.

d) A nominal Purchase Option

This is the traditional equipment financing arrangement which may take the form of a hire-purchase or conditional arrangement.(16)

4. Types of Leasing Activity

There are several types of leasing facilities which can be distinguished on the basis of tax, accounting and structural regulations. Here, for purposes of simplicity only those which may be applicable under current Turkish financial leasing legislation will be explained.

16) Ibid,p:16

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### 4.1. Full pay-out lease

The full pay-out lease describes a lease in which the lessor aims not only to recover the whole part of the initial capital investment out of rentals payable under the contractual arrangement with the lessee,but also to achieve a predetermined yield on the funds employed to finance the investment.

### 4.2. Sale and Lease-back

Another type of leasing activity,which can fall into the category of either a finance or operating lease,is the sale and lease-back.Under this type,a firm owning equipment sells the property to a financial institution and simultaneously executes an agreement to lease the property back for certain period under specific terms.An obvious feature of a sale and lease-back arrangement is that a business retains use of equipment while disposing of ownership.(17)

Basic aims behind this type of leasing arrangement are to provide working capital:generate a book or taxable profit where the fair market value of the equipment exceeds the depreciated value in the user's accounts; refinance on a medium or long term basis if the original purchase of the equipment was financed with short term funds or reduce financing costs by refinancing at a lower implicit interest rate.(18)

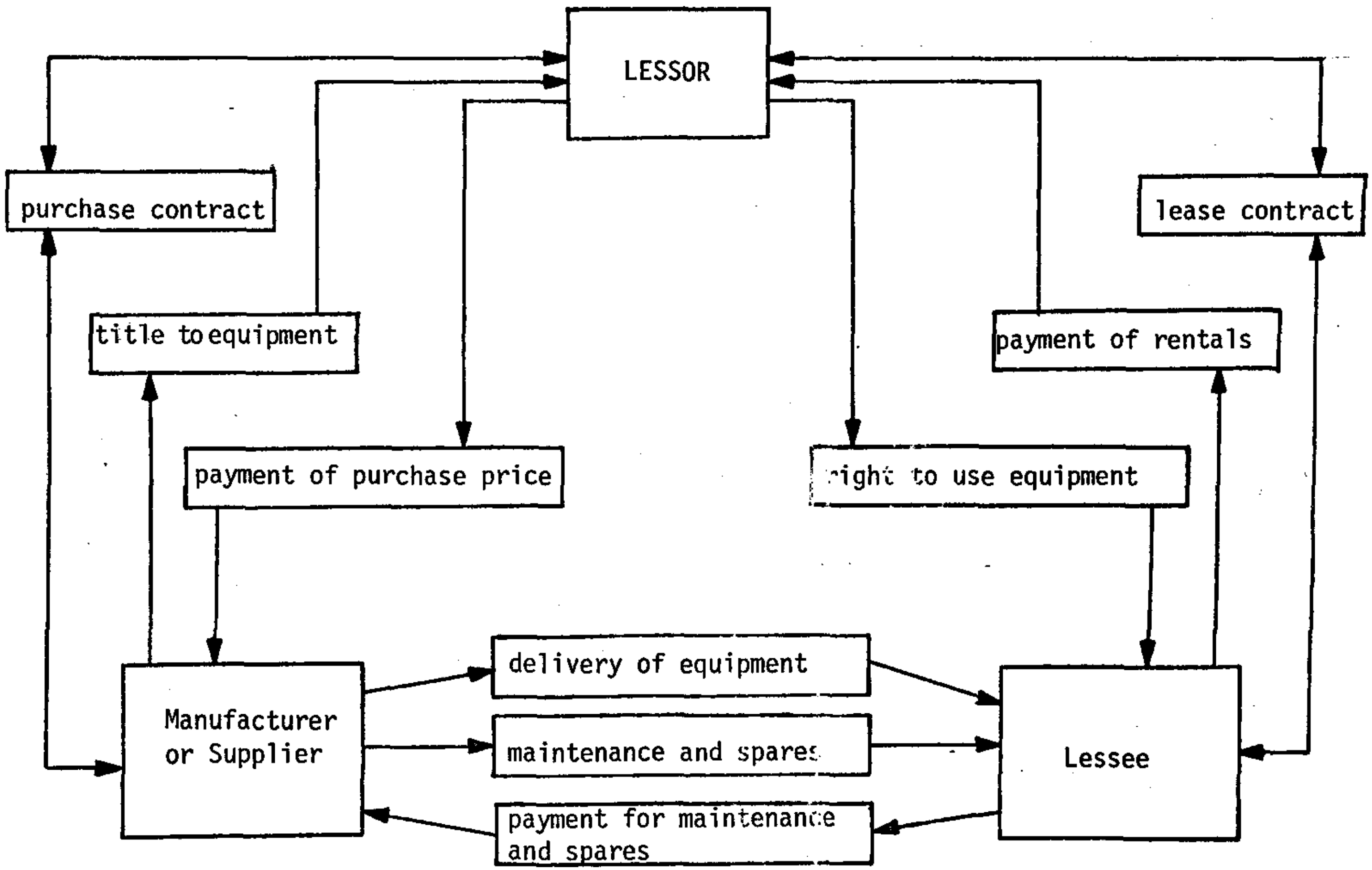
### 4.3. The Three Party Leasing Relationship

Most finance leases are based on a triangular relationship which the lessor provides the whole of the purchase price for the leased asset from its own resources including any borrowings for which the lessor is principally liable.See Figure 1

17) Weston,J.F.and Brigham,E.F.,Managerial Finance, Tokyo:Holt-Saunders International,1981, p:851

18) Clark,Tom.,Leasing Finance,London:McGraw Hill Book Co. Limited,1985, p:19

Figure 1: Three Party Leasing Relationship.



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## 4.4. The Leveraged Lease

In this type of leasing arrangement, the lessor provides only a proportion of the capital cost from its own funds to purchase equipment for leasing, known as the equity portion or equity funds. The balance of the funds required to meet the purchase price, known as the debt portion or debt funds, is often provided by one or more institutional investors. The institutional investors-typically insurance companies, pension funds, trusts, foundations and banks have no recourse to the lessor for repayment of their loans. The debt funds, the term of which is directly related to the term of the lease, are normally secured by a first charge or lien over the equipment and by legal assignment of the rental payments and other lease benefits. The cost of the debt, a function of the credit standing of the lessee, will be one of the principal factors in determining the implicit lease rate.

The lessor, or group of financial or other institutions acting together as the lessor, is known as the equity holder or equity participant. Because of the number of parties involved in a leveraged lease, there is frequently a requirement for two additional parties to manage the rights and obligations of the debt and equity participants. These are the indenture trustee and the owner trustee.

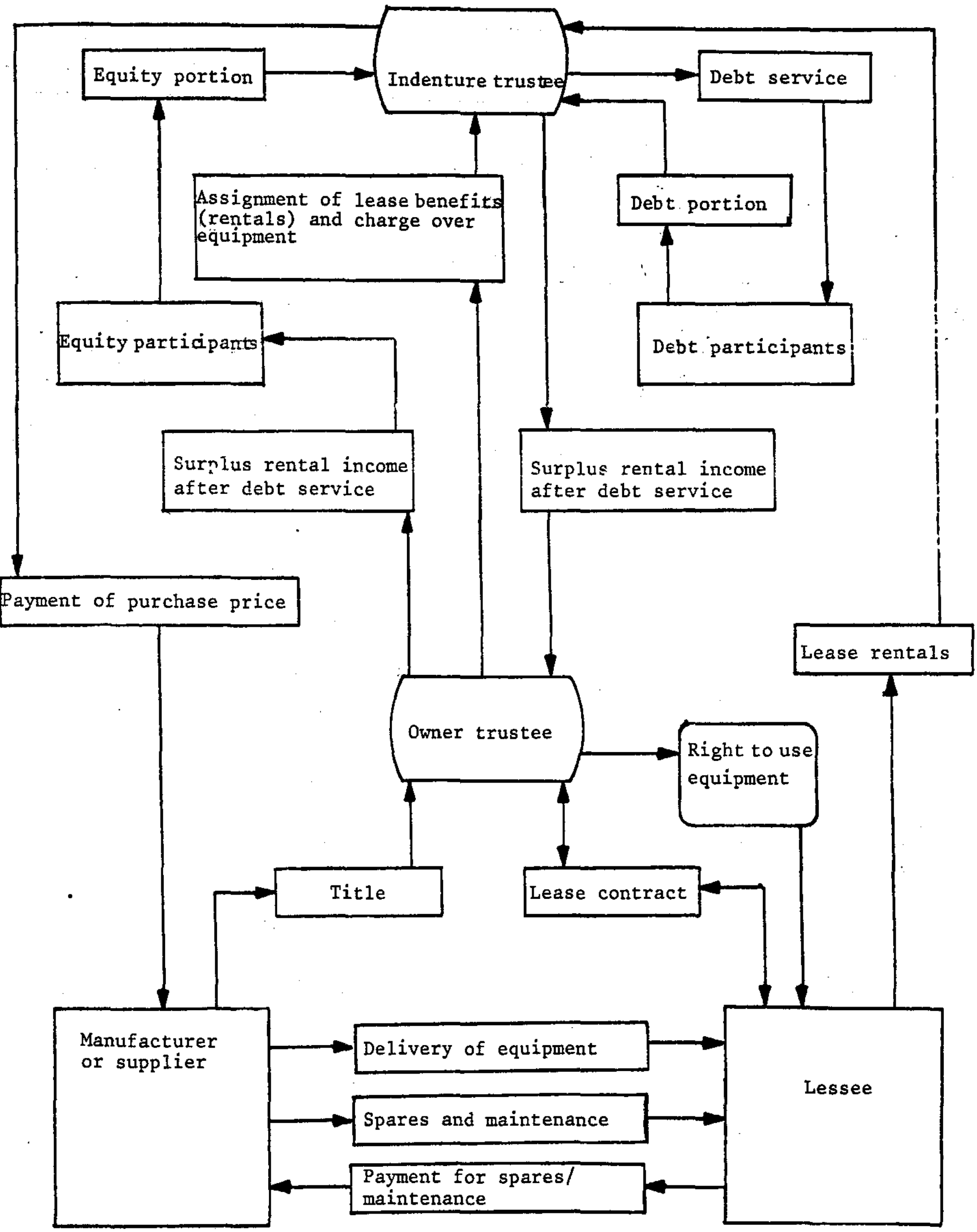
One of the attractions of the leveraged lease is that the equity participants obtain title to the leased equipment by providing only a relatively small proportion of its overall cost. Figure 2 shows the relationship between parties to a leveraged lease.(19)

## 4.5. Domestic and Cross-Border Leasing

The leasing of equipment by a lessor located in one country to a lessee in the same country is referred as domestic leasing, although it can have an international aspect. For instance, the equipment supplier may be

19) Ibid, p:19

Figure 2: The Leveraged Lease



located in another country or the lessor may be a subsidiary of a foreign company.

The leasing of equipment by a lessor located in one country to a lessee in another country is known as cross-border leasing. It is one of the most stimulating and challenging aspects of investment banking. On the positive side it offers full reign to one's creativity and numeracy of tax, legal and accounting knowledge. However there is a problem which is the continuing changes in the discipline of cross-border leasing which results in considerable risk and uncertainty for all the parties involved.

If summarized, obstacles faced when arranging a cross-border lease include; applicable law, currency risks, exchange controls, import and export permits and duties, income tax and withholding taxes and, finally different accounting and reporting requirements.[20]

20) Ibid, p: 19

the status quo. This is another routine investment decision.If purchase does not appear desirable,a financial lease will not be desirable either because the method selected to finance the investment does not change the income before financial charges. " The reliance on one form of finance for a given project will require offsetting action in connection with the next so as to restore proper balance to the firm's capital structure. In that sense, a corporation's long-term funds support all the items on the left-hand side of its balance sheet proportionately,and the use of some of the firm's debt capacity to finance particular outlays will necessitate compensatory amounts of equity finance for succeeding expenditures It is inappropriate, therefore,to mix the financing and investment segments of a decision in a cash flow analysis,as it is inappropriate even to attempt to attach one to the other." (22)

Thus the consideration of a financial lease should begin only after a company has previously decided that the purchase of a piece of equipment is desirable.This is the most important decision.Having made it,management may then be faced with several alternative methods of financing the acquisition;purchase for cash,purchase on an instalment credit arrangement or some other method involving debt financing,or acquisition via a financial lease.

A company's own funds are not necessarily the best way to finance investment in plant and equipment.Cash flow is the life blood of a business.Cash tied up in plant and equipment(fixed assets)is no longer available for a company's business activities;it is not available to finance stock,manufacturing,distribution and other profit generating activities.At its extreme, tying up cash in fixed assets can endanger the existence of the

22) Johnson,R.W. & Lewellen,W.G., Analysis of the Lease Or Buy Decision,Journal of Finance,27(Sept,1972),p:816

enterprise.Although businesses may fail through lack of profit,lack of cash-a liquidity crisis-is a much more common cause of failure."Moreover,a company's own funds are not free.Their real cost is the return they can make from being put to use-financing work-in-process,investment in stock or raw materials or as general working capital.The return on funds invested in this way may well be higher than the cost of using an appropriate leasing facility.So,a company should consider carefully before diverting its cash resources from financing profitable current activities to financing capital investment to secure future profits." (23)

23) Clark,T.,Leasing Finance ,London:Mc Graw Hill Book Co. Limited,1985,p:22

6. Similarity to Debt

Most of the cases written about financial leasing, to a great extent,concentrated on making comparisons between the cost of leasing and the cost of borrowing, to find out which method of finance be less costly under certain financial assumptions.In fact,there is a close similarity between the two. Anyone seeking support for the assertion that lease financing is essentially a form of debt financing could find acceptable provisions to show its similarity here.

One point is the fact that the lease creates a commitment on the part of the company to make a series of payment over a future period of time,which is as much a fixed obligation as the interest of a loan.These rental payments are in fact the equivalent of interest payments; they are determined by financial annuity tables without regard for the going rental rate on comparable properties.

The net lease arrangement is obviously intended to preserve the financial nature of the relationship, assuring the investor of his fixed return while relieving him of the responsibilities of ownership." The rejectable purchase offer in the lease contract is merely the counterpart of the right of prior redemption granted an issuer of debt securities." (24)

If additional support is needed,it might be found in the rather convincing evidence that the investor in a lease financing transaction looks more to the general credit standing of the company for his investment security than to the value of the property involved.

Perhaps further doubts about the close relationship between lease financing and debt financing can be cleared up by considering a refinement in the technique of lease financing which has come into prominence.This involves formation of a dummy corporation to act as

24) Gant,D.R.,Illusion in Lease Financing,Harvard Business Review,37(March-April,1959),p:123

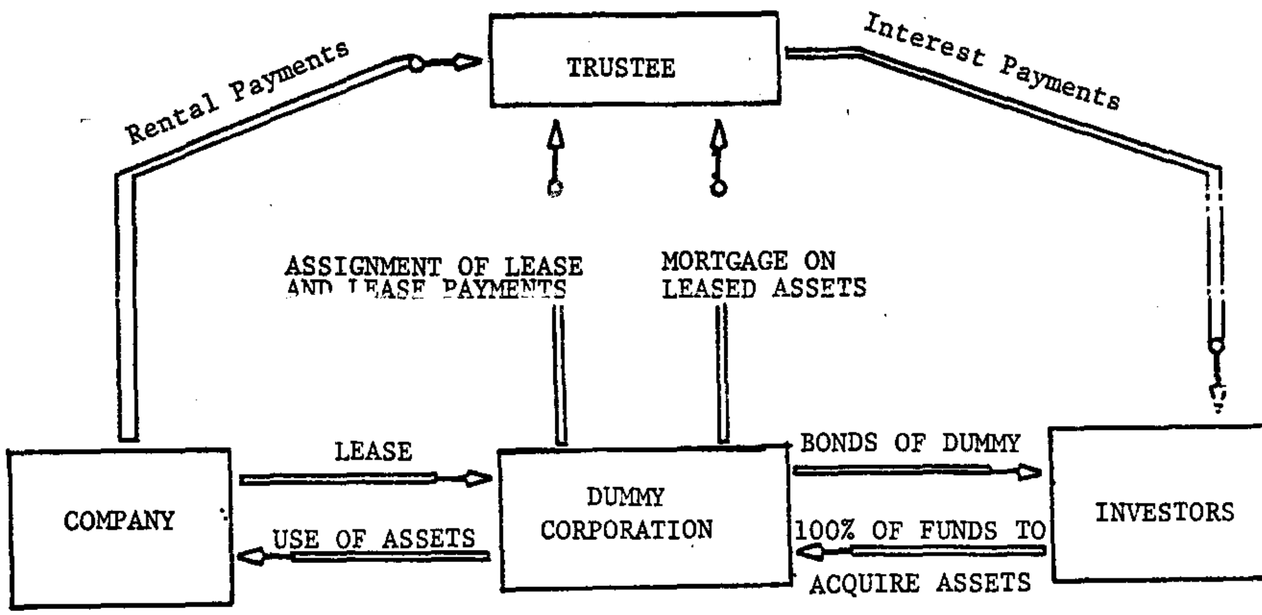
an intermediary between the company and the investor. The dummy is created for the purpose of acquiring certain assets and leasing them to the company. The relationship between the various parties to a typical transaction of this type, outlined in Exhibit 7, are as follows;

To obtain the funds required to purchase the asset, bonds of the dummy are sold to a group of investors. As security for these bonds, the interest of the dummy in the lease and lease payments is assigned to a trustee appointed to represent the investors. The company makes its rental payments directly to the trustee. These payments are intended to meet any expenses which the dummy might incur, such as trustee fees and taxes, and to provide the funds to meet the interest payments on the dummy's bonds. If the payments should prove inadequate to cover all these charges, the company generally agrees to advance the funds required to make up the deficiency, either in the form of additional rent or subordinated loans to the dummy. The dummy has no operating functions. Its only role in the transaction is to hold legal title to the asset and to act as a financing vehicle. The common stock of the dummy has no voice in its affairs as long as the bonds are outstanding, since control is vested in the trustee under the terms of the indenture. The common stock of the dummy is far from valueless, however, because it represents ownership of the residual value of the assets at the expiration of the lease. (25)

This is a highly complex way to go about borrowing money, but it is not different from any other lease financing transactions. The obligations assumed by the company are exactly same as those imposed by any financial lease.

25) Ibid, p:124

Exhibit 7: Relationships Created in a Typical Dummy Corporation Transaction.



The suggestion that lease commitments are a form of obligation comparable to debt has raised violent objections.

The principal counterarguments can be counted as;

a) Rent has traditionally been considered an operating expense and is included among the costs of doing business.

If it is to be considered a liability merely because it will continue in the future,why should the same reasoning not apply to all expenses of a continuing nature,such as heat,electricity,telephone service,or even labor and raw materials?

The fallacy in this argument is that ordinarily a company does not enter into fixed commitments to purchase a minimum quantity of materials or services over a period of time at fixed prices,regardless of whether they should be needed or not.(26)

b) A corporation's maximum liabilities under a lease in the event of bankruptcy are substantially less than those represented by debt obligations.

In the long term view,lease commitments rank equally with interest requirements,since the inability of the company to meet either type of obligation can result in insolvency. The fact that,once this unhappy situation is reached,the lessor will be entitled to a smaller claim than the debt holder is a doubtful consideration.(27)

26) Ibid,p:124

27) Ibid,p:124

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## 7. Reasons for Leasing

In this section, the advantages of leasing from the point of view of both the lessor and the lessee, will be clarified with their probable shortcomings.

### 7.1. Capital Saving

Leasing provides up to 100% of the cost of the equipment. In many cases no deposits or advance payments are required. Clearly, any leasing activity which require rentals to be paid in advance is not 100% financing. Nevertheless, leasing often does provide a higher percentage of financing than an equivalent borrowing facility. This means that a lessee may use available capital for other projects, for reserves, for seasonable expenditures, etc.(28)

The conclusion that a lease provides 100% financing is based on an erroneous assumption that it has no effect on our general borrowing power. Whether we borrow or lease, we are using up some of our credit. The real question is whether a lease that is equivalent to the amount of the debentures uses up as much of our borrowing power as the issue of debentures. This is a key question. If leasing provides more funds than borrowing in relation to a given amount of equity, it may be desirable even if it is more costly. "The fact that the relevant payments are spread out over a period of years rather than being concentrated in a lump sum does not justify a difference in the principle of their treatment, nor in one's view of the implicit composition of their financing. Indeed, the process of comparing the present value of estimated future cash inflows under a project with the project's initial cost in order to assess desirability in the normal purchase situation necessarily-and correctly- implies that the two sides of that comparison either use up or provide funds for the

28) Terry, Brian., <u>Need for Leasing despite All Change</u>, World Leasing Yearbook, 7th Edition, London: 1985, p:17

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enterprise equivalently in the long run debt-equity proportion chosen by the firm. "(29)

Long term leasing does not expand a firm's net borrowing power;its use merely substitutes indirect borrowing for direct borrowing.Nor does long term leasing reduce a firm's net borrowing power,where the lessors leverage is restricted,the firm is free to use its borrowing capacity on other projects.( 30 )

Analysis can show that leasing may indeed provide more funds than borrowing in relation to equity,not because leasing is a clever way of avoiding debt,but because it is not adequately recognized as debt both in the financial marketplace and in the financial tables.

7.2. Flexibility of Leasing

Leasing arrangements are very flexible. Leasing companies have proved more adaptable than banks and financing institutions with regard to contract structures.Rental payments may be varied according to the revenue expectations of lessees.(31) Another argument raised for the flexibility of leasing is that if we borrowed funds to purchase a store that subsequently proved to be poorly located,we would be bound to that location.If we were to lease the property, we could depart when the lease expired.

This argument assumes that the lessor has drawn the lease so that he does not recover his investment in the property during the term of the lease.This may be true for operating leases,but it is generally not the case on financial leases.Thus by the time a lease expires,we should expect to have paid most,in addition to interest

29) Johnson,R.W. & Lewellen,W.G., Analysis of the Lease Or Buy Decision,Journal of Finance,27(Sept,1972),p:816

30) Miller,M.H.& Upton,W.,Leasing,Buying and the Cost of Capital Services,Journal of Finance,31(June,1976),p:779

31) Terry,Brian.,Need for Leasing despite All Change, World Leasing Yearbook,7th Edition,London:1985,p:17

and service charges, if not all, of the cost of the equipment leased.Whether we borrow to buy the property or whether we lease it,we will have paid for it- either directly in cash or over time through the lease payments. If we can not profitably use the property,we have lost money.(32)

Another shortcoming in the argument is that leasing may actually prove less flexible than ownership if it should become desirable to discontinue the use of the asset during the primary period.Unless the lease provides a rejectable purchase offer,the company may be forced either to find a sublessee or to continue paying rent and related expenses for an asset it no longer needs.On the other hand,if the asset is owned,it can be sold for whatever it will bring (33)

7.3. Avoidance of Restrictions

Leasing may avoid loan covenants or capital investment restraints.While leasing is not legally borrowing and so may circumvent restrictive loan covenants and capital budgeting constraints,lenders and head office financial controllers are now more aware of the leasing loophole.This feature should not encourage a lessee to overspend.(34)

Although leasing may enable a lessee to avoid some of the restrictions that exist in a borrowing facility, it may bring restrictions on the use of the property leased.For example,lessee may be prohibited from making changes or adjustments.(35)

32) Johnson,R.W.,Financial Management,Allyn & Bacon Inc. Boston:1962,p:466

33) Gant,D.R.,Illusion in Lease Financing,Harvard Business Review,37(March-April,1959),p:129

34) Clark,T.,Leasing Finance ,London:Mc Graw Hill Book Co. Limited,1985,p:25

35) Johnson,R.W.,Financial Management,Allyn & Bacon Inc. Boston:1962,p:467

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## 7.4. Freedom of Cash

Another often cited advantage is that leasing increases earnings by freeing capital that would otherwise be get tied up in fixed assets for more productive uses. This is the main pillar on which lease financing rests. (36)

The following clarifies the reasoning behind this advantage asserted by the proponents of leasing.

Leasing does not tie up valuable working capital. A leasing facility preserves liquidity for other more appropriate uses.Furthermore existing credit lines are preserved through leasing Cash flow advantages stem from the lower upfront capital payments required on a finance lease compared to other forms of finance and the flexibility of lease payment requirements is useful for cash purposes.Mainly,the essence of this argument is that if we can only free our funds from fixed assets, which we have a low turnover,and invest in current assets,which we have a high turnover,we will improve the earning power of the entire business.

Unfortunately,the argument is not much valid.The conclusion arises because we are assuming that our method of financing determines the mixture of assets that we acquire.Thus if we borrow, we acquire fixed assets;but if we lease,we can avoid acquiring fixed assets and invest only in current assets with a high turnover.To operate our business we need a certain mixture of assets,both fixed and current. How would one go about breaking down the earnings of an enterprise for example,between the part contributed by the building and the part contributed by the merchandise in it ?There is no point in saying that some assets earn more than others.We need the services of all. Whether we have title to all the assets is beside the point.(37)

36) Gant,D.R.,Illusion in Lease Financing,Harvard Business Review,37(March-April,1959),p:127

37) Johnson,R.W.,Financial Management,Allyn & Bacon Inc. Boston:1962,p:468

Once we determined the assets needed, we then turn to the available methods for financing these assets. Among the possible methods are leasing and borrowing. We will not vary the total earnings that we derive from the predetermined mixture of assets by changing our methods of financing. In short, leasing does free cash, but so does borrowing. The real question is whether one method of financing is more expensive than the other.(38)

### 7.5. Hedge against Inflation

Leasing can be a hedge against inflation when equipment is acquired at current prices and rentals met out of future earnings.(39) Although in some cases, this apparent advantage can be chimera. In later years in a leasing deal, particularly if the rate is fixed, you are paying in yesterday's currency units for yesterday's purchase (40)

### 7.6. Tax Efficiency of Leasing

Is it in fact likely that the cost of leasing will be the same as the cost of borrowing? This is a crucial question. If any generalization can be made, it must be that, for a given company, leasing is likely to be more expensive than borrowing. Moreover, whereas a bond issue may often be refunded if interest rates decline sharply, we cannot refund leases.

Then, is there no cost advantage to leasing? Even though the cost savings may not stem from lower interest rates, they may arise either through tax savings or the postponement of income taxes. Lease rentals are generally fully tax deductible as operating expenses. If we borrow to acquire title to land and a building, we could depreciate only the building for tax purposes. In

38) Ibid, p:468

39) Clark, T., <u>Leasing Finance</u>, London: Mc Graw Hill Book Co. Limited, 1985, p:25

40) Terry, Brian., <u>Need for Leasing despite All Change</u>, World Leasing Yearbook, 7th Edition, London: 1985, p:17

contrast, if we lease them, our rental payments would include the cost of the land to the leasing company. Through the lease, thus, we are able to depreciate the cost of the land. As a result, we would pay lower income taxes.(41) The tax benefits arising on the acquisition of equipment may also be maximized through a leasing arrangement by reflecting in the rentals the value of an investment incentive which, because of a shortage of tax capacity or nontax paying position, is not fully available to the lessee.(42)

All things are fine here. But we should remember that when the lease expires, we would have paid the total amount of the cost of the property that we do not own. Our real problem is to determine the present value of the expected fair market value of the equipment at the expiration of the lease. There have been examples where the cost of the property has appreciated immensely over a period of years. We are risking the loss of this appreciation by leasing the property rather than borrowing to acquire the title.

Even if we pay the same total amount to acquire the services of assets through a lease as through borrowed funds, the lease may be advantageous if we can write off the cost of the property through the rental payments more rapidly than if we owned the property.(43) In fact, leasing makes it possible to write off the depreciable portion of the property over the basic term of the lease, which is generally shorter than the period which would be permitted for depreciation. The result is not a tax saving but a shift in the timing of deductions and tax payments, similar to the effects of accelerated depreciation. To the extent that the tax payments are

41) Johnson, R.W., Financial Management, Allyn & Bacon Inc. Boston: 1962, p: 470

42) Clark, T., Leasing Finance, London: Mc Graw Hill Book Co. Limited, 1985, p: 25

43) Johnson, R.W., Financial Management, Allyn & Bacon Inc. Boston: 1962, p: 471

deferred,the company benefits by having the use of these funds for the additional period.(44) "Alternatively,the lessor's depreciation deductions may be more attainable in the sense that the lessee may not as consistently have taxable income against which to claim the deductions.This argument is often made particularly in connection with accelerated depreciation schedules that could exceed lessee income in the early years of asset life.Such possible differences should not be ruled out; in effect, they connote more rapid de facto lessor write-off profiles but the carry-forward and backward corporate income averaging provisions of the tax law should substantially diminish their impact for all but the most marginal lessee enterprises.The realization of these tax benefits by the lessor depends on the existence of additional taxable income from other sources on his part,if his only business is leasing the one asset,the lease payments he receives are his only taxable earnings as well,and he confronts precisely the same deduction limits as would the lessee."( 45 )

It may be possible to achieve some advantage if the lease payments are scheduled in such a way that they are higher in the earlier years of the lease than the sum of depreciation and interest and, conversely, lower in the later years.When these conditions are prevalent,the present value of the tax deductions received under a lease plan is greater than the present value of the tax deductions under outright ownership.

The same advantage may be achieved in another way under financial leases.The agreement may be drawn to run for a relatively shorter initial term. During this time the lessor recovers his entire cost of the equipment

44) Gant,D.R.,Illusion in Lease Financing,Harvard Business Review,37(March-April,1959),p:126

45)Lewellen,W.G.,Long,M.S.& McConnell,J.J.,Asset Leasing in Competitive Capital Markets,Journal of Finance,31 (June,1976) p:796

and the lessee can deduct his payments to the lessor as expense;whereas if the lessee were to purchase equipment directly,he would have to depreciate it over a longer time span.

The interesting thing to note here is that drawing the contract in such a way that is advantageous in terms of taxes may make it disadvantageous in other aspects.For instance;it may not provide a purchase option, which has the effect of shifting part of the risk of obselescence to the lessor.This means that the lessor would expect to earn a higher profit on the transaction.Additionally,the lessor is also a tax payer and,as owner of the equipment,will be depreciating it in his tax returns.If he is willing to offer the lessee a stream of lease payments which appear advantageous to him,but which have the effect of creating more taxable income for the lessor in the early years,the lessor obviously must somehow adjust his lease payments to compensate him for his early tax payments for the benefit of the lessee.

Accordingly it is probably best to think of tax deductions as being part of the packaged cost of a lease plan.Leasing companies have thus tended to become entities specialized,among other things,to the maximum utilization of these tax subsidies,which are in turn reflected in equilibrium rental rates. When the leasing company also happens to be owned by the company that manufacturers the equipment, still another return in favor of leasing is created by the deferral of taxes on the manufacturing profit that the manufacturer gains by leasing rather than selling.(46)

The mere fact that the lease payments appear to be more advantageous than the tax deductions under ownership does not mean that the total cost of the lease

46)Lewellen,W.G.,Long,M.S.& McConnell,J.J.,Asset Leasing in Competitive Capital Markets,Journal of Finance,31 (June,1976) p:796

plan will be less than the total (after-tax) cost of ownership.(47)

In a note analyzing the implications of equilibrium for the cost of leasing,it has been shown that ,in general in Miller's world, leasing offers no advantages to companies that are either in a permanent tax-paying position or permanent non-tax-paying position.However, there may be benefits for firms that are in a temporary non-tax-paying position.( 48 )

Lease financing,then,is essentially a form of borrowing,resulting in obligations which are substantially the same as those incurred in borrowing money.When contrasted with ownership financed with debt, however,lease financing suffers in two very significant respects:

a) The investor normally demands a return on his investment during the basic lease period which is somewhat higher than the rate at which the company would be able to borrow on its direct obligation.

b) The other disadvantage,which is more significant, is that at the expiration of the basic lease period the lessee loses the remaining value of the property which it has paid for it. (49)

47) Vancil,R.F.,Lease or Borrow-New Method of Analysis, Harvard Business Review,39(September,1961),p:127

48)Brealey,R.A.&Young,C.M.,Debt, Taxes and Leasing, Journal of Finance,35(December,1980).p:1245

49) Gant,D.R.,Illusion in Lease Financing,Harvard Business Review,37(March-April,1959),p:126

Most prominent advantages were examined and the validity of them were analysed shortly.Then,whv has the popularity of financial leasing increased so greatly in the face of two such formidable disadvantages?

Many lessees find that leasing is more attractive than purchasing even if the sum of total payments be greater than the purchase price less the salvage value of the equipment acquired.Then we are coming to the question of what are the real services performed by a lessor which make leasing more attractive than buying. even though it apparently costs more than buying?

In a general way all of the functions performed by lessors fall into three broad categories.

a) Allowing the lessee to pay only the part of the full purchase price at the time he begins using the equipment- granting credit

b) Shouldering part or all of the risk that the equipment will soon become obsolete.

c) Packaging a series of legal,administrative,tax,and other expenses and adding them to the price of the lease.(50)

Let us examine each of the services in turn and consider certain implications of them for management.One should keep in mind that,since the performance of a function by the lessor usually comprises a cost for lessee,he must recognize what the lessee's direct cost of performing those same functions would be when computing the cost of acquisition by outright purchase.

Granting Credit

The most distinguishing characteristic of a leasing plan is that it permits the lessee to avoid paying the full purchase price of a piece of equipment on the date acquired.Thus,as a minimum,lease payments must provide enough revenue to the lessor to cover not only the cost

50) Vancil,R.F.,<u>Lease or Borrow-New Method of Analysis</u>, Harvard Business Review,39(September,1961),p:123

of the equipment but also the lessor's interest expense while he is waiting to recover his money,and to compensate the lessor for running the risk that he may not be able to collect the amounts due him from the lessee.

The interest charge by the lessor on the money which he has invested in equipment is the main reason that the total of the expected future lease payments exceeds the purchase price of the equipment.But,because the lease payments are spread over many future periods,it is misleading to make a comparison such as this rather the present value of the future lease payments should be found if such a comparison is to be valid.

Excluding the impact of income taxes for a moment, and assuming that the lessor performed no services for the lessee other than granting credit,it is easy to visualize a simplified leasing plan in which,if the future lease payments were discounted at the interest rate which the lessor is charging for the use of his capital,the present value of the lease payments made by the lessee would be exactly equal to the purchase price of the equipment.

While it is true that the acceptance of a leasing contract always has the effect of supplying capital on credit to the lessee,it is not necessarily true that the function of granting this credit is always performed by the lessor.In a legal sense,the lessor is absorbing the credit risk since he is the only other party to the leasing contract.In an economic sense,however,there are many situations in which the lessor acts only as an intermediary,receiving his capital from conventional sources and using it to purchase the equipment which is then turned over to the lessee.

As a practical example many leasing transactions have been arranged in which the lessor is really a dummy corporation established by the lessee in order to secure certain tax advantages from leasing an asset rather than owning it.The dummy corporation typically has only a nominal capitalization but is able to borrow large amounts of money from conventional financial institutions by assigning the rental receipts under the lease to financial institution.The financial institution grants the loan exclusively on the credit qualifications of the lessee,and looks to him for the repayment of its loan even though the loan repayments are nominally in the form of lease payments to the lessor.

Transactions of this type are only possible under a financial lease in which the lessee's obligation to make all of the lease payments is a noncancellable commitment. Obviously,if the lessee firm could cancel its obligations to make the lease payments,then the lending institution would be put in a position of trying to collect the unrecovered balance of its loan from the thinly capitalized lessor corporation, whose only asset would be a piece of used equipment of uncertain value.In transactions of this type,the lessor's function is something other than the entrepreneurial function of absorbing credit risks.But in most leasing transactions granting credit to the lessee is one of the functions performed by the lessor.(51)

Shift in Risk of Ownership to Lessor

A second major function that is often performed by lessors involves another kind of risk taking,this time not the risk of granting credit but the risk of early obsolescence of the equipment.As all businessman know, one of the most important estimates which is made by a prospective purchaser of a piece of equipment concerns the technological or market life of the equipment.

If we hold the title to a machine,we bear the risk of obsolescence.Would it not be better to shift this risk to somebody else and lease the services of the machine until it is superceded by more modern equipment?

51) Ibid,p:124

Consequently, when faced with a lease or borrow decision on equipment subject to high rate of obsolescence, leasing should be viewed favorably.(52)

Particularly in industries where the rate of technological change is rapid, the prospective customer may feel a great deal of uncertainty about the economic life of the machine that he is considering to acquire. Wrong decisions in this area can be very expensive and wrong decisions can be made either of these two ways;

a) by failing to acquire a piece of equipment soon enough in the hope that a more advanced model will come out within a short period of time or,

b) by acquiring a piece of equipment too soon, only to find that it is shortly rendered obsolete.

Faced with making the wrong decision, many businessmen prefer not to purchase such equipment outright but to lease it from someone else who will absorb the risk of early obsolescence for them.(53)

This is all very well and a valid argument if the lessor is not very intelligent. However, it is likely that he is as aware as the lessee is of the rate of innovation in the field. Indeed, since he is a specialist, he may be in a better position than the lessee is to judge the rate of obsolescence. It should be obvious that when the lessor assumes the burden, he expects to be compensated for it by the lessee. In some respects, this arrangement might be likened to an insurance contract in which the insurer(lessor) collects a premium from each person insured(lessee), and the sum total of all the premiums collected is sufficient to cover the cost of losses(the unrecovered value of the machines rendered obsolete). Like any insurer, the lessor also expects to

52) Johnson, R.W., Financial Management, Allyn & Bacon Inc. Boston: 1962, p: 465

53) Vancil, R.F., Lease or Borrow-New Method of Analysis, Harvard Business Review, 39(September, 1961), p: 125

make a profit for his risk taking, and lessees apparently are willing to permit this profit because of their exposure to potentially large individual losses. Consequently, he will include in his rental fee a charge for obsolescence and for other risks of owning the property. It will not be an explicit charge, but may be reflected in especially high payments during the early period of the lease that the lessor recovers his investment as rapidly as possible. If the rate of obsolescence is higher than the lessor had anticipated the lessee will benefit by having shifted the risk to him.(54)

Under financial lease contracts the situation is different. The lessee's commitment to make payments that exceed the purchase price of the equipment has the effect of placing on him most of the risk of obsolescence in much the same way as if he had actually purchased the equipment. Still, it is possible to have portion of the risk transferred to the lessor, depending on the terms of the agreement. The lessor may require lease payments during the initial term of the lease which will just recover the cost of the equipment and plus interest, so that his profit will be the residual value of the equipment at the end of the initial term. In such a situation he is running the risk that he will not be able to realize his profit if the machine becomes obsolete before the end of the initial term, and he may therefore require that the initial term of the lease be relatively short, so that his uncertainty about the value at the end of the term is not too great. Measuring total cost in such a situation requires explicit consideration of the expected value of the equipment at the end of the initial term of the lease.(55)

54) Johnson, R.W., <u>Financial Management</u>, Allyn & Bacon Inc. Boston: 1962, p:465

55) Vancil, R.F., <u>Lease or Borrow-New Method of Analysis</u>, Harvard Business Review, 39(September, 1961), p:126

A final function that is performed by all lessors has frequently been overlooked in the analysis of leasing expenditures,but must be specifically dealt with if we are to have a precise analysis.This function might be described as a packaging function of accumulating into a single total all the costs concerned with a given acquisition and recovering them through the stream of periodic lease payments.

Such costs make up a longer list than might at first be assumed.Included are not only the cost of the equipment and the interest payments on the money provided, but also the several auxiliary financing costs such as ;commitment fees for bank loans arranged in advance is required to purchase the equipment,the cost of carrying any compensating balances required by the lender, legal fees, administrative and clerical costs, the fee for arranging the transaction,which might be thought of either as the profit for the lessor under a leasing contract or as the fee that might be paid an investment banker for acting as a third party in arranging a piece of financing.

Additional charges in acquiring equipment,such as delivery and installation charges,inspection costs, consultant fees,certain interest charges such as those tied up in advance payments and other incidental or ancilliary costs are the part of the package and may be added to the capital cost of an asset and amortised over the lease period.(56)

It is conceivable that a lessor firm which buys assets in volume from their manufacturers could negotiate for lower average prices than would be quoted for single purchases by lessees. "Savings of this sort, however,can only be attributable to reduced transactions

56) Terry,Brian.,<u>Need for Leasing Despite All Change</u>, World Leasing Yearbook,7th Edition,London:1985,p:17

costs since the underlying manufacturing economics are not affected,i.e.,no change in total supplier output is occasioned by a mere re-routing of the assets through intermediaries to their ultimate users.The same goes for resale / salvage values.The lessor may be more active or more skillful in dealing in the associated second-hand asset market,his specialized knowledge may give him an edge.But if that market is itself reasonably competitive, lowered transaction costs again are the one legitimate source of potential savings.To the extent that many leasing arrangements involve assets manufactured for quite specific purposes,few of these transaction efficiencies are likely to emerge -indeed, they may be more than offset by the extra transactions costs of the intervening lease contract.Only in the case of leases of very standard,high volume asset items do any benefits appear to be realizable."(57)

The auxiliary financing costs may be quite small relative to size of the transaction,but if the transaction is large enough,they may be too large to ignore.

57)Lewellen,W.G.,Long,M.S.& McConnell,J.J.,<u>Asset Leasing in Competitive Capital Markets</u>,Journal of Finance,31 (June,1976) p:796

## 8. Pitfalls of Analysis

In terms of accounting standards and the techniques of financial analysis,financial leasing raises serious questions.

There may be little difference in the obligation imposed by a lease as compared with that created by debt financing.However,there is a very substantial difference in the method of reporting that obligation. A borrowing transaction is recorded on the balance sheet,a lease transaction is not.Interest paid on debt is shown as a financial charge on the income statement,rental payments are buried among cost of sales and selling and administrative expenses.

It is customary to evaluate a company's capital structure in terms of certain standard financial ratios. These ratios measure the relationship of its long-term debt to equity,at both book and market values.An even more important test is one that relates the interest requirements on this debt to the company's past earnings, for the purpose of determining the number of times these fixed charges were covered by earnings.

Ratios of this sort have no real significance of themselves,they must be evaluated by considering the nature of the industry,the company's position in that industry,and the stability or lack of stability in its past operations.

The absence of an accrued liability in the balance sheet would give a financial analyst the impression that the lessee appears to be in a much stronger position than he really is.Even if full information is not provided concerning lease obligations,most financial analysts can detect their existence by the lack of significant amounts of fixed assets and by the presence of rental payments on the statement of earnings.Theoretically,financial analysts can reconstruct the balance sheet to show the equivalent amount of debt, so that the lessee's implicit debt position could be compared to that of other company's relying on borrowed funds.But in this stage of analysis the difficulty arises because most financial statements reveal neither the remaining life span of the lease nor the original cost of the property leased.This information is necessary before determining the proportions of interest and return of principal in the lease payments.Thus the lack of adequate information,the difficulty of sound analytical procedures to adjust the lease payments,and the failure of many analyst to apply the financial methods available,have provided companies using leasing with more borrowing power than they deserve.Like all types of borrowing,lease obligations drawn on credit of the borrower,and credit is not a bottomless well.If it is used in one form,it is not available to be used again in another.

Has the significance of lease commitments as a form of indebtness gone unnoticed in the financial community? There are several indications that it has not.

In the first instance,many efforts have been centralized on making disclosure of leases a standard practice.On the disclosure of lease obligations,the American Institute of Accountants presented a set of recommendations.(58) See Appendix 1

Mainly,the discussions on the subject of whether the lease obligations should be shown on the balance sheet of the lessee is known as the capitalization issue.

Essentially,the concern is on whether it is legitimate in preparing financial statements to consider the commercial substance of lease transactions rather than their legal form.

There is a considerable divergence of views on the question of lease capitalization.In some countries,it is widely accepted that finance leases should be accounted

58) Accounting Standards,Current Text as of June 1,82. Published by the Financial Accounting Standards Boards, Connecticut,1982.,pp:L10-L112

for in accordance with their commercial substance (in the financial statements both of lessees and of lessors), in others, the legal form is rigidly accepted as the criterion for capitalization.(59) See Table 2

It is noteworthy that the countries which accepted capitalization tend to be those with more highly developed public capital markets.

To sum up, the argument for capitalization rests upon one of the fundamental accounting concepts in International Accounting Standard No.1, namely that "transactions and other events should be accounted for and presented in accordance with their substance and financial reality and not merely with their legal form."

Singapore Society of Accountants is explaining its support for capitalization as;

" while the legal form of lease agreement is that the lessee may acquire no legal title to the leased asset in the case of finance leases the substance and financial reality are that the lessee acquires the economic benefits of the use of the leased asset for the major part of its useful life in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge. If such lease transactions are not reflected in the lessee's balance sheet, the economic resources and the level of obligations of an enterprise are understated, thereby distorting financial ratios. It is therefore appropriate that a finance lease be recorded in the lessee's balance sheet both as an asset and as an obligation to pay future rentals."(60)

It would be idle to claim that it is not always easy to distinguish finance leases from operating leases which convey much more limited rights and obligations and are adequately dealt with through revenue. However,

59) Chadder, R.V.J., The Capitalization Debate, World Leasing Yearbook, 7th Edition, London: 1985, p:25

60) Ibid, p:25

the accounting and business communities should not use this difficulty as an excuse to avoid improving reporting.

If there is to be a broad change, the impetus comes from the group which, by failing to take action, has allowed the problem to reach its present proportions-the public accounting profession.

Table 2

| Commercial Substance Countries | Legal Form Countries |
|---|---|
| Australia | France |
| Belgium | Germany |
| Canada | Hong Kong |
| Ireland | Italy |
| The Netherlands | Japan |
| United Kingdom | Norway |
| United States | Sweden |

Source: Leasing Finance by Tom Clark

## 9. Turkish Front

Leasing does not happen to be a wide spread method of financing capital equipment in Turkey. Rather it has very limited application.It has been practiced up to now in real estate,farm and pasture land,sometimes,factories and hotels,and computer systems.Except for computer leasing,others mentioned above are conventional rent.With computers two types of leasing have been used up to now,one is operational leasing,and the other is hire and purchase.Other applications of leasing center around the activities of the Islamic Development Bank,financing equipment leasing for the State Economic Enterprises in Turkey.

In this second major part,the new Financial Leasing Act will be evaluated on the basis of legal.tax. accounting,funding and regulatory aspects while considering all crucial facts which have been analyzed in the first part.

### Current Legislation

Today,contrary to many foreign countries,there is a specific legislation concerning financial leasing as follows:

1) Financial Leasing Law,Law Number:3226,enacted on June 10,1985.Published in Official Gazette No.18795,dated June 28,1985.

2) Council of Ministers Decree on "Determination of Terms and Limits of Leasing Transactions."Decree No. 85/9866,date:September 11,1985.Published in Official Gazette No.18882,dated Sept.28,1985.

3) Announcement by the Ministry of State and Vice Premiere on "the Statue pertaining to Establishment, Embranchement and Audit of Leasing Companies." Published in Official Gazette No.18882,dated Sept.28,1985.

4) Announcement by the Ministry of Finance and Customs on "Principals and Procedures Pertaining to Bonds,Custom Taxes and Duties of Assets Leased under Law 3226." Published in Official Gazette No.18882,dated Sept.28,1985.

5) Announcement by the Ministry of Finance on "Income Tax Laws,Application of Capital Allowance." Published in Official Gazette No.18882,dated Sept.28,1985.
6) Council of Ministers Decree on" Incentives and their Applications." Published in Official Gazette ,December 5,1985,No.18949.
7) The Import Regime,Undersecretariat of Treasury and Foreign Trade (Article 24).Published in Official Gazette No.18970,dated December 12,1985.

As it is seen,there is an extensive set of legislation to regulate the leasing activities in Turkey.Though there had been arguments against the necessity of a separate leasing legislation, rather carrying this activity within the framework of the existing regulations,in a very complicated area like leasing which is directly linked to set of legislations pertaining to(not in order of importance):

1) Civil Code,Law of Obligations,Commercial Code
2) Customs
3) Taxation
4) Incentives
5) Foreign Trade
6) Capital Markets
7) Money and Central Bank
8) Foreign Capital

(which are by themselves huge set of legislation), a separate set of Leasing Legislation will firstly serve to condense the relevant required legislative environment into an understandable and managable one,and secondly,it will provide an environment of certainty and confidence to the foreign lessors whose attention we want to attract to Turkey.(61)

61) Ilkorur,K.,Leasing and Financial Institutions, ITO Financial Leasing Seminar Note,(April,1986),p:6

Borrowing for Capital Investment

The high cost of borrowing in Turkey,and general lack of liquidity especially with respect to medium and long term credits,are important factors to consider for leasing in terms of both cost and pricing.The highlights is that borrowing at a non-preferential credit rate is done mainly as a last resort for working capital purposes. Such borrowing rates from commercial banks are in around 60-70% where 45-50% is the nominal rate , 3% financial transaction tax is charged on interest and commission,and finally , there is 2 5 to 10% mandatory contribution to Resource Utilization Fund.

Only those loans which are subsidized are realistically affordable for capital investment. Under the above fund scheme,a tax is levied on bank loans and the proceeds contribute to that fund at the Central Bank.Depending on the equity-debt using proportion used in financing the capital investment,it may qualify for a 7% rebate from this fund if the capital investment is being realized in developed regions.

The monetary policies adopted during recent years depressing the economy overall and the high cost of credit made demand for medium to long term credit currently weak.Some medium term credits are utilized for working capital but they are basically refinancings of short term credits.The past devaluations of the Turkish Lira have created a psychological barrier against the the assumption of foreign exchange risk although ,at the current real interest rates on domestic loans, foreign exchange borrowings may be more attractive than in the past.Finally,domestic currency resources for development banks like T.S.K.B are scarce,and therefore restrict their ability to make capital investment loans.

9.1. Legal Aspects

Turkey is governed by a civil code and by a code of obligations based on the Swiss Model.They do not specifically address the concept of leasing. However, although it may be logically possible to extent treatment of hire or purchase by instalment to leasing, Financial Leasing Law No.3226 has formed its own limitations and procedures sharply leaving those shown in civil code.Of importance are the issues of;

1) Rights and obligations of the lessee
2) Damage and loss of assets
3) Third party purchase of the asset
4) Bankruptcy
5) Default and repossession
6) Lease contract

1) Rights and Obligations

The lessee is the quiet owner of the assets subject to the lease during the tenure of the lease and he has the right to derive every benefit thereof in accordance with the purpose of the lease.The lessee is obliged to utilize the assets subject to the lease with due care according to the provisions and conditions stated in the lease. Unless otherwise stated in the lease,the lessee is responsible for the protection and maintenance of the assets and has to bear all charges for the maintenance and repairs thereof.

2) Damage and Loss of Assets

The lessee is responsible for the loss and damage of the assets during the tenure of the lease.The lessee's obligation is limited to amounts uncovered by the insurance compensation.However, the lessee shall pay this obligation concurrent with lease payments.According to this article, the lessee is also responsible for the damages and loss caused by the external environmental factors over which the lessee has no control.This is not the case in operating lease.The lessor is responsible for all kinds of damages and losses of the assets being leased.

3) Third Party Purchase of the Asset

The lessee cannot transfer to other parties its possession rights of the assets or in other words, the lessee can not sell the assets subject to the leasing. The lease shall be drawn by a public notary. A lease pertaining movable assets shall be registered in a special registry at a public notary located in the domicile of the lessee. A lease pertaining immovable assets shall be registered in the Land Register where immovable property is registered and leases for ships shall be registered in the Ship Register. If the lessor does not have a branch office in Turkey, the lease shall be registered with the Ministry to which the Undersecretariat of Treasury and Foreign Trade is attached.

At this point, there are some practical problems such as the difficulty in selection among numerous public notaries in big cities, kinds of information to be registered, filing procedures of registrations. However, problems of this sort will not be a major obstacle for leasing.

Although the Turkish law protects the third party who acquired an asset in good faith, after registration, acquisition of real rights by third parties on the assets subject to financial lease cannot be asserted against the lessor according to the Law.3226.

Unless otherwise stated in the lease, the lease terminates in cases of bankruptcy or initiation of a lien aginst the lessee, death of the lessee or loss of capacity to act or liquditation of the lessee's company.

4) Bankruptcy

In the case of bankruptcy of the lessee and prior to the establishment of the bankruptcy bureau, the bankruptcy officer separates the assets subject to the financial lease from other assets held by the lessee. Objections to the decision of the bankruptcy offices can be filed. If a lien is initiated against the lessee, the lien execution officer shall rule exempt the assets subject to the financial lease from execution.

In the case of bankruptcy of the lessor, the lease remains valid against the board of bankruptcy until the end of the period. If a lien is initiated against the lessor, the assets subject to the financial lease cannot be attached during the tenure of the lease.

5) Default and Repossession

The lessor may cancel the Lease if the lessee does not pay the Lease Payment within 30 days after payment is due. However, if it is so agreed that the ownership of the property will be transferred to the Lessee at the conclusion of the Lease, then this period shall not be less than 60 days. When the lease terminates, the lessor does not have the right to buy the leased assets as stated in the lease or choose not to purchase the assets, he is obliged to return the assets subject to financial lease immediately. If the lease is cancelled by the lessor, then the lessee is obliged to pay all future lease payments and to pay for all damages of the lessor.

This article is significant for the development of financial leasing in Turkey. First of all, it is not consistent with the assertion of which financial leasing will be an advantageous financing instrument for small or medium sized investors. The most critical characteristic of those investors is their liquidity problems. Furthermore, if the investment is a new one, the cash outflows will be more in those primary years. In such a situation, a probability of being faced with a liquidity crisis normally exists. Secondly, the leased asset may be the hard core of the main business for small and medium entrepreneurs. Under those conditions, if the lessee could not pay one of the lease payments on the date due, he must give the asset back immediately. If it is the only asset for the production to continue, by doing so you immediately cut cash inflow lines for that company. Afterwards to expect the lessee to pay all future lease payments is meaningless, because the lessee is already in a default position for only one lease payment. Even if the asset is not the main business line,the reasons for liquidity crisis should be considered carefully by the lessor.What if the default happens to be in the very early payments of the lease ? Then again, will the lessee be obliged to pay all the future lease payments to the lessor ?

Another argument related with this subject is that the lessee has to give the asset back immediately to the lessor,but the latter should not expect the lessee to pay the rest of the lease payments. Because the lessor could lease the asset to any other lessee or could sell it as soon as possible.

Those are the sides of the picture when looked from the lessee's stand point.

As opposed to above arguments,lessors have developed their own approaches.The first one is that the lessor is committed to pay the interest payments scheduled in conformity with the timing of the lease payments.Secondly,it will sometimes be difficult to find a new lessee soon enough to pay the due interest payments,or it is suspicious to sell the asset at a fair price in the market immediately.Under those conditions, the lessors have the right to expect a kind of compensation by the lessees against those probable risks.

The right way for both the lessor and the lessee is that in a default position the lessee should be responsible for the loss of the lessor that is uncovered in any way.That is,if the lessor sells the property at an approximate price to its fair market value,the net loss from this transaction should be covered by the lessee.If the lessor gives the equipment to a new lessee, the net loss up to that time should be covered. However,the lessors should not exploit this approach by selling the property at an unrealistic price or by leasing it at a very low rental when compared with the original lease rental. But,at this moment,it should be pointed out that the solution selected for a default case by the Unidroit Rules is parallel with the Law 3226.

If the main purpose is to preserve the investments, the first thing to be done is to preserve the investors equally.

6) Lease Contract

Details of the lease transaction;e.g. fixed or floating rate,term,rental,right to prepay,purchase option, etc.,can all be incorporated in the lease contract.

The minimum term for a lease contract is 4 years normally,and under some conditions which are very limited,the leasing period can be shortened.In the case of a financial lease being provided from abroad,the lease payments cannot be less than the equivalent of $ 25.000 in T.L.per annum.However, there is no limitation on the leases being made in local currency.

One of the important articles in the law is that "the ownership of the assets subject to financial leasing rests with the lessor.However, the parties can agree that the lessee may have the option to purchase the asset at the end of the lease period."(Article 9)

In an hyperinflationary environment,the assets are rapidly appreciated,so the residual value of the asset on lease will constitute a considerable amount of money. In such a situation,the lessor would expect to make use of this appreciation .Directly related to these issues, remarketting value will be either determined nominally in the lease contract,or will be included in the lease payments as if it is the part of the cost of the property being leased. At this stage,the lessee should carefully analyze the conditions of the lease contract.

The expected pattern that will probably be followed for the application of the purchase option in the lease contracts is that the purchase price will be realized at a certain percentage of the fair market value for the equipment at the end of the lease contract, which is to be approximately lower than remarketing value. The most important part in a leasing activity is the preparation of the lease contract.The obligations of both lessor and lessee should be explained in detail. For the sake of both clearness and comparability, a single format for the lease contracts for the same industrial sectors may be structured.

## 9.2. Taxation

In general,the present tax rate is 46%,and a corporate leasing entity,regardless of its status as a commercial or financial entity,would be subject to taxation at that rate.The lease is exempt from any kind of taxes,duties,and charges.

The shortcomings in Taxation will be examined under the headings shown below:

1) Corporate and Income Taxes
2) Incentives
3) Tax Exemption
4) Witholding Tax
5) Capital Gain and Losses

1) The determination of the periodical income or loss is clear.The rental is an expense deduction for the lessee in the periods paid in,and income for the lessor for the it period belongs to.With this method, a tax deferral is occuring, which creates, to a great extent, a loss of revenue for the government.However,a financial lease rental might be treated differently. Conceivably only the interest portion might be expensed or taxed as income.And also,a differentiation on this determination should be made according to the existence of the purchase option in the lease contract.In order to protect this tax advantage from abuses,those advantages should be limited to the lease contracts that really contain a purchase option.

2) In order for leasing to be competitive vis-a-vis borrowing,the subsidization scheme should apply to it.According to Financial Leasing Law,the lessor is entitled to all investment incentives granted to the lessee under an investment certificate in accordance with the principles to be determined by the State Planning Organization.(SPO)

SPO communique dated December 5,1985 No.86/1 forsees that both parties i.e.the lessor and the lessee should apply to SPO to obtain the Investment

Encouragement Certificate.According to the communique, the lessor is entitled to the following incentives;

- Custom Duty Exemptions and VAT application

The asset subject to financial leasing may be either leased from a leasing company which does not have a branch or subsidiary in Turkey or it may be leased from a company established in Turkey.Meantime, the asset on lease may or may not be related to an investment for which an investment licence is obtained.

Custom Duty and VAT application vary according to the various alternatives discussed above.

a) Leasing from a company established in Turkey

1) Imported Assets

If the lessee has an investment incentive that provides customs duty exemptions which are also transferrable to the lessor,under these circumstances, VAT is also accrued by the Customs Authorities but upon obtaining a guarantee letter from the lessor it is deferred until the lessor collects the same amount of VAT from his deliveries.When the necessary documents are submitted to the Customs, the accrued VAT is written off by the Customs.The banks which are directly involved with leasing face an important problem here.Since the banking transactions are not subject to VAT but the banks charge Banking and Insurance Transactions Tax at the rate of 3%, this may not be offset against VAT accrued but deferred by the Customs.Otherwise,this type of arrangement will create an extra cost for the lessee. That is,the same operation will be treated differently sometimes by applying to it VAT or transaction tax, depending on the status of the enterprise realizing the operation. This problem has been confirmed by the tax authorities.As a result,this understanding of the law should be changed. One of the solutions can be the establishment of subsidiary leasing companies by banks if no change has been made, or to change it.

If an investment incentive does not exist, customs duty paid by the lessor is added to the cost of the asset and it is subject to depreciation. VAT paid to the Customs is deducted from the lessor's VAT liability in five years ( one year in investments under investment licence) and in five equal instalments.

2) Locally Purchased Assets

If an investment licence is not available,VAT paid by the leasing company is deducted from the future VAT liability in five years.If an incentive exists,the lessor will be able to deduct VAT paid in one year.

b) Leasing from a company which does not have a branch or subsidiary in Turkey.

If the lease agreement does not grant the right to purchase the asset or if an investment incentive is not available,the asset will be imported to Turkey [illegible] the temporary exemption regime.A guarantee should be submitted to the customs for future tax liabilities. If at the end of the lease,the assets are permanently imported to Turkey,the customs duty is assessed on the original price of the asset and at the exchange rate prevailing at the date the tax obligation has arisen.

Additionally,the following examination of this major subject will show its importance in the application phase.

First of all,a financial leasing company will pay a total of 10% VAT once for the goods it will purchase and,as noted earlier,it will deduct this payment from the instalments in five years ,which, in turn will create a great financial burden over the leasing company. Of course,this problem exists for the newly established lessors. The burden will decrease as the portfolio of the leasing company improves.

Secondly,for the equipment leased from abroad, it is possible to defer customs duties to a great extent. The deferment is applicable to all agreements that have no purchase option in it.Besides, if the investment is being realized with an " investment encouragement certificate "in which there is no customs duty exemption and if that contract contains a purchase option, the tax will be deferred again. As a result, either there will be no tax or it will be deferred.

The Article 29 involves two important shortcomings. One is, the deferment of tax is only applicable to the leasing contracts written to foreign leasing companies. But, leasing contracts can be written to the subsidiaries of foreign leasing companies or to the leasing companies established in Turkey. Thus with those provisions, foreign leasing companies have gained a priority over others.

Furthermore, another missing point is the VAT paid for imports. Only two options can be exercised in imports; either VAT will be paid or it will be deferred for the investments under an incentive. VAT Law does not give any other application for the treatment of goods imported. Thus, the Article 29 is invalid because of the taxation techniques.

- Investment Allowance

30%-100% of the approved investment amount is deductible from taxable income for projects depending on the region and the sectoral basis. The allowance is applicable to all expenses with the exception of purchase of land and spare parts and construction of houses for employees' use. There are strict deadlines and procedures which are set by the Income Tax Law and Regulations to obtain an Investment Licence and to apply it to investments. If those deadlines and procedures are not met, it is not possible to benefit from investment allowance.

In the past, foreign investors were not allowed to benefit from the investment allowance by the tax authorities. This problem has been resolved by the new Tax Law No.3239 which has been effective since Jan 1, 1986.

Investment allowance which is deducted from taxable income is subject to 10% withholding tax. Since the Corporation Tax is 46%, this represents 36% tax saving for the leasing company.

The Ministry of Finance has also issued a communique dated September 28,1985 No.146 on the specific tax issues relating to the application of investment allowance to financial leasing companies. The communique confirms that since the lessor is owner of the asset,he is entitled to investment allowance.However,the lessor may benefit from the investment allowance starting from the year the asset is delivered to the lessee, not from the year the lease agreement is signed. The communique also stipulates that if the lease agreement is terminated for reasons other than those specified by the Financial Leasing Law,the lessor will pay back to the tax office all tax savings and their penalty.

-Premium from Resource Utilization Fund

For the projects over 1 billion T.L. 7% or 20% premium is paid without making equity-debt using proportion on the realized part of the investment. For the projects under 1 billion,this premium will be applied only on the part realized with credit. Certain investments such as production of spirits and electricity and importation of ships etc. are not entitled to premium.

- Premium for the purchase of locally produced machines and equipments is also available for the lessor.The premium is 15% of the asset purchased.

Capital allowances available on the purchase of most types of plant and machinery is claimed by the lessor and reflected to the lessee in the form of reduced rentals.This reduction of the lease rentals is attractive to those companies whose taxable profits are insufficient for them to obtain immediate and full benefit from the allowances to which they would be entitled if the equipment were to be purchased.

Another problem exists for the assets leased having an investment licence which is issued at the project level and, therefore,the asset user level.The assets imported under an incentive licence may not be sold outside for ten years. This is contradictory to the nature of leasing business that requires the sale of assets if the lessee exercises his option to purchase it. Another point requiring further consideration is the transfer of leased assets,in cases of uncontrollable conditions,to third parties which may not have the same degree of incentives.(62)

3) Tax Exemptions

Lease agreements are not subject to Fiscal Stamp Tax and other charges applicable to agreements.The exemption is particularly important from the Fiscal Stamp Tax standpoint since under normal conditions .all agreements are subject to 0.5% tax and an additional 0.3%tax if a bidding decision is taken on the amounts indicated in the agreements.However,Financial Leasing Law,article 8 imposes certain registration procedures with the public notary and the land registry which are subject to registration fees.Those fees are as important as Fiscal Stamp Tax and the Law 3226 does not foresee an exemption for registration formalities.The exemption of such fees would be another positive factor to decrease the cost of leasing plan.

4) Witholding Tax

If the lessor is a nonresident company,the gross lease payment will be subject to withholding tax.Turkish branches of foreign companies are also considered as nonresident companies. According to Financial Leasing Law,the government has the authority to reduce the withholding tax rate to zero percent, which has not yet been exercised .Presently,withholding tax rate is 20%. However,the nonresident leasing company has the option to accept the withholding tax as the final tax liability.Alternatively,the lessor may file a tax return on the net income basis which is determined as the difference between the lease income and the related direct expenses incurred for leasing transaction.But home office charges are not deductible for Turkish

62) Ibid,p:10

taxation purposes.Taxes withheld are deducted from the tax liability computed on the lessor's net income at the rate of 47.38%.

One of the main shortcomings in taxation is related to the withholding tax. There are various approaches regarding this issue.

The first argument is that" as long as there is no withholding tax on interest payments on other forms of foreign borrowings,(Decree No.84/7826, Official Gazette March 16,1984) there should not be any tax on lease rentals.Furthermore,if one day a withholding tax is levied upon all sorts of foreign borrowings,those transactions put into effect previously with no tax should keep this status since payment schedules are to be devised without tax."(63) The lessees are also supporting this argument because the withholding tax,as a cost component,is being reflected in the lease rentals.

But is it correct to diminish it to zero ? The disagreement on the issue stems from the fact that the whole amount of the lease rental is being accepted as an operating income and taxed on that basis. Unfortunately, the total amount of the lease rental paid does not correspond to the income derived from that transaction. Part of it corresponds to depreciation and interest, and the rest corresponds to capital payments.The revenue part corresponds to the interest and depreciation portion.The witholding tax has to be applied on the revenue portion of the lease rental.Thus the segregation of the revenue part for levying withholding tax is necessary for the development of financial leasing in Turkey.

Although such separation is accepted by the authorities,they also point out the difficulty in separating the interest and other components. The difficulty is due to the fact that first, foreign

63) Ibid,p:11

leasing companies should keep their books according to the accounting procedures and rules accepted in Turkey, for finding the revenue portion of the lease rentals in order to levy the withholding tax on it,secondly because of the complexity of the necessary calculations to separate the interest and depreciation portion from the other components in the lease contract.

Under these circumstances,the fair way to be followed can be the preparation of a document by the international or national auditing companies for the determination of the revenue components in the lease rental which is then to be approved by the Ministry of Finance.Thus, right at the beginning ,tax office,lessor and the lessee will be aware of the amount to be paid as withholding tax.if this can be realized,then diminishing the withholding tax rate to zero will be functional for the attraction of foreign capital into Turkey.

5) Capital Gains and Losses

One of the advantages of leasing is the reflection of profitability from benefits/incentives to the lessees by the lessors in the form of reduced rentals,or through rental rebates.As in all financial institutions,the profitability of leasing companies depend,to a great extent,on the cost and the composition of their funds.And one of the efficient ways of generating funds is through own operations. According to Article 328 of Tax Procedure Law the income or loss generating from the sale of fixed assets should be recorded to the income statement of the year of sale.There is one exception to that rule;if the asset is sold for reasons of renewal or modernization or sold by a management's decision specifying necessity of its sale,the profits resulting from this transaction can be kept on the balance sheet for three years.The leasing business, by its very nature,apart from the necessity of generating funds through operations,will have to sell its assets to lessees.Especially,in an inflationary environment that is probably going to be accounted as profit.Leaving such profits within the leasing company will bring low cost funding opportunities,the results of which are reflected to the lessees.(64)

64) Ibid,p:9

## 9.3. Accounting Aspects

In Turkey, the standardization of the reports and auditing procedures could not be improved. This situation poses serious problems in at least two areas;

- credit analysis of the lessee
- leverage ratios

Even though his financing activities are secured by the underlying assets, a potential lessor would need some standardized guidelines for evaluating the credit worthiness of lessees. Another point is, leasing has a distinct advantage over borrowing if the lessee is not compelled to disclose his true leverage on the balance sheet. In the United States, leasing gained popularity by being a form of disguised debt, and despite the enforcement of FASB 13, leasing only appeals to certain firms if it can be structured as an off-balance sheet transaction. Of course this aspect of leasing would not be relevant unless standard accounting practices are compulsory.

### Lease Accounting

For the operating type of leasing practiced in Turkey, the asset would be shown as an investment by the lessor and would be depreciated by him. Rentals payments are recognized as income. If rentals are received in advance, they can be itemized temporarily under liabilities, and amortized annually into income. The lessee would not show the lease or the asset on his balance sheet, but would deduct the rental as expense. This approach follows the operating method of lease accounting. The accounting method to be employed by the lessors and lessees for the financial leasing transactions have not been exactly specified. It is explained by the authorities how the leasing transactions are to be accounted for both in the books of the lessor and the lessee. The main difference of this accounting procedure when compared with the above operating method is the addition of a footnote to the existing rule. Let aside the impossibility of capitalizing the lease receivables and payables on the balance sheets,moreover the information supplied in the footnote should be devised and leasing companies should show their lease rental receivables and the lessees,lease rental payables on their balance sheets additionally.

"This sort of requirement as well as the separation of interest earnings/payments from the principal amount might even push into thinking of having the services of internationally accepted auditing companies on a compulsory basis at the initial stage." (65)

Depreciation

New guidelines were passed in December,1982 to take effect in January,1983.Except buildings,land and very special equipment,assets are depreciated on a straight line basis of 25% per annum.The double declining balance method may be elected over four years.A switch can be made from straight line to double declining balance ,but not vice-versa.All assets which were acquired during a single year,or which comprise a single accounting entry must be depreciated the same way.In the case of used assets, the purchaser may redepreciate on the acquisition price of the asset.(Remember the tax loophole)

As per the Financial Leasing Law,normal repair and maintenance expenses related to assets subject to financial leasing should be borne by the lessee. However if the lessor incurs expenses such as to increase the value of the asset,those expenses are capitalized and depreciated by the lessor over the remaining useful life of the asset.If the expenses incurred increase the useful life of the asset,they are depreciated starting from the year they are capitalized and the useful life of the asset is also extended.

Capital Gain or Losses

A sale price over and above a depreciated book

65) Ibid,p:9

value for an asset is taxed directly as income at the corporate tax rate.If an asset is sold and replaced with a new one with a similar productive application within three years,such capital gain can be deferred. The gain goes into a special entry on the liability side of the balance sheet which is amortised by the depreciated amount of the new machine annually.

Revaluation of Assets

In order to adjust asset values more realistically in line with inflation,the Turkish government has allowed the revaluation of fixed assets.The undepreciated portion of the asset base is multiplied by a coefficient and the difference between the revalued amount and the old book value is included among equity as a revaluation fund entry.This is an attempt to overcome the lack of an inflation cost accounting system in Turkey,and helps measurably to reduce inflationary phanthom taxes,and excessive capital gains on sales of assets which have appreciated with inflation.

If the lessor is a resident taxpayer,he will be able to revalue the fixed assets according to the provisions of Fiscal Procedural Law.

Revaluation fund established as a result of revaluation may be used to increase the capital and to give free shares to the shareholders of the leasing company.Revaluation of assets subject to leasing and the use of the revaluation fund is important for the leases where the lessee has the right to purchase the asset.The Financial Law is silent as to this value which will be the basis for sale(net book value, etc.)According to the general provisions,market value of the assets will be considered as sales value. Again,another inconsistent situation is the expectation that the purchase option will be realized at a lower level against market price. If a lower price option is declared on the contract, and if the lessor revaluates its asset,then an asset having a high capital cost will be sold at a very low price compared with that revaluated capital amount.

Those kinds of transactions will probably lead to certain taxation problems.

In this connection the following alternatives are possible;

- If the revaluation fund is added to the capital before the sales take place,the profit from the sale is computed as the difference between the sales and the net book values.This will result in important tax savings for the lessor.
- If the revaluation fund is not added to the capital before the sales.the fund relating to the asset which is sold will be considered as accumulated depreciation and the profit subject to taxation will be increased by that amount.As a result,for tax saving purposes revaluation fund will be added to capital, most of the time, by the lessors for the assets for which the lessee has the right to purchase and this will put lessees into an disadvantageous position in an hyperinflationary environment.

The addition of the revaluation fund to the capital then will have positive impact on the leverage of the lessor because of the increased equity.

## 9.4.Regulatory Aspects

The classification of leasing as a financial activity has raised the question of how it should be regulated in terms of institutions permitted, shareholding and funding.

Financial institutions which are permitted by Leasing Legislation to write transactions are as follows;

- Leasing Companies:Corporations with a minimum capital of T.L.1 billion,incorporated locally,local or foreign capital or both.
- Branches of foreign Leasing companies,minimum branch capital of $ 2 million.
- Special Finance Companies(Islamic Finance Companies) enacted according to Council of Ministers Decree No: 83/7506,dated December 16,1983.
- Investment Banks established according to Article [illegible] of the bank Act No:3182

Article 49 of the Banking Law states that commercial banks may not buy or sell equipment directly for commercial purposes."Though the Leasing Act itself does not specify it clearly,it is understood by way of implication in Article 20 of the announcement of the Ministry of State and Deputy Prime Minister,that the commercial banks cannot enter into leasing as primary market institutions through their specialized departments.However,they are entitled to establish their 100 % owned subsidiaries. Though this special disrimination may result in problems with respect to funding,it will be useful for the development of above financial institutions because of the reason that the commercial banking system in Turkey is heavily oriented towards collateral based lending rather than lending against financial statements which is the crux of the project financing where leasing is mostly needed as a medium to long term financing."(66)

66) Ibid,p:7

Article 48 of the Bank Law states that a commercial bank's total participation in non-banking activities cannot exceed 10% of its equity and reserves. However, if an activity or company is founded under a special law, such as development and investment banks, then this restriction will not apply. T.S.K.B, partly owned by Is Bank, would be eligible to do leasing because of its status as a specialized development bank, not subject to commercial bank regulation.

The regulations do not leave other financial institutions like brokerage companies active in the primary market and insurance companies active in the secondary market .

Lessors will comply with the procedures and principles established by the Ministry of Finance and Customs in keeping books and records and producing financial statements and financial report filing requirements.

The leases can be written both fixed and variable. They may be in local currency or in foreign currency. Turkish lessees and lessors may write leasing contracts in foreign currency . Assets subject to the lease may be both immovable or movable. Intangible and industrial rights such as patents cannot be subject to a lease agreement. Leasing of used, renewed, faulty, sub-standard, soiled or low quality equipment from abroad subject to permission for importation is subject to the pre-permission .Financial leasing activities relating to an Incentive Certificate are not subject to those provisions.

Although the leasing companies are financial institutions they are supervised as the other financing entities, they are sometimes treated as commercial companies such as in cases of VAT application. The lessors would like to see that leasing is conceived as another method of providing medium to long term financing for capital goods and therefore is not subject to any elements that would put leasing and leasing institutions in an advantageous or disadvantageous position vis-a-vis other forms of financing and other financial institutions.

In this respect, leasing companies would like to have a leverage ratio of 1:20 instead of 1:15, to put them into equal position with the banks. By the way, investment banks established according to Article 95 of Bank Act:3182 and the Special Finance Companies are not subject to leverage ratios.

There is some disagreement between the authorities as to the way leverage is defined for leasing companies. It is argued that it is disadvantageous when compared with the leverage applied to the banks. A leasing company with a capital of T.L 1 billion is entitled to have credit facilities up to T.L 15 billion which will be converted into leasing transactions. But since the criterion on limits to individuals is lease rental receivables and since such receivables do include the interest earnings, in reality, the total volume of leasing transactions that the company is able to write is lower than T.L 15 billion. (67)

The counterargument is that there is no such relation between those limits, since one is global restriction on the borrowings of a leasing company in order to prevent overdebtness, while the limit on the transactions on individuals is a specific restriction in order to diversify the risk among the various lessees rather than only a few lessees. Here, the only point that can be reformed is to increase the leverage ratio. However the reason of the present situation is simple. In Turkey, financial leasing, as a medium term financing instrument, is newly developing and it is also recommended by the authorities of I.F.C having had experiences in developing countries. Right at this stage, it is appropriate to begin with such a ratio. Depending on the near future developments, it can be

67) Ibid, p:8

adjusted according to the needs and conditions of the lessors.

Considering the above arguments,it can be concluded that there is no discrepancy between the limits as it is asserted,but the criterion on individual limit should be rephrased to exclude the interest earnings from the calculations of restrictions on leasing transactions. This is quite important especially in an inflationary environment.

## 9.5. Funding Aspects

Sources and costs of funding for a leasing entity are major obstacles. At present, the Turkish Lira is very limited and costly. The most popular method of funding is in the form of debt from commercial banks. Besides, the addition of revaluation funds to capital for the issuance of free shares to stockholders is another way of funding. Of course this transaction does not provide new cash funds to the company. With respect to the increased capital, the borrowing capacity will increase. Investment loans are made at around 40% by TSKB, while credit from commercial banks ranges from 25% to 30% for subsidized projects to about 70% for nonpreferential credit. Those firms relying on borrowed capital as opposed to equity have suffered crushing debt service obligations that are essentially [illegible]. It is within this range of cost to the lessee that leasing must conform if it is to make sense.

As far as funding sources are concerned, there are inequalities between the leasing companies and other financial institutions that are permitted to write leasing transactions. "Though Leasing Companies may borrow funds on the securities market through issue of bonds, debentures and similar securities provided that they comply with the Law No:2499 on the securities market and the relevant legislation, the major disadvantage of leasing companies compared to the Investment Banks and the Special Finance Companies is that according to Article 95/2 of the Banks Act, the Investment Banks can accept funds (deposits) from their clients, and the Special Finance Companies can accept deposits from the public and companies, not just like commercial banks, but quiet sizable amounts. Therefore, with respect to funding the Special Finance Companies do have a definite advantage over the others, ordinary leasing companies being devoid of such funding means." (68)

68) Ibid, p: 9

This argument is reasonable,but also there are some drawbacks in that claim.

A leasing entity could accept deposits,but would then fall under banking regulations which, at the same time, prohibit the purchase or sale of assets for commercial purposes.The only way to overcome this restriction would be to define leasing as strictly financial activity,and therefore permit the purchase or sale of an asset for financing purposes only.This would rule out operating leases from the financial regulations.Another serious drawback to taking deposits is the overhead cost of establishing a branch network.

Another approach both for funding sources and increasing the variety of financial instruments in the capital market is to permit the selling and buying of leasepapers as the other money market instruments.

Additionally,it would be useful for the Leasing companies to do direct borrowings from foreign investors like the Foreign Trade Corporations.

With respect to the sources of funding,the following institutional investors and the financial instruments in the capital market can play crucial roles in the functuality of leasing more rapidly.

Development Banks T.S.K.B

As previously mentioned, TSKB could engage directly in leasing,however,its Turkish Lira resources are very restricted owing to the following:

- It may not accept deposits from public.
- Limits exist on the amounts of securities equity that it may issue.
- Rediscount facilities with the Central bank are limited.
- Loans from the Government are made only under exceptional situations.
- Issuing bonds at present is expensive because of the withholding tax imposed on bearer bonds.

TSKB's medium to long term resources in foreign exchange are more available,but then the lease contracts must be repaid in that currency,or must be indexed to cover the foreign exchange risk,which is at present perceived to be a major obstacle to marketing the leases in view of recent devaluations of the T.L.Discussions with local corporations revealed that many firms would rather borrow at 70 % in lira on a term basis than take on a foreign currency liability.The devaluation risk of the Lira is considered to be high in the private sector.(69)

TSKB can realize leasing transactions with the corporations which are under their control because of the mortgage right, thus it can provide financial sources for the entrepreneurs having limited capital. The only difference of this application from the existing one is the need for lower warranties and the lower capital accumulation. The ownership of the property rests with TSKB and this puts the entrepreneurs having difficulties to find sufficient colleteral for borrowing in order to finance their investments,among the potential investors.

Islamic Development Bank

TSKB has had discussions with IDB about a credit line to finance the medium term projects in the form of leases.The fact that IDB has a presence in Turkey through Government backed leases with State Economic Enterprises,would make them an obvious prospect for financing in the private sector.During the meeting in June 1983,the Board of Directors of IDB has accepted to change the existing Line of Equity agreements into Line of Equity and/or Leasing.( 70 ) In addition to purely a funding source,IDB should be considered as a potential foreign shareholder in a leasing enterprise.
In Exhibit 8,funds financed through leasing by Islamic Development Bank is given .

69) Snyder,J.,Preliminary Issues on the Potential of Leasing in Turkey,I.F.C. Publications,(April,1983),p:33
70) Oguz,S.,A Research on Leasing in Turkey,Hazine ve Dis Ticaret Mustesarligi,p:23

EXHIBIT 8 Islamic Development Bank Funds for Leases

| COMPANY | Amount of Credit | Term of Lease | Date of Contract |
|---|---|---|---|
| | US$m | | |
| Tumosan (Purchase of Agriequipment) | 11.50 | 5 | January 1979 |
| Testas (Line Circuits) | 16.41 | 5 | January 1980 |
| Turkiye Cimento Sanayi (Equipment) | 6.34 | 8 | May 1981 |
| Kumas (Modernization) | 10.27 | 8 | May 1982 |
| Tumosan (Motor Manf.) | 13.80 | 8 | February 1984 |
| Turk-Libya Transp.Co. (Shipping Lease) | 8.00 | 7 | August 1984 |
| Hacettepe Hospital (Medical Equipment) | 12.68 | 8 | November 1984 |
| DESIYAB-Line of Leasing | 10.50 | * | November 1984 |
| Ipras (Petrol Lines) | 13.70 | 10 | November 1984 |
| Ortadogu (Equipment) | 9.00 | 8 | March 1985 |
| Ziraat B.-Line of Leasing | 10.00 | * | * |
| Total | 124.20 | | |

Source:Undersecretarial of Treasury & Foreign Trade

Other Foreign Banks and Loans

The Central Bank maintains a facility where importers of equipment can swap Turkish Liras for foreign currency.There is presently no shortage of foreign exchange in that facility because of low investments.If the leasing company could devise a reasonable method of covering foreign risk by passing it on to the borrower in the lease contract and such leases would become marketable in a more stable balance of payments climate,foreign exchange loans from other foreign banks and borrowings in the Euro bond market would constitute a source of funding.(Remember the withholding tax on lease payments remitted abroad which would be added to the cost)

Money Market Instruments

At present,issuing and trading commercial paper is illegal.To make commercial paper marketable,it would need a direct guarantee or at a minimum,a moral guarantee with a recognized name.Commercial paper borrowing would be suitable for only a fraction of the leasing entity's funding requirements where a lease contract may extend for four years.

Bonds

Issuing medium term bonds would be an important potential funding source if the cost could be brought down.Because there is a withholding tax on bonds at a rate of 25 %. Variable rate or indexed bonds would be an important adaption to make bond issuances affordable in the current environment.

New Debt Instruments

A new debt instrument for medium term funds,backed by the leased asset and/or the lease contract might be feasible.Such leasing paper could be syndicated to individual investors, or placed with institutional investors,such as pension funds.(71)

71) Ibid,p:36

Pension Funds

One potential source of institutional finance are pension funds, either for direct loans or for assigning lease contracts. Presently, banks and the military have pension funds. OYAK, the military fund, could be a share holder in a leasing entity.

Discounting Lease Contracts

Discounting lease rentals or assignment of lease contracts is a popular funding mode in the United States. The lease receivables can be treated just like any other receivable and discounted by the commercial banks. That is, " the discounting and assignment of the lease contract itself should also be reconsidered. In this line, as long as T.C. Central Bank rediscounting facilities are available, the Leasing Companies should be entitled to make use of these facilities."(72)

72) Ilkorur, K., Leasing and Financial Institutions, ITO Financial Leasing Seminar Note, (April, 1986), p:9

10. Economic Contribution

The contribution of leasing to capital markets has been multi-faceted,but leasing is undoubtly one of the most effective ways of allocating scarce financial resources to new capital investment.Every amount of money used by leasing companies in their businesses is spent on productive plant and equipment.By channelling all their funds directly into new equipment,leasing companies avoid the leakage problem,faced by banks and other types of financial institutions,of funds being diverted by borrowers to non-priority uses.Furthermore in this time of international debt difficulties, investment of available funds in productive assets ensures that there is a stream of income generated to meet rental payments.Exhibit 9 shows how the proportion of the leasing as a percentage of the total investment in plant and equipment in OECD countries has increased.

This feature highlights the unique role played by leasing in the economy.Most transactions in the secondary capital markets represent transfer of existing financial instruments between investors rather than the raising of new funds.The vast volume of trading in outstanding securities does not represent new capital formation.

Leasing has contributed in several important ways to the growth and performance of capital markets. In support of the productive sectors of the economy,leasing will increase the competition among sources of finance, support the industrial modernization and small businesses and will aid the implementation of industrial and fiscal policies.

Exhibit 9 The Penetration of Leasing in Capital Formation % of Total Investment

| COUNTRY | 1978 | 1979 | 1980 | 1981 | 1982 |
|---|---|---|---|---|---|
| North America | | | | | |
| Canada | 4.4 | 6.3 | 5.6 | 4.7 | 3.3 |
| United States | 15.6 | 17.0 | 21.9 | 25.6 | 27.9 |
| Average | 14.7 | 16.1 | [illegible] | 23.6 | 25.5 |
| Europe | | | | | |
| Austria | 1.9 | 2.6 | 3.0 | 2.8 | 2.8 |
| Belgium | 2.6 | 3.4 | 3.3 | 3.0 | 4.6 |
| Denmark | 1.3 | 1.9 | 2.0 | [illegible] | [illegible] |
| Finland | 1.4 | 2.4 | 3.7 | 6.6 | 7.2 |
| France | 6.8 | 7.9 | 7.7 | 7.3 | 8.5 |
| Germany | 2.0 | 2.2 | 2.2 | 2.0 | 3.0 |
| Ireland | 0.5 | 0.5 | 0.6 | 1.6 | 2.0 |
| Italy | 4.7 | 5.2 | 5.3 | 6.2 | 6.5 |
| Luxembourg | 0.5 | 3.1 | [illegible] | [illegible] | 5.1 |
| The Netherlands | 4.7 | 5.1 | 5.9 | 6.2 | 5.1 |
| Norway | 2.8 | 2.7 | 3.7 | 5.6 | 9.8 |
| Spain | 2.5 | 3.6 | 2.2 | 3.2 | 4.5 |
| Sweden | 3.0 | 4.1 | 4.5 | 8.5 | 9.0 |
| Switzerland | 2.0 | .3.7 | 4.5 | 5.1 | 4.9 |
| United Kingdom | 8.0 | 10.0 | 11.6 | 13.3 | 13.0 |
| Average | 4.3 | 5.2 | 5.6 | 6.3 | 6.9 |
| Japan | 4.8 | 5.8 | 6.2 | 7.0 | 8.3 |
| Australasia | | | | | |
| Australia | 26.4 | 30.2 | 25.0 | 22.2 | 23.1 |
| New Zealand | 3.6 | 4.9 | 3.0 | 14.2 | 20.4 |
| Average | 24.4 | 27.8 | 23.7 | 21.5 | 22.8 |
| Overall Penetration | 9.2 | 10.5 | 12.3 | 14.1 | 15.0 |

Source:Leasing Finance by Tom Clark

11. Conclusion

The statistics and various restrictions on leasing have revealed some downs among the ups,but generally the performance of leasing industries has been positive in the world though it is a very complicated financial mechanism that is directly linked with different legislations.

As far as the existence of a financial leasing act is concerned,the regulation and order is appropriate. But the leasing act, alone is not sufficient for the development of financial leasing in Turkey,besides the related legislations should be carefully examined in order to find out the inconsistent points.

The main issue at this moment is the positive approach by the authorities for making the necessary changes when the market conditions show the need. If the changes could not be realized rapidly in order to satisfy the desires of the related parties,to have such a positive approach would not be meaningful.

Leasing would have to have a particular advantage,such as flexible repayments or immediate financing,to induce the lessee to pay the additional cost of another intermediary when he could approach the commercial banks directly.

Leasing would be viable in Turkey only if a leasing entity would be able to attract funding from other institutional investors at an overall cost which would allow a reasonable spread.

The existing system of large discrepancies between lending rates on subsidized and nonsubsidized loans makes it virtually possible for leasing to be attractive unless it could provide the same subsidy elements as the banking system.In the long run, development of the capital market for the introduction of commercial paper, medium term bonds with adjustable rates would also be useful.

Given the funding problem can be resolved, there exists an appropriate environment for the financial leasing to be functional.

The growth of financial leasing has won many supporters. They have pointed out many advantages which it offers, advantages which make the alternative of ownership outmoded.

As noted earlier, it is seen as basically another form of debt financing, an extension of the preference for borrowed capital. And from this point of view, there are dangers in the growing trend toward financial leasing to the extent that companies using it fail to appreciate the implications of their mounting lease commitments merely because they are buried in a footnote rather than appearing as liabilities on the balance sheet.

In this respect, the capitalization of the financial leasing transactions both in the books of the lessors and the lessees would create a confidence environment for those investors planning to finance their investments by financial leasing rather than financing with borrowing. In order to do that, first a distinction should be made between the financial leases and the operating leases. This type of official classification is necessary in terms of accounting and taxation treatment of those leases. Of course this classification would not exclude the operating leasing transactions, which were already practiced under current regulations. Another positive factor that would be brought by the capitalization is, because the obligations are accounted in the books clearly, this would, at least, prevent the imaginary leasing transactions.

Also, it would be helpful in the development of the adoption of standardized accounting and auditing procedures in Turkey.

As long as this classification is not be drawn, the Financial Leasing Act would mainly serve the needs of the consumer oriented investment sector rather than serving those of the industrial production oriented sector.

Furthermore with the introduction of financial leasing,insurance companies would find a new business opportunity in that area which is residual value insurance.

Additionally,the establishment of a National Association would provide a medium for exchange of knowledge and ideas,develop a code of practice, and make available to compile statictics for the industry.

Leasing is as costly as other forms of financing instruments.Besides it necessitates certain rules and prescriptions to be followed because it is a complex financing instrument.As far as the lack of experience with financial leasing to date,it can be concluded that the private and the public sector would be supplied with the technical aspects of financial leasing. Furthermore, this would provide more secure environment and naturally some guidelines for the foreign leasing companies which approach leasing transactions with a degree of reservation.

Moreover,the adverse revenue consequences should be reconsidered because of the recognition of tax deferment to every kind of leasing to be realized.

As long as all the inconsistencies are properly handled and the recommendations,after a thorough examination, are put into effect, financial leasing can be an opportunity for the development of our financial market.

Appendix 1

Recommendations by the American Institute of Accountants on the disclosure of lease obligations are as follows;

The committee believes that the material amounts of fixed rental and other liabilities maturing in future years under medium and long term leases and possible related contingencies are material facts affecting judgements based on the financial statements of a corporation,and that those who rely upon financial statements are entitled to know of the existence of such leases and the extent of the obligations thereunder irrespective of whether the leases are considered to be advantageous or otherwise.Accordingly,where the rentals or other obligations under medium and long-term leases are material in the circumstances,the committee is of the opinion that:

a)disclosure should be made in financial statements or in notes thereto of:

1) the amounts of annual rentals to be paid under such leases with some indication of the periods for which they are payable

2) any other important obligation assumed or guarantee made in connection therewith:

b)the above information should be given not only in the year in which the transaction originates but also as long thereafter as the amounts involved are material: and

c)in addition,in the year in which the transaction originates,there should be disclosure of the principal details of any important sale and lease transaction.

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