# THE ROLE OF MERCHANT BANKS IN EQUIPMENT LEASE - FINANCING IN NIGERIA: A CASE STUDY OF INTERNATIONAL MERCHANT BANK PLC

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A PROJECT SUBMITTED TO THE POSTGRADUATE SCHOOL, AHMADU BELLO UNIVERSITY, ZARIA IN PARTAIL FULFILMENT OF THE REQUIREMENTS FOR THE AWARD OF MASTERS OF BUSINESS ADMINISTRATION (M.B.A.) DEGREE

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AHMADU BELLO UNIVERSITY, ZARIA

JULY 1994

# D E C L A R A T I O N

I he. by declare that this project report has been written by me, and that it is a record of my own research work. All sources of information and where applicable other writer's views have been duly acknowledged in forms of list of references.

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# C E R T I F I C A T I O N

THIS PROJECT : THE ROLE OF MERCHANT BANKS IN EQUIPMENT LEASE - : A CASE STUDY OF INTERNATIONAL MERCHANT BANK PLC, by SANI ABDULLAHI DANGAJI meets the regulations governing the award of the degree of Masters of Business Administration of Ahmadu Bello University, and is approved for its contribution to knowledge and literary presentation.

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| Dean of Postgraduate School | Signature | 11/03/00 Date |

# D E D I C A T I O N

This project is with respect dedicated to my Father - ALHAJI SANI DANGAJI and my Mother MRS (HAJIA) HALIMA SANI DANGAJI

## A C K N O W L E G E M E N T

I thank Almighty Allah for giving the opportunity, strenght and the grace to complete this course, making me a proud holder of this noble degree - the M. B. A.

Next, my thanks goes to my parents who have given me every kind of support and encouragement that was possible.

I would also like to thank my project supervisor, Mallam Mukhtar Y. Abubakar for his valuable instructions, co-operation and for sparing me his time in accomplishing the success of this project. I am equally grateful to all members of teaching staff of the Business Administration Department.

My special thanks and appreciation goes to Alhaji Mohammed Lamba - Senior Manager/Head, IMB (Nigeria) Plc Abuja Office and all the members of staff of IMB Plc Kaduna Branch. I also wish to thank the Manager/Head of the Leasing unit, IMB Plc Lagos for providing me with most of the materials I needed on the subject.

There are also a few friends of mine whom I feel I should mention here because I gained quite alot from their companionship. They are Lawal Abdullahi, Bala Wakili, Mustapha Sukola, Tijani Musa, Shehu Abdullahi, Salisu Lawal, Kabir Mohammed, Bello Mohammed and a cousin of mine Alhaji Magaji J. Nuhu.

Finally, I wish to thank all other persons too numerous to mention for their encouragement and spiritual well wishing towards the successful completion of this programme.

## ABSTRACT

Merchant Banking is a recent development in Nigeria. So, also is equipment lease - Financing, a Function that is performed by most of these Merchant Banks. Equipment leasing is a means by which one party allows another the use and possession of an asset (the equipment on lease) for a period of time, on the payment of specific rentals over the period of the agreement.

In Nigeria today, leasing has assumed the most veritable means of corporate Financing by most industries due to high premium on capital and huge cost out-lay for capital equipment acquisition. As a non-conventional, way of creating funds for capital asset acquisition, equipment lease financing spread across the different sectors of the economy, mainly manufacturing, agricultural, construction and transportation industries. Also, equipment lease financing tends to analyse the lessor-lease relationship in respect to the type of contractual agreement they entered. Tax aspects, economic and accounting procedures of both lessor and lessees are analysed.

The leasing industry in Nigeria has a strong prospect for growth. Therefore, to integrate series of economic reforms and to consolidate further and other government policies on industrial development, our industries should be committed to lease financing as an alternative means of capital asset acquisition.

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# CHAPTER ONE

# INTRODUCTION

## 1.1 INTRODUCTION

The search for alternative source of finance as a result of the limitations by the planners of the Nigerian economy has finally focused on Equipment-lease Financing, as an important source of finance which hitherto has not been effectively tapped. Leasing is today probably the fastest growing avenue of capital financing in Nigeria. More and more corporate bodies are turning to leasing organizations for this custom-packaged alternative source of financing.

Equipmentlease financing can be said to be a technique of acquiring asset for the purpose of running a business by a firm without incuring direct initial cash outflow before acquiring the asset. Rather the cost will be paid through instalmental payments (rentals). Leasing can formally be defined as a contract between a lessor and a lessee, giving the lessee possession and right to the use of a specific capital asset owned by the lessor for an agreed rental payment over an agreed period of time. Fast growing, profitable companies often find that it is smarter to pay for equipment as they use it, instead of paying in advance for the use by buying the equipment with cash. The increasing popularity that lease financing received is mostly attributable to the advantages it offers compared to conventional system of financing.

In sourcing funds required for financing the setting up of an industry, businessmen and women, entrepreneurs and industrialists, traditionally use loans (long and short term) and bank overdrafts. The consequence of this practice is that before the investment starts making returns, the Bank officer will come knocking requesting for the liquidation of the overdrafts and before you know it a Receiver will be appointed. This is because in the process of obtaining the loan/overdrafts the whole factory asset must have been pledged as collateral under a debenture. It has also been found that term loans and overdrafts have not been of particular assistance to the establishment and growth of industries.

Therefore, once lease financing is selected as the preferred financing technique, the manager should be alert to factors that will ensure that the financing is planned, negotiated and executed to the best advantage of the business.

Leasing is usually financed by institutions such as investment companies, Development Banks, Merchant Banks and recently Commercial Banks. Out of all the above-mentioned institutions, Merchant Banks are the dorminant lessors due to their wholesale nature and corporate focus on industries.

Roads Nigeria Ltd was the first customer in Nigeria to be granted equipment on lease, in order to carry out its construction business by NAL Merchant Bank.

On a global scale, it is interesting to know that South Korea, which is fast becoming an industrial nation, about 80% of the machines used by their industries are acquired on lease basis. This same instrument of project financing is what has been effectively utilised in the United States of America, Japan and most of the industrialised countries.

Therefore, since the main thrust of Nigerian's economic development programme is industrial development, it is believed that if our industrialist take full advantage of the benefits of leasing, the nations dream of becoming a member of industrialised nations of the world would be realised within the shortest possible time.

## 1.2 STATEMENT OF THE PROBLEM

Industrialisation is the effective weapon for the foundation of sound economic development in less developed countries, as such various governments encourage the establishment of great number of industries. These industries are financed through various alternative forms among which is "leasing".

With the series of economic changes in Nigeria, especially during the Structural Adjustment Programme, purchases of imported machinery and equipment become difficult, thereby making equipment-lease financing a favourable option to acquire these assets.

However, a number of constraints in lease finance as an alternative form of financing attracts many publications by different personalities including bank executives, government officials and Private individual businessmen. These problems include:-

1. The constant review of monetary policy and the inflational trend of the economy due to the fall in the value of the naira which affects the ease of securing funds under lease arrangement.

2. The lack of awareness among potential investors (industiralist) on the whole concept of leasing and the benefits derive there of.

3. The constant review of credit policy guidelines by the Central Bank of Nigeria serves as a serious draw-back to lease transaction.

4. Severe liquidity constraints and scarcity of foreign exchange affects the ability of Merchant Banks to honour the growing number of applicants.

5. The sectional discrimination of leases affects the distribution of equipments on lease to different sectors of the economy and further creates pending applicants.

These and other related problems are what this study aim to analyse.

## 1.3 OBJECTIVE OF THE STUDY

The study will throw more light and examine the magnitude to which Merchant Banks, particularly International Merchant Bank Plc are engaged in equipment lease financing in Nigeria.

Therefore, the specific objective of this study are:-

1. To create awareness among potential investors (lessees) and lessors on the whole concept of leasing and the benefits derivable thereof.

2. To evaluate leasing as a non-conventional means of asset acquisition, bearing in mind lessee - lessor relationship in terms of the attractivess of the transaction.

3. To examine the conduct of International Merchant Bank Plc in relation to equipment lease financing.

4. To identify the constraints faced by Merchant Banks in equipment lease financing and the possible solutions.

5. To examine leasing as a sophisticated financing tool and alternative to buying.

## 1.4 SCOPE AND SIGNIFICANCE OF THE STUDY

This study covers the concept of leasing which reveals different forms of lease financing between lessor and lessee. The study will also consider the following types of lease arrangement:

1. Finance lease or full pay out lease.
2. Operating lease
3. Consortium lease
4. Leveraged lease
5. Sales-Aid leasing

However, the scope of the study is specifically on the unique function of equipment lease financing by Merchant Banks in general and International Merchant Bank in particular as a case study.

One of the principal functions of a financial manager include among others realising sources of capital asset acquisition and the possible alternatives open to the business. Leasing being one of the options of assets acquisition through contractual agreement between lessors and lessees has a significant role to play. It is therefore hoped that the study will assist in improving the understanding of contractual relationship within the legal and financial capacity of lessors and lessees.

In addition, the concept of equipment lease financing is new in Nigeria, fundamentally therefore, this study will improve the awareness of both lessors and lessees on lease financing. The study will also expose the risk minimization tendency to both lessors and lessees, which fundamentally dictate the manner of lease arrangement right from its inception.

Finally, the study definitely is important to the Bankers, Business organization and to individual investors who may be interested in acquiring assets through lease arrangement at the advantage of their respective businesses or to act as lessors in the case of Bankers.

## 1.5 PROBLEMS AND LIMITATIONS OF THE STUDY

No research work of this nature can be successfully completed without some limitations. The major limitation of the study was the cost invloved and time constraints, as most of the data used were obtained in Lagos. This is because the Equipment Leasing Association of Nigeria do not have a branch in Kaduna. Also most of the required data on leasing from International Merchanct bank (NIg.) Plc have to be obtained from Lagos, the Head Office.

Human error and sentiments were other considered limitations of this study; because information obtained and series of discussions I had with people are sources of data used, as such there is possiblity of human error of commission or omission.

Despite all these constraints, quite a lot has been done on the study, which will clearly improve our understanding on the role of Merchant Banks in relation to lease-financing. It is also hoped that the study will further serve as a basis for subsequent work on the topic or other related areas.

## 1.6 HYPOTHESIS

The hypothesis questions to be asked and tested are:

1. That Merchant Banks assumes a pivotal function all aimed at among others, achieving economic stabilization.

2. That equipment lease financing provides one of the cheapest means of acquiring capital assets for industries.

3. That Merchant Banks are dorminant lessors.

4. International Merchant Bank Plc (IMB) is one of leading merchant Banks in equipment lease financing in NIgeria.

5. That equipment lease financing is necessary for the accelerated industrial development of Nigeria.

6. That most potential lessees are not aware of the benefits derived from equipment lease financing.

7. That government policies and regulations encourage equipment lease financing as a means of capital asset acquisition.

## 1.7 OPERATIONAL DEFINITIONS

Merchant Banks: A Merchant Bank is a wholesale bank licensed under the Banking Act, 1969 (Amended 1989) that engage in medium and long term activites such as acceptances, loans and advances, deposits, equipment leasing, foreign exchange services, project financing, issuing house services, investment and financial advisory services and so on.

Lease: This is a means by which a firm can acquire the economic use of an asset for a stated period of time.

Lessee: A person or firm to whom assets is leased.

Lessor: A person or firm that leases the asset i.e. he is the owner of the asset on lease.

Rentals: This is a periodic payment by which a lessee obtains possession of the leased asset.

Advance Payments: One or more of the lease payments that are required to be paid to the lessor at the beginning of the lease term.

At Risk: Being exposed to potential loss.

Collateral: Collateral under a lease is the equipment which is leased.

Broker: A company or person who arranges lease transaction between lessees and lessors

Conditional Sale: A transaction for purchase of an asset in which the user, for Federal income tax purposes is treated as the owner of the equipment at the outset of the transaction.

Finance Lease: A financing device whereby a user can acquire use of an asset for most of its useful life. Generally, a finance lease is non-concelliable during the term of the lease; rentals are net to the lessor; and the user is responsible for the maintenance, taxes and insurance.

Inception: The beginning of the lease term.

Operating Lease: A contract under which the asset is not wholly amortized during the non-concellable period of the lease i.e. the asset is leased to the lessee at a rate which does not cover cost and profit to the lessor.

Consortium Lease: For assets requiring very high capital outlay or where a lessor wishes to share the risk with others, two or more parties may come together to jointly lease an asset on a joint venture.

Cross-border Leasing: This is a type of leasing arrangement where the lessor and the lessee are in different geopolitical entities.

Leveraged Leasing: A situation whereby a third party finances, usually, most of the cost of asset purchased by the lessor, with the lessor providing only a minimal portion of the cost. The lessor's return is leveraged by the funds provided.

Residual Value: The value, either actual or expected, of leased equipment at the end, or termination of the lease.

Refundable Security Deposit: An amount paid by the lessee to the lessor as security for fulfillment of all obligations outlined in the lease agreement, which is subsequently returned to the lessee once all obligations have been satisfied. Security deposits are typically refunded at the end of the lease term.

Payment In Advance: A payment streem in which each lease payment is due at the beginning of each period during the lease.

Present Value: The discounted value of a payment or stream of payments to be received in the future, taking into consideration a specific interest or discount rate. Represents a series of future cashflows expressed in today's Naira.

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

Maturity: The end of the lease term, assuming that all of the obligations contained in the lease agreement have been made.

Wet Lease: This is a lease arrangement in which the leased asset or equipment come with the personnel or crew to operate the equipment e.g. leasing of Aircrafts.

Pay-off: When the lessee purchases the leased asset from the lessor prior to the end of the leased term.

Sale and Leased Back: A transaction in which an investor purchases assets from the owner and then leased such assets back to the same person. The lessee gets the sale price (and can return it to his capital) and continue to enjoy the use of the assets.

Special Purpose Equipment: Equipment which is unique and has no value except as junk to anyone other than the original user.

Useful Life: The period of time during which an asset will have economic value and be useable. Sometimes called the economic life of the asset.

## 1.8 PLAN OF THE STUDY

The project is organised in five chapters. The first chapter is the introductory part, while chapter two reviews literature on equipment lease financing with particular attention on the whole concept of leasing, how it is generally practised by Merchant Banks in Nigeria, the advantages leasing offers as compared to other forms of financing and the legal/regulatory environment of lease financing business in Nigeria.

Chapter three presents the background of the study, the various methods of data collection used for the study and the methods of data analysis. The background of the study considered are historical perspective of Merchant Banks and equipment lease financing, Merchant Banks performance in equipment lease financing and the Equipment Leasing Association of Nigeria (ELAN). The fourth chapter is the presentation and analysis of data collected during the course of the research, leasing as practised and carried out by International Merchant Bank Plc (IMB) will be intensively discuss.

Finally, chapter five which is the concluding chapter makes a summary of the various chapters outlined above. It also comes out with conclusion and, recommendation on how equipment lease financing can be effectively carried out by Merchant Banks in Nigeria.

# CHAPTER TWO

# LITERATURE REVIEW

## 2.1 THE CONCEPT OF EQUIPMENT LEASE FINANCING

Baker and Hayes (1946) defined equipment leasing as follows: "A lease by definition is a contract between a lessor and a lessee, giving the lessee possession and right to the use of a specific capital asset owned by the lessor for an agreed rental payment over an agreed period of time".

However, the lessee incures several obligations for the usage of the leased asset. These obligations include periodic lease payments, usually monthly or quaterly. The lease contract also specifies who is to maintain the asset. The lessor pays for the maintenance, repairs, taxes, and insurance under the maintenance lease, whereas the lessee pays these cost under a net lease.

The United Kingdom Equipment Leasing Association defined equipment leasing as "a contract between a lessor and lessee for the hire of a specific asset selected from a manufacturer or vendor of such assets by the lessee. The leasor retains ownership of the asset. The lessee has possession and use of asset on payment of specified rentals over a period".

From the above definition therefore, it is clear that the lessor retains ownership of the specific asset which is the subject matter of the lease, whereas the lessee holds possession and use of the assets during the contracted period of the lease. Thus, it is this separation of ownership and

use that is the central focus of the concept of equipment leasing as distinguished from all other payment by instalment forms of transaction. Also over the specified period of time of a lease contract, the lessee is obliged to pay specific rentals for the possession and use of the equipments, non-payment of which may jeopardise his right to the possession and use of the equipments.

The lease contract also typically specifies some kind of option to the lease at expiration. The option might be to renew the lease for another lease period, or to purchase the asset on expiration of the lease usually by surrendering the security deposit.

TERMS AND CONDITIONS OF A LEASE CONTRACT

A lease will normally be tailor-made to suit the requirements of both the lessee and lessor in respect of the particular asset being leased.

The following are characteristics commonly found in a lease agreement: Richard Brealey (1988).

(A) Rentals payable for the use of leased assets are paid in equal amounts and at equal intervals usually in advance. However, flexibility can be provided allowing variations in amounts paid or the timing of rentals to meet the special requirements of the lessee. Somethimes certain advance payments are required at the start of the lease.

(B) Since the asset is chosen by the lesse, the lessor does not, in the agreement, take any responsibility for its suitability or condition.

(C) It is a condition of most leases that the lessee is responsible for arranging insurance. This will usually cover not only fire, theft and damage to the asset itself, but also injury to third parties and other risks. The lessee would normally be responsible for delivery, installation, maintenance and repairs.

(D) At the termination of a lease, the lessee often has the option of either selling the equipment as Agent of the lessor, entering into an agreement for an additional lease period at even lower rates or purchasing the equipment by surrendering the security deposit.

(E) There is usually a sale agreement between the lessor and the vendor of the equipment to be leased to the lessee. This agreement usually warrants that the equipment is free from defects and that the seller will have facilities to repair the equipment from time to time. There is also usually a provision for the seller to repurchase the asset in the event that the lease agreement is determined as a result of default by the lessee.

TYPES OF EQUIPMENTS ON LEASE

The equipment leasing association of Nigeria (ELAN) annual report of 1992 volume ii has identified as follows: Lease financing can be provided for a wide variety of equipments such as:

i. Computers and peripherals
ii. Fleet of Vehicles, Aircraft, Boats, Ships and Trawlers
iii. Medical and laboratory equipment
iv. Telecommunication equipment
v. Water drilling rigs
vi. Capital equipment for industries
vii. Agricultural equipment and machinery
viii. Quarrying and mining equipment
ix. Survering and precision equipment, generators
x. Printing equipment

THE LEASE PROCESS

The lease process is similar from company to company, yet due to a company's organisational structure, mode of operation and market niche, situations may exist within an organisation that will alter or eliminate the need for some of the steps being presented. Chief Oladele Olashore - Chairman Lead Merchant Bank Nigeria Limited has identified the following steps:

THE LESSEE

The leasing process begins with the lessee, who is interested in acquiring a piece of equipment. At this poiht the lessee will have gone through a two-part process. The first is a capital budgeting analysis to see if the benefits are sufficient enough to justify the costs of the acquisition.

After deciding whether or not to acquire the new equipment, the lessee must then decide on a means of financing the acquisition. Otherwise known as the lease versus buy decision. However, the sophistication and degree to which these steps are carried out will depend on the size of the lessee and/or transaction. For instance, a small business would most likely not perform a formal capital budgeting analysis, whereas a large firm would be more likely to do so.

Once the lessee has decided to lease, it may solicit lease proposals from various lessors. Often times a request for proposals is sent out to lessors outlining the general needs of the lessee, such as equipment specifications, term, end of lease options and so forth.

THE LESSOR

The lessors or leasing companies may generate new lease business in one of two general ways. One is where the lessor has its own lease origination capabilities (i.e "sales force") and two is where the lessor acquires a lease from a lease origination. The second is referred to as a lease acquisition. Some companies however, may do both. Here, we will assume that the leasing company originates its own transaction.

Once a lessor locates a potential lessee the lessor's marketing representative will gather the relevant information from the lessee. The marketing representative will structure and price the lease. A residual specialist, in turn, should be active in assisting the pricing department in determining the residual value to use in marketing. The marketing representative then prepares a commitment letter or proposal, as to rate and term, subject to credit approval by the lessor.

At this point, the next few steps shift to the lessee. The lessee will compare the proposals that it has received, as well as considering both quantitative and qualitative criteria such as lessor experience and financial strength. Then the lessee selects a lessor. (Some lessees may forego the bid process and do business with only one, or a limited number of lessors).

Typically, the lessor will not begin the credit approval process until the lessee has accepted the general terms of the lessor's proposal. However, in some cases, a lessee's credit may be pre-approved, due to the size, stability and lessor knowledge of the lessee or because a master lease agreement with the lessor is already in place. During the credit process the lessor will require the lessee to submit appropriate financial data.

Once the lessee's credit has been approved the lease is ready for documentation. Although varying somewhat between lease companies, the documents required to evidence the lease transaction will generally include the lease agreement, an assignment to the lessor of the lessee's original purchase order.

If a commitment letter has not yet been signed many lessors will have their marketing representative prepare one while the final documents are being put together. Once the final documents are prepared, and signed by both parties, the lessor then procures the equipment, generally using borrowed funds to pay the manufacturer. As soon as the equipment is delivered and found in acceptable condition, the lessee signs the Certificate of Delivery and Acceptance.

The lessor's operations or lease Administration group will then make certain that the lease is accounted for properly, that accurate billings are sent to the lessee, lease payments are received, insurance is maintained and taxes paid. Occasionally, the collections functions will be neccessary to follow-up on a slow or non-paying lessee.

During the lease term the lessee's responsibilities will include the timley remittance of payment, although the lessee may also be required to maintain the equipment, pay licences or taxes and provide insurance for the equipment.

At the end of the lease terms, assuming a purchase option exists in the lease agreement, the purchase option amount must be determined. The purchase option amount is normally communicated to the lessee well in advance of the lease termination, so that a timely transfer of ownership can occur.

If the lessee decided not to purchase or renew the lease the lessee must communicate its intent to the lessor within a specified period of time. Some lease agreements state that the lease will be automatically extended at the original lease rate if the lessee fails to communicate its intent to the lesssor within the prescribed time frame. The marketing group then remarkets the equipment. These eforts include selling the equipment or leasing to a new lessee. Once the lease term has ended and the equipment is disposed off, the lease process is complete.

As was described earlier, the lease process may vary based on lessor, product, ticket size, etc. In a money-over-money lease. For instance, the process is much the same, however, certain steps may not be necessary. Since residual pricing and disposal of the equipment will not be an issue (because the equipment is usually owned by the lessee at the end of the lease), the remarketing group may not be included.

LEASE PROCESS FOR A LEASE BROKER

The broker, by definition, will not become the ultimate lessor in the lease. Instead, a broker acquires a lease transaction from a lease originator and then eventually sells it to a third party, known as an equity investor, in return for a fee. The broker can either acquire the lease or be the lease originator - Oladele Olashore (1989).

When acquiring a transaction the broker may get involved in the lease at any point during the lease process. Throughout the process the broker will be actively working to secure the debt funding for the transaction.

ELEMENTS OF A LEASE

The elements of the lease agreement are linked to three distinct phases of the lease. As mentioned earlier, the exact elements contain in any lease agreement will differ from lease to lease. A guid to lease financing by Hayes, R.S has identified the following phases:-

PHASE I - INCEPTION OF THE LEASE

The lessor pays for the equipment and any additional transaction costs, while collecting from the lessee any required advance payments, upfront fees, or security deposits.

PHASE II - DURATION OF THE LEASE

During this phase the lessor receives payments from the lessee.

PHASE III - LEASE TERMINATION

Residual value, which is what the lessor expects to receive from the disposal of the equipment at the end of the lease term, either through sale or a new lease, is the key consideration in this phase.

In addition, the value from tax benefits, maintenance contracts or insurance premiums should also be considered throughout the lease.

Two key elements of a lease that deserve further discussion are payments and residual. Because of the various payment arrangements available, leasing is a very flexible financing tool that can meet the needs of every lessee. Although monthly payments are most common it is not unusual to set up quarterly, semi-annual or annual payments.

These payments can either be in advance or in arrears. The term payments in advance refer to a payment stream in which the lease payment is due at the beginning of each period during the lease. Payments in arrears refer to a stream in which each lease payment is due at the end of each period during the lease. To satisfy a lessee's cash flow constraints, leases may be written which call for equal or level payments each period, or for payments that vary in amount over time, such as step-up, step-down and skipped-payment leases.

Step-up leases consist of increasing lease payments during the lease term while a step-down lease consists of decreasing or declining lease payments over the term of the lease.

A skipped-payment lease, on the other hand, is one in which payments are required only during those business periods when the lessee's cash flow can handle the lease payments.

Residual value and lease payments both represent inflow to the lessor, therefore, the higher the assumed residual value, the less the lessor needs to charge in the form of lease payments.

With regard to the residual and the end of the lease term, the lessee typically has three options (1) the option to purchase the equipment (2) the option to renew the lease or (3) the option to return the equipment to the lessor.

Purchase option can be either at the equipment's fair market value or at a bargain price. Also, the residual value in a lease can be either guaranteed or unguaranteed. When residual value are unguaranteed, the lessor takes on the risk that the equipment may or may not be worth its expected value at the end of the lease term. A lessor can reduce this exposure by insuring or obtaining a guarantee of the residual value. However, most purchase options is by surrendering the secuirty deposit to the lessor.

Lease renewal options generally state the additional time period beyond the expiration of the initial lease term, and the renewal payment amounts. The lessee is usually the one to decide whether or not to exercise the purchase or renewal options.

However, the lessee can always return the equipment if a purchase or renewal option is not exercised. If the lease was written as a close-end lease, the lessee must return the equipment to the lessor unless a subsequent agreement for renewal or purchase is reached.

There will also be situations when a lease does not reach maturity or when a change to the original lease agreement takes place due to the lessee's decision to either pay the lease off, terminate the lease or upgrade the equipment.

When a lessee purchases the equipment before the end of the lease term it is known as a payoff. When the lessee returns the leased equipment prior to the end of the lease term it is referred to as an early termination. If the lessee wants to either increase the capacity or improve the efficiency of leased equipment, the lease would opt for an equipment upgrade.

## WHAT MAKES A LEASE A LEASE

It is important to recognise that while two parties may have labeled an agreement a lease, it may or may not be a lease from a tax or a financial reporting view point.

According to Modigliani and Miller (1963):- The issue of "at risk" is a major criterion used for determining whether a lease is a tax lease or a non-tax lease. If the lease is a tax lease (i.e. the lessor is at risk), the lessor will receive the tax benefits of ownership and the lessee would be entitled to deduct the lease payments. If the lessor is to be considered at risk, a tax lease should not contain a bargain purchase option or specify a lessee guaranteed residual value, among other complexities. Either of these two events remove all the residual risk from the lessor.

In those cases where the lease conditions fail to meet the criteria for a tax lease, the transaction is determined not to be a tax lease and is referred to as a money-over-money lease. The transaction is nothing more than a conditional sales contract in the guise of a lease; where the lessee is bearing the risks of ownership and will be entitled to the tax benefits, such as depreciation.

The financial reporting criteria as to how a lease agreement is classified are determined by the NIgerian Accounting Standards Board (NASB). The NASB classification of a lease hinges upon whether the contract points a purchase of equipment, or to usage only. If, according to the NASB creteria, of which there are four basic tests, the intent of the parties is to characterise a purchase of equipment in the guise of a lease, it is called a capital or finance lease. If the intent of the agreement is for usage only it is called an operating lease.

Risk and intent are major factors in determining if a lease is a lease for tax and financial reporting purposes.

TYPES OF LEASING ORGANIZATIONS

Independent, or third-party leasing companies represent a very large part of leasing industry. These companies are independent of any one manufacturer. They generally purchase equipment from various manufacturers and then lease the equipment to the end-user or lessee, although some may deal exclusively with the product of one manufacturer.

Financial institutions included in leasing, such as banks, and finance companies are also considered independent lessors. Many of these financial institution lessors not only provide lease financing to lessees, but funding to other leasing companies as well.

According to J Van Horne (1963) :-" A captive, or two party lessor, is created when a manufacturer decides to set up its own leasing company to finance its products. The manufacturer realizes that by providing lease financing it can increase the sales of its products over the level of sales utilizing traditional financing".

Another key player in the leasing industry is the lease broker. The lease broker, or packager, may fund the interested lessee, arrange for the equipment with the manufacturer, secure financing for the lessor to use in purchasing the leased equipment, locate the ultimate lessor in the lease transaction, or provide a combination of these services. The lease broker typically does not retain the lease transaction for its own account.

## 2.2 TYPES OF LEASE FINANCING

Equipment lease financing fall into two general categories: finance lease and operating lease. Statement of accounting standard on leases march 1992

FINANCE LEASE

The finance (or capital or full pay-out, as it is sometimes called) lease is one in which the lessor recovers through the lease payments, all cost incurred in the lease plus an acceptable rate of return without any reliance upon a future residual value. From these perspective a finance lease is an agreement which has characteristics of a purchase agreement. A finance lease is a lease that conveys the following:

(i) actual ownership;

(ii) potential ownership through a bargain purchase option;

(iii) or effective ownership through any means, such as an unduly long lease term in which asset exhaustion occurs in the hand of the user.

From the above definition, a finance lease anables the lessee make a series of fixed financial obligations (rentals) as consideration for his use of the equipment spread over a period of time equal in proportion to the economic life of the equipment. Also, lease contract is non-cancelable during the obligatory period, i.e. the lessee is irrevocably obligated to make lease payments until the expiration of the lease.

OPERATING LEASE

Operating leases are those which have the characteristics of a pure usage agreement. The obligation to pay under an operating lease does not appear on the lessee's balance sheet, hence, the term off balance sheet financing. In other words it is a contract under which the asset is not usually amortized during the non-cancellable period of the lease.

The lessor purchases the equipment and leases it out to the lessee but at a rate which does not cover cost and profit to the lessor. This should be of particular interest to those who require equipment to carry out specific contracts.

An operating lease contract is not subject to the non-cancelability condition and it is cancellable with due notice. Also, operating lease is a relatively short-term in length (usually shorter than the economic life of the asset) and without the lessee having to pay for the entire capital cost of the assets.

TAX AND NON-TAX LEASES

In order for the lessor to claim the tax benefits of ownership, which is what occurs in a tax lease, the lessor has to take on the risks of owing the equipment as well. For example, if the lessee is permitted to purchase the equipment for one Naira, or automatically becomes the owner of the equipment at the end of the term, the lease would most likely not to be a tax lease because the lessor does not have any residual risk.

The lease rentals charged in a tax lease are impacted by the tax benefits claimed by the lessor. Because of the tax benefits, the lease payments can be lower than on a corresponding loan. This is not always so, however, in a small ticket market, for example, tax benefits may be used to increase the lessor's yield, rather than to reduce payments.

If a lease fails to meet the criteria of a tax lease, then it will be considered a nontax lease or a conditional sales contract. In a non-tax lease, the lessee is, or will become, the owner of the equipment and is therefore at risk and entitled to all the benefits associated with owning the equipment. Non-tax leases, which are conditional sales contracts in the guise of lease, are often referred to as money-over-money leases.

In a money-over-money lease the lessor seeks after a "spread", or the difference between the interest rate at which the lessor borrows, and the rate of return in the lease. For example, if the lessor borrows funds at 18%, and has a rate of return in the lease of 21%, the spread would be 3%. Lesses may prefer money-over-money leases instead of conditional sales contracts because the lease nature of the transaction allows them to avoid the rigors of the capital budgeting process.

## OTHER FORMS OF LEASES

### LEVERAGED LEASE

In a leveraged lease, the lessor borrows a significant amount of non-recourse money by assigning, or discounting the lease payment stream to the lender in return for upfront cash. This cash amount represents the amount of the loan and is equal to the present value of the future lease payments.

Non-recourse means that the lender is looking to the credit worthiness of the lessee and the value of the equipment for payment, not to the lessor. In fact, the lessee will generally make lease payments directly to the lender in a leveraged lease. The assignment or discounting of lease payments represents a funding technique used by a large segment of the leasing industry. The lessor will have to put equity (cash and/or recourse borrowings) into the transaction in the amount of the difference between the cost of the equipment and the debt. In an assignment, the debt is equal to the present value of the assigned lease payments.

In a single-investor lease the cash paid represents a lessor's equity as well as pooled funds which have been borrowed from a variety of sources, normally on a recourse basis. Recourse means that the lessor is fully at risk for any borrowed funds.

BUNDLED LEASE

A bundled, or full-service lease is one that includes many additional services such as maintenance, insurance, and taxes. These are paid for by the lessor and the cost of them is build into the lease payments. If, however, the lessee must seprately seek out and pay for maintenance, insurance, and taxes, then the lease is said to be net of these services, hence a net lease.

MASTER LEASE

A master lease is a lease line of credit which allows a lessee to add equipment under the same basic lease terms and conditions as originally agreed to, without having to renegotiate a new lease contract. This agreement is for a stated period of time, typically one year, and reflects a maximum amount that can be used during this time frame. The lease rate in a master lease may either be fixed at the time of the agreement or it may be determined when the equipment is delivered, in order to reflect current market conditions. The characteristics of master leases will be different in each situation.

DIRECT LEASE

This represents a straight forward lease contract between a lessor and a lessee where the equipment tenor and rent are covered under a lease agreement for the obligatory period of the lease. It is an agreement by which the lessee acquire the use of asset usually directly from the manufacturer. IBM for example leases computers, and xerox leases copiers to their clients.

CONSORTIUM LEASE

Syndicated or consortium leasing is where a group of firms arrange the deal (just like in a loan syndication), may be because the item involved is very expensive and requiring a huge financial outlay. A member of the leasing consortium or an outside party would hold the agency to be formed by the interlessors agreement and executes the joint lease agreement on behalf of the joint lessors.

CROSS-BORDER LEASE

This is another type of lease arrangement where the lessor and the lessee are in different geopolitical entities. Although there are no restrictions precluding the NIgerian lessors from claiming capital allowances on a cross-border transaction, but such transactions are subject to Exchange control approvals.

SALE AND LEASE-BACK

A sale and lease-back is an arrangement whereby a firm sells an item it owns, needs, and then lease it back. It is a form of transaction that converts fixed assets owned by a company into cash. It pays the rentals from business proceeds while using the money relaized from the sale for other purposes. This however enables the lessor (instead of the lessee) realize any residual value the asset might have at the end of the lease period.

As liquidity is very important for most companies, sale-lease-back can help firms enhance their liquidity through:

(i) providing an immediate source of cash;

(ii) consolidating old loans with an extended repayment term which may also be impacted by residual value; and

(iii) flexible lease structuring option which allow a lessee to better manage its cash position.

## 2.3 CAPITAL ASSET ACQUISITION AND LEASE FINANCING DECISION

IMB's Bronchure on equipment lease financing (1989) mentioned that:

The decision to acquire a capital asset commences with a felt need for the use of an asset which may be neccessitated by the need to:-

i. Increased installed capacity
ii. Add on new production lines
iii. Upgrade on existing lines etc.

The financing method available to the company are on or off-balance sheet such as:-

i. Cash purchase
ii. Term loan financing
iii. Operating lease
iv. Financial lease.

The financing method decision normally take the following factors into consideration:

i. Cost minimisation
ii. Cashflow convinience
iii. Legal and other constraints.

Decision to acquire or not to acquire an asset is considered under capital budgeting. Under a cost/benefit analysis, to acquire an asset, the benefits from investing in the asset must exceed the cost. Cost will normally include:-

i. Initial cash outlay to acquire the asset.

ii. Other costs i.e. labour, materials, disposal costs, tax liabilities and variable overheads.

While benefits will include:-

i. Increase in revenue

ii. Cost minimisation

iii. Tax savings - Investment allowances and capital allowances

WHY LEASING

Within the past decade leasing has mushroomed into a multimillion naira Industry. There are five major reasons, or categories of reasons, why lessees lease equipment. The five reasons are:-

i. Economic or financial

ii. Financial reporting

iii. Income taxes

iv. Technological

v. Flexibility.

ECONOMIC OR FINANCIAL

The economic attributes of a lease are considerable. The monthly rentals in the lease can be quite low when compared to the loan payments levied by a bank, due primarily to the impact of the residual value in a lease.

The tax benefits generated in the transaction will influence the lease payments as well. The lessor can lower the lease payments when receiving value from tax benefits, although, as was mentioned earlier, the lessor may use tax benefits to increase its yield.

Longer lease terms also help to lower the lessee's lease payments. The repayment of the equipment cost is spread out over more periods so less payment needs to be charged each period to recover the entire cost.

Leasing also requires little, if any, upfront cash outlays. Most leases require just one payment upfront versus the normal down payment requirements on an instalment loan. The combination of upfront and lower subsequent payments helps to preserve working capital.

Additionally, leasing provides firms with another source of financing, thus allowing them to diversify their funding sources.

FINANCIAL REPORTING

Entities are constantly striving to have their financial statements look as strong and healthy as possible to their shareholders and lenders. When a company purchases equipment and finances it with a loan, an asset, as well as the corresponding liability appears on the balance sheet. If, however, the company chooses leasing, and that lease is classified as an operating lease, then no asset or liability would appear. Hence, the term operating lease has become synonymous with off-balance sheet financing.

Off-balance sheet financing is sought after for a variety of reasons: to keep debt off the balance sheet, to improve the financial ratios of a company, and to potentially enhance the company's ability to borrow in the future. It is also conceivable that in the early years of the lease the operating lease will improve the company's reported earnings when compared to a finance lease or purchase.

INCOME TAXES

The value of tax benefits to the lessor can influence the lease payment charged to the lessee. A built-in reciprocity exists in tax leasing, in that the lessor - owner in a tax lease receives the tax benefits given up by the lessee user and, in turn, may pass those benefits on to the lessee in the form of a lower lease payment. The lessee also receives a tax benefit since the lease payments are fully deductable.

TECHNOLOGICAL

In today's rapidly changing environment there is always the risk that high technology equipment, such as computers, will become obsolete. Indeed, the risk of technological obsolense is one of the primary reasons for leasing. Leasing can help lessees transfer the risk of owing equipment which is no longer technologically useful.

This transfer of risk can be accomplished in several ways. The most obvious would be for a lessee to enter into a short term lease agreement, thereby requiring the lessor to assume the technological risk through residual value. If the equipment is still useful at the end of the lease term, the lessee could then renew the lease. If the equipment becomes obsolete during the lease term, the lessor may replace it with newer technology through what is known as a takeout, or an equipment upgrade.

In a takeout, the lessor, through its access to the secondary market, will find a new home for the original equipment because equipment that is obsolete to one entity is not necessarily obsolete to another. For new and untried technology many lessees prefer leasing the equipment on a short term or experimental use basis.

FLEXIBILITY

A company may simply need the use, not the ownership, of a piece of equipment. Leasing can help a company avoid many of the headaches associated with equipment ownership. For instance, leasing can transfer the burden of disposing of the equipment to the lessor, who typically has better access to the used equipment market.

The lessee can also contract with the lessor to take care of other aspects of ownership such as insurance, maintenance and property tax by bundling these costs into the lease payment. many lessees appreciate this one-stop shopping aspect of leasing.

LEASING VERSUS TRADITIONAL FINANCING

Over the years, both debt and equity financing have been broadly used by companies seeking new capital goods/equipment. Both of these methods derserve serious consideration when an equipment need arises. Here, are some of the advantages leasing offered many progressive companies as compared to both debt and equity financing:-

1. Leasing usually gives a cheaper rate. This is particularly true in the case of a company that cannot take advantage of such tax benefits as capital allowances and investment allowances. Lessor can purchase the equipment, claim the tax benefits, and pass the savings along to the lessee via low lease rates.

2. Leasing is a new source of funds. It spares the use of other credit sources, both public and private placement. It conserves existing lines of credit for other purposes and allows full use of borrowing capacity.

3. Public disclosure of financial information is not required when you make a lease arrangement. It would be required in a prospectus for a public offering of debt or equity. Leasing therefore is sometimes described as off-balance sheet financing.

4. Leasing avoids the dilution of ownership that is inevitable with the sale of securities to raise capital.

5. Most leases provide 100% financing. Sometimes not even a deposit or down payment dips into capital.

6. Lease payments can be flexible. They can be structured to coincide with earnings generated from the equipment used, or they can follow the pattern of a seasonal business.

7. Leasing can allow longer terms than other finacing methods. Amortization of equipment cost can be spread over a longer period.

8. Depending on a loan agreement, leasing may sometimes be excluded from debt in computing ratios and limitations under existing borrowing agreements.

LEASING VS CASH PURCHASING

The situation in every company is different, so it is impossible to make hard and fast rules about when to lease and when to do cash purchase. Below are some of the advantages offered by leasing as compared to cash purchasing:

1. Leasing conserves capital.

2. In the case of an unplanned or unexpected equipment need, leasing offers an attractive alternative especially to the company that tries to "budget" capital goods expenditures.

3. Lease payments can provide a cashflow superior to that of a purchaser over the early years of the equipment's life.

4. Leasing offers exclusive tax advantages. rentals may be fully deductable operating expenses. Thus, a N500 a month rental, for a company in a 45% tax bracket, would mean a net cash outlay of N275 a month. Rental deduction may be superiror to or timed better than depreciation deductions when the lease is shorter than the depreciable life of the equipment.

5. Leasing is an effective hedge against inflation. If inflation continues, this means you will be paying less for equipment today and will be making lease payments with tomorrow's inflated naira, the net is a positive effect on cash flow.

6. Leasing can help a company find a prudent way around budget limitations. And because rentals payments are operating expenses, they may have no effect at all on capital expenditure budgets.

7. Leasing is a helpful tool in a back-to-back financing. Costs are easy to forecast and account for. The user knows how long he will have the equipment and exactly what he will pay for it. This can be measured very closely against the revenue expected from the equipment.

8. Heavy depreciation deductions and interest expense for purchased equipment can impair a company's book income or reported earnings. During the early years, a lease permits a regular rental expense. This results in a minimum impairment of book income.

Finally, it must be noted that, leasing does not necessarily work for every company. Leasing is not good medicine for a a sick company. The whole idea of leasing is to enable an efficient company to effectively use conserved capital. It would be coined that: it is an attempt to build the best out of a good environment, it is not meant to make a good out of a bad scene.

Therefore, the questions a smart financial executive should ask himself are:

i. Will I be able to efffectively and efficiently utilized saved capital? If you cannot convience yourself of the ability to use the capital saved

to work for greater profit and make more money, leasing is not for you.

ii. Will the level of inflation be higher next year and in the near future? If you believe prices are going to come tumbling down, you might just as well pay for capital equipment now. But know that continued inflation makes it a good idea to defer as much payments as possible and pay later with cheaper Naira.

## 2.4 ACCOUNTING FOR LEASES AND COMPUTATION OF LEASE RENTALS

The accounting treatment of leases, reflect the commerical substance of the lease i.e. whether it is an operating lease or a finance lease. Once we are able to understand and appreciate the distinction, it will become easier to understand the accounting entries. It is therefore of utmost important at this juncture that we again define the two main trypes of leases. The statement of accounting standard on leases as issued by the Nigerian accounting standard board has categorised leases into two broad categories:

a) Operating lease

b) Finance or Capital lease

### a. OPERATING LEASE

This is the one in which the lessor retains all the risks, obiligations and rewards of ownership. In this instance, the lessor is primarily concerned in operating an asset in order to make profit from it.

He is usually responsible for the maintenance and insurance of the leased assets while the lease term covers only a part of the anticipated useful life of the asset so that the lessor does not amortise the asset fully in his books during the lease term. In essence, operating leases are often relatively short term agreements with the same asset being leased in succession to different lesses.

B. FINANCE OR CAPITAL LEASE

This is a direct opposite of the technical operating lease i.e. the risk, such as idle capacity, technical obsolese and the rewards of ownership (i.e. use of asset, gain in realisable value) are transferred to the lessee. Usually the agreement is non-cancellable without a major penanlty being paid by the lessee and the lessee also has the option to buy the asset for a nominal amount upon the expiration of the lease term.

In broad terms, the accounting treatment in respect of leases should be considered in terms of:-

a) Accounting by the lessors

b) Accounting by the lessees.

However, for our purpose, we shall dwell mainly on the accounting treatment in the books of the lessors, to enable us appreciate the entries that will be made in the books of the Banks/Financial institutions providing the lease.

A. ACCOUNTING FOR OPERATING LEASE

TREATMENT IN LESSOR'S BOOKS

ACCOUNTING POLICY: Assets leased under operating lease should be treated as fixed assets and depreciated over their estimated useful lives based on the depreciation policy for that class of asset. The annual depreciation charge should be taken to the profit and loss account. The Rental income from leases, exclusive of charges for such services as insurance and maintenance should be recognised on straight line basis over the period of the lease.

LEASE ACCOUNTING RECORDS AND PURPOSE SERVED. (OPERATING LEASE)

1. LEASE (FIXED) ASSETS ACCOUNTS

This is debited with the cost (i.e full cash value) of the leased asset acquired. The contra entry is of course a credit to the vendor (seller's) Account. Where there are several classes of lease assets, the global (total) cost of the assets will be reflected in the leasing (fixed) Asset Account in the general ledger. However, each of these assets/class of assets must have a subsidiary ledger maintained for each customer and schedule of lease assets, so that the total for all the subsidiary ledger/schedule must agree with the bulk sum in the general ledger.

2. DEPRECIATION ACCOUNT - LEASING ASSETS

These are of two classes viz;

(a) DEPRECIATION (LEASING ASSETS) ACCOUNT

This is an expense account which is a charge (debit) to the profit and loss account, reflecting the depreciation chrage for all classes of leasing asset for the control period.

(b) CUMULATIVE DEPRECIATION (LEASING ASSET)

This is a provision (balance sheet) account and is the contra to the depreciation expense account in the profit and loss account. The account must always be in credit and the balance on the account must be supported by a schedule which will show the cumulative depreciation for each asset/class of assets.

3. LEASE REPAYMENT SCHEDULE

For every lease that is booked, the total rentals payment due is analysed as to the total instalments due, the due dates, security deposit due, (where applicable, and strictly in finance leases) the with-holding tax component of the payment schedule. The schedule is of critical importance as it provides a basis for generating entries on the dates when the rentals income are due.

Once there is a change in interest rate, a new payment schedule will be prepared to reflect the total rentals due, due dates etc as per the new calculation for the remaining period of the lease. The schedule is also used to advise clients in advance of the due period.

4. LEASE INCOME RECEIVABLE ACCOUNT: LEASE INCOME ACCOUNT ETC

The lease income receivable account is used to capture the rental income due, on due dates (there entries are based on the figure in the lease repayment schedule). This is to say that on due date, each lease is recognised as a debtor to the bank.

In order to appreciate the completeness of the entries to be passed, the following accounts are explained together; ON DUE dates of lease payment:

DR - Lease Income Receivable Account (Balance Sheet)

CR - Lease Income Account (Profit and Loss)

Being rental income due for period (either monthly or quarterly) on the asset(s) lease. The subsidiary ledges (i.e for each customer) is updated immediately to reflect the amount due.

ON PAYMENT of due rentals (if there are no interest penalties);

DR - Cash/Bank/Clinet's Account (as case may be, i.e. if payment is by cheque or direct debit to current account).

DR - Tax Prepared Account (for any with-holding tax netted of gross rentals due).

CR - Lease Income Receivable Account - For the gross rental income.

However, it should be noted that:-

(a) The with-holding tax paid by the client on behalf of the lessor must be supported by original copy of the receipt issued by the Inland Revenue so as to enable set off by the lessor against the tax liability due.

(b) All other things being equal, the balance on the lease income receivable account should be nil at the end of each month/quarter.

Interest Accruals Account - Leases

Interest Suspense Account - Leases

(Lease)Interest Account - Others

Most lease agreements make provisions for penalty on late lease rental payments. The normally range between 1 to 2 per cent above the lessor's prime lending rate on the rental instalment due, if payment is not made within a specified period of time, say 14 days. The following entries are passed:

DR - Interest Accruals Account - Leases

CR - Interest Suspense Account - Leases, for outstanding interest penalties on rental payments. For entries will be raised either at the end of a control period (quarterly/monthly) or when payment is made on the due sum but the interest (penalty) has not been forwarded.

Once payment on the interest penalty is made the following entries should be passed:

DR - Bank/Cash/Customer Account (as case may be).

CR - Interest Accrual Account to reflect the settlement of outstanding liability.

AND

DR - Lease Interest Susupense Account

CR - Interest Income Account - Others.

To reflect the realisation of the previous amount suspended on the interest income account.

B. ACCOUNTING FOR FINANCE LEASE

GENERAL COMMENTS:

1. (a) In a finance lease the asset is not just rented, but purchased over the period of the agreement. This may include payment of a residual value at the end of the lease period. In effect, the asset acquired in a finance lease should be capitalised in the balance sheet of the lessee while the depreciation and attributable finance charges should be debited to the profit and loss account.

If this is not done, the capital employed and actual and contingent liability of the lessee will be understated. Moreover, inter firm comparison will be difficult to make.

(b) The capitalised value of the asset in the balance sheet of the lessee should be the lower of the fair value of an asset and the present value (using discount tables or programmable calculators e.g. HP12C) of the minimum lease payments. In other words, it will be the cash price of the asset.

(c) The asset (i.e. capitalised value) should be depreciated over the period of expected use, consistent with the lessee's depreciation, policy for the class of the assets.

2. In the book's of the lessor, the treatment is however different. The diferences are:

(a) The lease will be recorded NOT as a property, plant or equipment but as a receivable. This is because "the substance of a finance lease contract is the provision of a secured loan". "Lease rentals therefore are partly a repayment of principal and partly a finance charge to reimburse the lessor for his investment and sevices".

(b) The receivable amount will be equal to the net investment of the lessor in the lease. This will normally be "the total future minimum lease payments less finance charges allocated to future periods. At the beginning of the lease, this is normally equal to the cost of the equipment i.e. only the capital amount".

(c) Also at the beginning of the lease, the lessor will state in his account:

i. the gross investment in the lease (i.e the capital/loan amount) and the;

ii. Unearned finance income (deferred interest income) from the lease.

The unearned finance income will be deferred and allocated to income over the life of the lease.

LEASE ACCOUNTING RECORDS AND PURPOSE SERVED (FINANCE LEASE)

1. LEASE REPAYMENT SCHEDULE

Same as in operating lease

2. LEASE DEBTORS ACCOUNT

This is debited with the total rentals due from the lessee, (i.e the capital loan amount and the unearned finance income from the lease). This gross financial obligation from the lessee is stated therein at the inception of the lease. The contra entries are:

i. a credit to lease interest suspense account

ii. a credit to vendor (sellers account)/or customers account or bank, depending on whether an immediate purchase of the asset is being made, or it is a sale and lease back transaction etc.

3. LEASE INTEREST SUSPENSE ACCOUNT

This is maintained to capture the attributable finance charges due from the lessee.

NOTE

The net investment of the lessor in the lease at any point in time is arrived at by deducting the outstanding balance on the lease interest suspense account from the balance on the lease Debtors Account.

4. SECURITY DEPOSIT ACCOUNT

This is credited with the amount paid towards securing the residual value of the asset at the expiration of the lease. It may be interest bearing or non-interest bearing depending on the way the lease is structured.

INCOME RECOGNITION

There are several methods of recognising the income from a finance lease. However, it is important to note that every rental payment in a finance lease is made up of two components:

(a) An interest charge on finance provided by the lessor. This proportion of interest is credited to the profit and loss account.

(b) A repayment of part of the capital (loan) cost of the asset. This is credited to the lessee's account to reduce the outstanding liability.

The proportion of rental repayment that is accounted for either as interest or principal repayment is derived by for using either of these methods:

(a) The level spread method i.e. the finance (interest) income are assumed to accrue evenly throughout the period of the lease.

(b) Actuarial method - this assumes that the interest earned is the implicit interest rate of the lease multiplied by the outstanding capital amount of the lease. The interest amount reduces on the payment of each rental but it will be highest at the commencement of the lease. (The easiest way to make the calculation is by using a programmable calculation such as HP12C)

(c) Sum of the digits method - This is closely approximates to (b) abouve but the calculation is not based on the interest factor but based on the sum of digits in the total instalmental payments. For example, if there are 3 instalmental payments, the sum of the digits will be 6, i.e. (1+2+3) instalments). The interest (rate) applicable in each of the instalments are as follows:

i) Payment of 1st instalment = 3/6 x Rental payment

" " 2nd " = 2/6 x " "

" " 3rd " = 1/6 x " "

As a recap, the accounting entries will be

1. ON DISBURSEMENT

DR - Lease Debtors Account

CR - Cash/Vendor/Client's Account (as case may be i.e whether it is a payment to the vendor (seller) or a sale and lease back), for the loan/capital amount of the lease.

DR - Lease Debtors Account

CR - Lease Interest Suspense Account for the unearned lease finance income due from the lease.

It should be noted that the repayment schedule is prepared at the inception as described previously.

2. RENTAL PAYMENTS (If payment is made on due date)

DR - Cash/Lessee's Bank Account (depending on the mode of payment).

CR - Lease Debtors Account

CR - Security Deposit Account

Being a reduction of total outstanding liability to the Bank, AND raise a separate journal:

DR - Lease Interest Suspense Account

CR - Lease Income Account (P & L)

(It should be noted that the repayment schedule is also updated immediately as to the interest component and principal components of the repayment).

3. LATE RENTAL PAYMENTS

However, rental payments may not be made on due dates and it is necessary to capture the income due from the lessee at the period. The following approach is suggested:

Raise a journal;

DR - Lease Interest Receivable Account (A Suspense Account).

CR - Lease Income Account (P & L) being recognition of lease interest income due.

(It should be noted that the lessee's outstanding liability to the bank is reflected on the balance of the lease Debtors Account).

Once payment is made;

DR - Lease Interest Susupense Account

CR - Lease Interest Receivable Account

being realisation of lease interest income previously suspended, AND;

DR - Cash/Lessee's Bank Account (depending on the mode of payment).

CR - Lease Debtors Account.

Being reduction in outstanding liability on payment of overdue rental.

4. INTEREST RATE CHANGES

During the tenor of a lease facility it sometimes happen that the implicit interest rate used in calculating the lease rental payments, changes because of increase or decrease in the lessor's base interest rate.

What this implies is that the outstanding balance in the lease debtors account will have to reflect the new indebtedness to the bank. In effect, it is only the finance charge portion of the total liability of the lessee that will change while the principal portion outstanding will represent the basis of calculating the new rental payment.

The approach is as follows:

(a) Calculate the new rental payments due and prepare a new repayment schedule.

(b) Reverse the existing balance on the lease interest suspense Account, i.e.

DR - Lease Interest Suspense Account

CR - Lease Debtors Account.

Being reversal of expected lease interest income due to changes (increase/ decrease in interest rate).

AND SIMULTANEOUSLY

DR - Lease Debtors Account.

CR - Lease Interest Suspense Account.

Being recalculation of expected lease interest income resulting from interest rate adjustment.

5. NON-PERFORMING LEASES

In a finance lease, provision should be made for outstanding interest income, whose likelihood of payment is deemed remote, as follows:

(a) DR - Bad Debt Expense (Leases) Account

CR - Bad Debt Provision (Lease) Account

Being provision for lease interest income.

(b) When the rental payments are considered irrecoverable then-

DR - Bad Debts provision (lease) Accounts

CR - Lease Interest Receivable Account

Being write-off of previous lease interest incurred previously taken to profit.

The capital portion of the lease account should be accounted for through a Reprocession Account as follows:

DR - Lease Interest Suspense Account

CR - Lease Debtors Account

Being write-back of balance on the lease interest suspense account to lease debtors account.

DR - Repossession Account

CR - Lease Debtors Account

Being outstanding capital cost of leased equipment now recovered.

The present practices are summarised below:

1. DISBURSEMENT

On disbursement of the leasing facility, the following entries are passed:

DR - Lease Assets Account

CR - Vendor Account/Client Account (as the case may be) being cash/ payment on acquisition of leasing asset. (subsidiary ledges are opened/updated) for each client/new lease. The balance on the leasing asset - General Ledger Account must agree with the control totals for the subsidiary ledgers and also the table as per the schedule of leasing assets.

2. DEPRECIATION OF LEASE ASSETS

Assets acquired for the purpose of lease are depreciated over the shorter of the lease period or the normal depreciation period for that class of assets by the bank. The depreciation of leasing assets is accounted for like that of any other asset through the profit and loss account for each month i.e.

DR - Depreciation (Expense) Account - Profit & Loss

CR - Cumulative Depreciation - Leasing Assets (Balance Sheet Account).

Lease Assets are stated at the lower of cost or net realisable value. Any diminution in the value of leased asset below the cost of the assets are reflected by revaluing the assets to show the (new) net realisable value. The difference between the carrying amount and the net realisable value, (if lower) are written off to the profit and loss account.

3. LEASE RENTAL PAYMENT

On the due dates (as per repayment schedule) of the lease payments:

DR - Lease Income Receivable Account

CR - Lease Income Account

Being rental income due for period (either monthly/quarterly) on the assets leased.

The subsidiary ledgers - immediately for each client/lease assets. The total balance on the lease income receivable account must agree with the general ledger balance for control purposes.

NOTE:

1. Any penalty payment(s) should be credited to the Repossession Account.
2. The value at which the equipment is brought into the books is the balance on the loan amount i.e. the bank's net investment in the lease at that date.
3. Subsequent disposal for cash should be reflected through the repossession account, the net loss/gain on sale of repossessed equipment credited to the profit and loss account.

The above entries are maintained both for individual clients and control account are also maintained for all clients so that the balance of the general ledger account will be the same as the total for the control accounts.

ACCOUNTING FOR FINANCE LEASES -

PRESENT PRACTICES AND NEED FOR UNIFORN TREATMENT

The approach described above both for operating and finance lease represent summarised/simplified requirements of the Accounting Standard Board (SAS II), the British statement of Standard Accounting Practice (SSAP) 24 on leases and Hire purchase transactions.

However, although most banks and financial institutions in Nigeria undertake finance lease, but these are accounted for in their books as if they are operating leases. In essence, what we are saying is that:

a) The leasing assets are reflected in their balance sheets as fixed assets and depreciated accordingly.

b) Lease income (gross lease rentals) is only stated in the books as at when due and no obligations for future rentals are disclosed in their financial statements.

On payment of the due rentals (if there are no interest penalties):

DR - Cash/Bank/Client's Account (as case may be, i.e. if payment is by cheque or direct debit to current account).

DR - Tax pre-paid Account (for any withholding tax netted off gross rentals due).

CR - Security Deposit Account (for security deposit portion of the total amount received).

CR - Lease Income Receivable Account - for the gross rental income.

4. SALE OF LEASES ASSETS

At the expiration of the lease, the lease agreements normally provide that the lessee has the first option to buy the asset at a specified percentage. The purchase consideration is normally the security deposit which should now approximate the purchase consideration.

The following accounting entries are passed on the disposal of the leased assets:

DR - Security Deposit Account

CR - Lease Assets Disposal Account

Being transfer of purchase consideration from the security deposit account on the expiration of the lease term.

DR - Lease Assets Disposal Account

DR - Cumulative Depreciation - lease Assets

CR - Lease Assets Account

CR - Lease Assets Disposals Account

Being transfer of the cost and cumulative depreciation on lease asets to the disposal account on the expiration of the lease asset to the lessee. The difference on the account usually a credit balance, is written to the profit and loss account as profit/loss on disposal of lease asset.

5. NON-PERFORMING LEASES

For non-performing leases i.e. where lease rental payments are in arrears and the chances or repayment are doubtful; the following accounting entries are suggested:

a) DR - Bad Debts - Expense (Leases) Account

CR - Bad Debts Provision (Lease) Account.

On provision for possible non-payment of the lease amount.

b) When the rental payment are considered irrevocable then;

DR - Bad Debts provision (lease) Accounts

CR - Lease Income Receivable Account.

However, where no provision has previously been made the entries will be;

DR - Bad Debts Expense Accounts (leases)

CR - Lease Income Receivable Account.

COMPUTATION OF LEASE RENTALS

Computation of lease rentals should be by the use of the following formular:- IMB Bronchure on leases (1989).

LEGEND

Pv = Prevent Value = amount of lease facility

R = Number of periods (periodic rentals in lease term)

i = Interest rate per period

a = Rental amount

FORMULAE

i. PMT = Pv/a

ii. Where rentals are payable in arrears.

$$a = \frac{\left(\frac{1}{(1+i)n}\right)}{i}$$

iii. Where rentals are payable in advance.

$$a = \frac{1 - \left(\frac{1}{(1+i)n-x}\right)}{i} + x$$

and x = the number of rentals payable in advance.

This formulae assumes that after payment of the advance rental or rentals, the first of the remaining rentals is paid at the beginning of the second period.

FORMULAE FOR CALCULATION OF MONTHLY RENTAL,

TAKING INTO ACCOUNT A RESIDUAL VALUE.

LEGEND

Fv = Future Value

n = Number of periods (periodic rentals) in lease term.

i = Interest rate per period

$v^n$ = Discount factor

$Pv^n$ = Present value of the future value after n periods.

FORMULAE

i. $V^n = \frac{1}{(1+i)^n}$

ii. $Pvn = Fv \times V^n = \frac{Fv}{(1+i)^n}$

iii. $Pmt = \frac{Pv - Pvn}{a}$

Where Pv = the present value of the lease facility.

NORMINAL VERSUS EFFECTIVE YIELDS

Lease yields are usually quoted on an annual nominal basis, which does not capture the compounding effect of reinvested cashflows i.e. the compound interest.

To convert a nominal yield to an annual effective yield the following procedures should be followed:

a). Use the compound interest formular.

$$\left(1 + \frac{\left(\frac{i}{na}\right)}{100}\right)^{nj}$$

i = Annual nominal interest rate

na = Compounding periods per day

nj = Compounding periods under consideration

quarterly effective = 3, semi annual effective = 6,

annual effective = 12.

The formular first converts the annual nominal rate to the periodic nominal rate corresponding with the compounding period (typically monthly). The periodic nominal rate is then converted into decimal form by dividing by 100. The number "1" is added solely as a mathematical convention. Raising the periodic nominal rate (in decimal form) by an expomential power reflecting the number of compounding periods under consideration will yield the appropriate effective rate.

## 2.5 TAXATION TREATMENT FOR LEASES AND ADVANTAGES

The Federal Board of Inland Revenue (FBIR) has come up with a criteria for determing who receives tax benefits. The issue of "at-risk" is the major criterion for determing whether the lessor is "at-risk" or not and will receive the tax benefits of ownership and the lessee will be entitled to deduct the lease payments or rentals as a business expense. For taxation purposes therefore, most lease payment are recorded as an expense.

However, in cases where the lease condition fail to meet the (FBIR) criteria for tax-lease transaction is determined not to be a tax-lease but a money-over-money lease, which is more or less an instalment sale contract in the guise of a lease. In these case the lessee is bearing the risks of ownership and is entitled to the tax benefits such as depreciation, but is not entitled to deduct the entire lease payments as it does in a tax-lease. If the lessor bears the risk of ownership, the lease is termed a tax-lease and must claim tax benefits of ownership. A tax lease must not contain a bargain purchase option or specify a lessee guaranteed residual value.

CAPITAL ALLOWANCES

The concept of capital allowances is to allow for the recovery of the cost and possibly the replacement of assets used in generating the income of a trade or business.

Under general account practice, income cannot be said to be determined without a provision for the value of the capital asset consumed in producing the income. Through provision for depreciation, the accountant systematically charged the cost of a fixed asset against periodic income over the estimated useful life of the asset. The amount charged each year depends on management's estimate of the fixed asset's useful life, depreciation method, fixed asset cost and the estimated scrap value. Although, by experience, industries tend to accept a standard life span for certain classes of assets, depreciation charges on like assets vary among companies.

In order to impose some uniformity, depreciation charge is disallowed for tax purposes and in its place a uniform "government depreciation" or capital allowance is granted.

Capital allowances in Nigeria are based on historical cost of the assessment year to which they relate. They do not have anything to do with asset replacement or the so called real economic depreciation. It is normally granted on depreciable tangible assets. Thus, assets that cannot suffer wear, tear or obsolense and intangible assets do not qualify for capital allowances. The rates are determined by Government and may have no real relevance to the existing economic environment.

WHO CAN CLAIM CAPITAL ALLOWANCES?

A company may be granted capital allowances in any year of assessment only upon a written claim or if the board considers it reasonable and just to do so. The company is however expected to prove:

(a) the ownership of the asset;

(b) that the asset is in use in a trade or business;

(c) the expenditure thereon is incurred wholly, exclusively necessarily and reasonably for the purpose of the trade.

The Industrial Inspectorate Act, No. 53 of 1970 makes it mandatory for a company to submit its capital expenditure plan to the Inspectorate Division of the Federal MInistry of Industries for all planned capital expenditure exceeding N20,000.00. The certificate of acceptance normally issued by the Inspectorate Division is accepted by the Federal Board of Inland Revenue as proof of ownership and value.

To qualify for capital allowances, the asset must be put in use in a trade recognised by the tax Acts. For instance an individual cannot claim capital allowances on his private motor car used in travelling to his place of employment because he is not carrying on a trade recognised by the Tax Acts. On the same premise, companies cannot claim capital allowance on assets used in respect of non-trading activities. The expenditure will still be required to pass the test of WHOLLY, EXCLUSIVELY, NECESSARILY AND REASONABLY used for trade or business. Where an asset is used for both personal and business purposes, the tax Acts provide for granting proportionate allowance. A part owner in any qualifying asset may also claim proportionate capital allowance. A claiment need not be a NIgerian company.

ASSETS TO WHICH CAPITAL ALLOWANCE APPLY

The Tax Acts define the assets which qualify for capital allowance. The broad classifications are as follows:

- Building
- Industrial Building

- Mining
- Plant
- Manufacturing Industrial Plants
- Construction Plants
- Public Transportation Motor Vehicles
- Ranching and Plantation
- Plantation Equipment
- Research and Development
- Motor vehicles
- Agricultural Plant
- Housing Estate
- Furniture Fittings

BASIS PERIOD

Capital allowances is granted for a period for which a company reports it's profit or loss. For a normal period, the basis period is the same for both assessable profits and capital allowances. The following exceptions apply:

(a) Where two basis period everlap, the period common to both periods is deemed to fall in the earlier basis period for the purpose of granting allowances other than annual allowance.

(b) Where there is a gap between two periods, and the latter period is not the period of cessation of business, the gap is deemed a part of the latter basis period.

(c) Where the latter period in (b) above is part of the cessation period, the gap is deemed part of the earlier period.

TYPES OF ALLOWANCES

The allowances and charges available are as follows:-

INITIAL ALLOWANCE

Where a company has incurred qualifying expenditure wholly and exclusively for the purposes of its trade or business in respect of any asset during its basis period for a year of assessment, it will be entitled to claim "initial allowance" in the basis period for the year of assessment in which the asset was first used for the purpose of its trade or business.

If either the vendor or the buyer of the asset has control over the other, or both of them are subject to the control of some other person, the board would determine the amount of initial allowance which is just and reasonable in the circumstances. However, this must not exceed the amount which would normally have been allowed. This allowances is not available on buildings acquired from persons that previously used them in a trade or business.

ANNUAL ALLOWANCE

In its basis period for a year of assessment, when a company owning an asset has incurred in respect thereof qualifying expenditure wholly or exclusively for the purpose of its trade or business, whether or not an initial allowance has been claimed, the company is entitled to an annual allowance on such expenditure.

Under CITA 1979, annual allowance is claimed on the residue of the expenditure, whilst under the Finance (Miscellaneous Taxation Provisions) Decree of 1985, it is claimed on a straight line basis after deducting initial allowance.

Where the basis period for any year of assesament is less than one year (i.e. 12 months), the annual allowance is reduced proportionately. To qualify for capital allowances, the asset must be in use at the end of the basis period.

INVESTMENT ALLOWANCE

The Finance (Miscellaneous Taxation Provisions) Decree of 1985 provides that where a company has incurred expenditure on plant and equipment used in agricultural production other than in marketing and processing, such company shall be allowed an investment allowance of 10% of the expenditure incurred. This investment allowance has been extended to new production machinery by the 1990 budget statement.

BALANCING ALLOWANCE

This will arise where there is a disposal of asset. Where a company owns an asset, on which it has incurred qualifying expenditure and then disposes of the asset, for an amount lower than the residue of the expenditure, a balancing allowance is given. The asset is said to be disposed of if any of the following events occur:

(a) In respect of building and civil strutures of a permanent nature.
- if the relevant interets therein is sold, or
- in the case of a concession, when the concession comes to an end, or,
- in the case of a lease, when it comes to en end;
- if the building, structure or works are demolished or cease altogether to be used for the purposes of the trade or business.

(b) In respect of plant, machinery or fixtures, if they are sold, discarded or cease altogether to be used for the purposes of the trade or business.

The value of an at disposal is the net proceed of the sale of the asset or of the relevant interest therein. If the asset is disposed other then by sale, value is taken to be the open market value of the asset less the expenses of sale, and where insurance compensation is paid, the net proceed by such money or compensations will be deemed to be the net proceeds. Where an asset on which qualifying expendtiure has been incurred is disposed of together with any other asset, an apportionment will be made.

If an asset is disposed of in circumstances wherein the owner continues to remain the owner of the asset, he is deemed to have bought the asset for a price equal to the residue of the qualifying expenditure at the disposal date plus the amount of the balancing charge or less the amount of the balancing allowance. The qualifying expenditure prior to the disposal will be left out of the books.

BALANCING CHARGE

These are charged made on the disposal of the asset or the relevant interest therein on which qualifying expenditure has been incurred for a price higher than the residue.

It would have been inconceivable that a lessor or a lease would qualify to claim capital allowances on leased assets through the tests discussed above if there are no statutory provisions to that effect.

At present, leasing is treated cursorily in our tax statutes. The company's Income Tax Act, 1979 as amended, the only statute dealing with leasing, provides that:

1. "Where a company owning any asset:-
   (a) has incurred capital expenditure in respect thereof for the purposes of leasing that asset for use wholly, necessarily and reasonably for the purposes of a trade or business carried on or about to be carried on by a person and

(b) leases the asset to such person; and

(c) during the whole or part of the term of the lease, the asset is used wholly and exclusively by such persons in such trade or business.

The provision of this schedule shall apply, with such necessarily modifications as the board may direct, as though such expenditure were incurred wholly, exclusively, necessarily and reasonably for the purposes of a trade or business carried on by the owner from the date when such expenditure was incurred and as though the owner were using the asset for the purpose of such last mentioned trade or business in the way in which and for the purpose of periods during which the asset is in fact in the first-mentioned trade or business.

2. For the purposes of this paragraph, "in relation to the trade or business which an owner is to be treated carrying on, his basis period for any year of assessment shall be taken to be the year immediately preceeding that year of assement".

Finally, we may ask, who qualifies to claim capital allowance; the lessor or the lessee? The Act envisions the owner of the asset meeting laid down criteria; ipso facto, the lessee is ruled out here, as under the general provisions, to make claims for capital allowances.

The Act however makes the qualifying of capital allowance on lease assets the arbitrary privilege of the Federal Board of Inland Revenue who is empowered to grant the allowance based on the provisions of the law with such necessary modifications as it may, in its almighty whims, direct. This may not cover the Board's arbitrary powers to grant capital allowances to the lessee because he is not the dejure "owner" by whatever stretch of imagination the word "owner" may be conceived. A lessee under a finance lease may be an owner in substance, at least by accounting standards. However, it is doubtful whether this generally accepted accounting practice can overrule the strict provision of the Act. Be that as it may, the Act fully covers the board in rejecting the claims of a lessor under its 'necessary modifications'.

Prior to the issue of International Accounting Standard on leasing, the board only recognized the lessor for the capital allowance claim. This earlier posture has since changed. It is now common request from the board that persons making capital allowance claims on leased assets supply the underlying lease agreement for scrutiny.

The Act also makes it a precondition that the lessee must use the equipment for the purposes of a trade or business carried on or about to be carried on. The Act defines trade or business as one whose points are assessable under the Act.

Thus, on strict to the ACt, assets leased to corporations and persons not carrying on a trade or a trade whose profit is not assessable under the Act cannot qualify for capital allowances. The fact that the profit would have been assessable had it not been exempted, is a mere after thought. The board has continued to grant capital allowances to owners of assets leased to some companies and organisations which do not carry on a qualifying trade. The grant is of course a privilege as against a right.

The claimants may not have any enforceable rights against the board should the privilege be withdrawn.

Syndicated leases are adequately provided for through the proration of capital allowances. The board however insists on treating synducated leases as joint ventures.

Cross-border leasing may create problems for the Nigerian corporate lessors as the lessee's profits do not fall under assessable profits under Nigerian laws. It may be, however, that the board will treat the cases on their own merit whenever the situations arise. An offshore lessor will not encounter this type of problem.

MEASUREMENT OF CAPITAL ALLOWANCES

| Qualifying Capital Expenditure | Initial Allowance | Annual Allowance |
|---|---|---|
| (i) Furniture and fittings | 15% | 10% |
| (ii) Research and development | 25% | 12 1/2% |
| (iii) Motor vehicle | 25% | 20% |

In 1989, the initial allowances were changed as follows:

| Expenditure in respect of: | Rate per cent |
|---|---|
| Building Expenditure | 5 |
| Industrial Building Expenditure | 15 |
| Mining Expenditure | 20 |
| Plant Expenditure (excluding furniture) | 20 |
| Manufacturing Industrial Plant Expenditure | 25 |
| Construction Plant Expenditure (excluding furniture and fittings) | 25 |
| Public Transportation Motor Vehicle Expenditure | 30 |
| Ranching and Plantation Expenditure | 30 |
| Planting Equipment Expenditure | 20 |
| Research and Development Expenditure | 25 |
| Motor Vehicle Expenditure | 25 |
| Agricultural plant Expenditure | 25 |
| Housing Estate Expenditure | 20 |
| Furniture and Fittings Expenditure | 15 |

The latest amendment is silent on the annual allowances. It is therefore safe to assume that they will qualify for the same annual allowances obtainable before.

RESTRICTION

The amount of capital allowances to be deducted from assessable income in any year of asseeement shall not exceed 75% of such assesable income in the case of a tax payer engaged in the manufacture of any product, and 66 2/3% in the case of any other business.

The restriction above does not apply where the tax payer is in the agro-allied industry.

Agro-allied industry is defined as one which:

- establishes or manages a plantation for the production of rubbers, oil palm, cocoa, coffee, tea and similar crops.

- cultivates or produces cereal crops, tubers, fruits of all kinds, etc.

- establishes or manages animal husbandry, i.e. poultry, piggery, cattle rearing, fish farming.

- engages in food production.

This restriction on capital allowance for manufacturing companies was repealed by the 1990 budget statement.

2.6 REGULATORY ENVIRONMENT/LEGAL ASPECTS OF LEASE FINANCING

From legal point of view, William D.(1978) observed that lease financing can be divided into three major categories namely;

1. Sale and lease back of real property
2. Chattel leases intended as security agreement
3. True leases of personal property.

According to Bresly and Young (1989):

"The first category involves signing an agreement between lessor and lessee on real property such as buildings, land or even part of the buildings. While the second category encompasses leasing of practical equipment such as aircraft, computers etc. And lastly, third category involves leases of personal property".

Laws, decrees, Act and guildlines are normally enforced to direct the ethic of leasing business, which the rules fundamentally will be accepted e.g. all long term leases must be in writing. Unfortunately laws in Nigeria are silent in most aspects of lease operation, as such many individuals are calling the attention of the government to that effect. Condified law on leasing in Nigeria should be established to avoid gray areas in lease transaction.

However, some important legal aspects of lease financing need to be evaluated as follows:

LESSEE OBLIGATION TO PAY RENTALS

Lease contracts always contain an express promise known as a convenant which bonded the lessee to make a series of payments in specified amount at a specified interval for a period of times. In the absence of this convenant, the implied obligation stipulates that rentals should be paid to the tune of reasonable amount and this is payable at the end of the term.

Any breach of contract by the lessee, will entitled the lessor to decline the lease at the expiration of the agreement and will give him right to regain possession of the property for breach of any of the convenants.

TERMINATION OF THE LESSEE'S OBLIGATION ON RENTAL PAYMENT

The implied condition to pay reasonable rental by a lessee cease to exist, when the lease hold is transfered by agreement. This is when the lessee assigns a lease that does not contain an express agreement to pay rental, the implied condition to pay reasonable rental passes to the assignee. This is not true where the lease contains an express agreement of the lease to pay rental.

Under an express convenant to pay rental the lessee remains liable despite the fact that he has assigned the lease-hold to another lessee unless the lessor releases him from the obligation.

EFFECT OF DESTRUCTION OF THE PROPERTY ON THE LESSEE´S OBLIGATION TO PAY RENTAL

Richard and Myers (1981) reported that most leases contain clauses covering the fortuitous destruction of the premises. A typical clause provides that, on damage by fire or other fortuitous cause, the lessor will repair and restore, and that if the premises are wholly unusuable the lessee´s obligation to pay rental will be suspended until the premises are restored, but that if the lessor decides to demolish and reconstruct the premises, the lease will terminate.

THE OBLIGATION TO REPAIR AND RESTORE

The lessee is under no duty to make any repairs to the property, unless the lease expressly provides. Also the lessee is not obliged to repair or restore substantial or extraordinary damage occuring with fault or to repair damage caused by ordinary wear and tear.

EXPIRATION OF THE LEASE AGREEMENT

A lease for a definite term expires at the end of the term by virture of its own limitation. Most lease financing agreements are for a definite term.

THE INDUSTRIAL INSPECTORATE DECREE 53 OF 1970

Prior to the establishment of the Industrial Inspectorate Department within the Federal Ministry of Industries, Government appointed some Inspection Agents: the S G S, Collet Brett and MEK-IND Associates to inspect and issue valuation certificate for NIgerian imports which confirm the actual values that qualified for foreign exchange repayment. In the bid to indigenize this process, government cancelled their appointment in 1969 and in 1970 promulgated Decree 53 of 1970. This decree is cited as the supplement of official gazette Nol 57 Vol. 57 of 22/10/70.

THE DUTIES OF THE DEPARTMENT

The duties of the department are stated in the decree as follows: "It shall be the duty of the Department generally to carry out investigations into any proposed, new and existing undertaking involving any proposed capital expenditure and in particular for the purpose of determining the investment valuation of the undertaking, that is:-

a) The actual [illegible] (whether foreign or local) employed or proposed to be employed in the undertaking.

b) The actual valuation of building, plants and other machinery employed or proposed to be employed in the undertaking and any addition thereto".

"The industrial Inspectorate Department shall also obtain necessary information on economic trends in the country and for the purpose, the Department shall:-

a) prepare and keep records of matters relating to any undertaking investigated by it;

b) prepare and keep records of all industrial plants and equipment in the country, their value and the value of similar plants and equipment in other countries.

THE OBJECTIVES OF THE DECREE

From the duties prescribed by the Decree the objectives can be summarised as follows:-

a) only the actual values of capital undertakings are recorded to prevent illegal repatriation of funds under cover of repayment for imported capital goods.

b) prevention of falsification of tax claims on capital expenditure by companies.

c) the planning of economic development in the country based on factual information and actual and up-to-date data.

NOTIFICATION OF INTENTION TO INCUR CAPITAL EXPENDITURE

In accordance with section 3(1) of Decress 53 of 1970 establishing the Department, "any person proposing

a) to start a new undertaking involving the expenditure of not less than N20,000.00 or

b) to incur additional capital expenditure of not less than N20,000.00 in respect of an existing undertaking shall give to the Director, notice of intention in the form specified in schedule I of the Decree: (i.e Form I).

The purchase of equipment for leasing as per the definition of the Decree is a form of capital undertaking. The lessor who engages in this undertaking involving equipment of value not less than N20,000.00 should therefore notify the Director, Industrial Inspectorate Department by filing the prescribed Form I before the lease agreement in structured with the particular lessee.

failure to notify the Director is an infringement of section 3(1) of th decree ·1 as per section 3(4) of the same decree attracts a penalty of N1,000.00 on each count.

RENDERING OF CAPITAL EXPENDITURE RETURNS

When the particular lease transaction has been fully executed, returns on the actual capital expenditure incurred should be rendered using the Departments' Project Completion Forms and the Returns Summary Form.

The relevant documents that should accompany the returns are given as follows:-

a) FOR DIRECT LEASE (FINANCE LEASE AND OPERATING LEASE)

i) Purchase Invoice.

ii) All shipping documents in respect of imported assets.

iii) Evidence of payment for the assets.

iv) Lease Agreement.

b) FOR SALE-AND-LEASE-BACK TRANSACTION

i) Purchase or Commercial invoice for the assets

ii) All shipping documents from the lessee to establish the First Cost of the assets.

iii) Lease Agreement.

iv) Sale Agreement.

v) Evidence of payment for the assets.

c) SYNDICATED LEASES

i) The Lease Agreement which spells out the respective contributions of the participating lessors.

ii) Descriptions with values of the assets belonging to the respective participating lessors.

iii) The other documents listed in (a) or (b) above depending on which type of lease is applicable.

THE IMPLICATION OF THE INDUSTRIAL INSPECTORATE DECREE

After satisfactory investigation of the returns has been carried out by the Department, the Certificate of Acceptance that will be issued is meant for the assets that have been put into use. The ownership of the assets on lease rests with the lessor and hence it is the lessor that is entitlked to the capital allowance.

# CHAPTER THREE

## BACKGROUND AND METHODLOGY

### 3.1 HISTORICAL DEVELOPMENT OF MERCHANT BANKS IN NIGERIA

Merchant Banking is a relatively new line of business in the Nigerian Financial System. It all began in 1961 with the establishment of Phillip Hill (Nig) Limited which later merged with the Nigerian Acceptances Limited (now NAL Merchant Bank) in 1969.

Prior to the merger in 1969 however, the two firms engaged in identical set of activities which included:

a) Financing of commodity exports by granting credits to the marketing Boards;
b) acceptance of deposits from institutions;
c) provision of loans and advances;
d) lending money to businessmen and businesses;
e) provision of issuing house services.

The two institutions resolved to merge since they engaged in the same field of business and as a result of the fact that there was apparently no enough business for both to engage in. The merger was even facilitated by the fact that the two firms were of British origin and ownership.

The NAL Merchant Bank Ltd remained the only licensed merchant bank operating in the country until later in 1973. The UDT Bank (Nigeria) Ltd was born out of the reconstruction of the United Dominion Subsidiary of UDT International, which in turn was a wholly owned subsidiary of United Dominion Trust Ltd. Before August 1973, the UNited Dominion Corporation (Nigeria) Limited which was incorporated in 1960 was engaged in hire purchase business in Nigeria. The name of the Bank was changed in 1977 to Nigerian Merchant Bank Ltd (now Nigerian Merchant Bank Plc).

The year 1974 witnessed the establishment of two additional merchant banks of which International Merchant Bank (IMB) Plc (then named First National Bank of Chicago) was one. The other one was ICON Ltd (Merchant Bankers). By 1975 the number of merchant banks in operation had increased to six. Merchant banks operating in the country as at end of 1991 numbered 54 with over 100 branches. Merchant banking is commerce or trade oriented, a fact which is reflected in their location in major commerical centres. Those that have branch offices usually site them in State capitals in order to capture business opportunities in certain regions of the country.

Merchant banking business in Nigeria was very / until the NIgerian Enterprises Promotion Decree was promulgated. The oil boom of mid 70's and the Third National Development Plan (1975 - 1980) which was launched in the euphoria of the oil boom altered considerably the Nigerian banking scene and gave tremedous impetus to merchant banking.

Also, the changing structure of the economy towards increased industrialization which requires the type of services that merchant banks provide, such as wholesale banking, medium and long-term financing, debt factoring, equipment leasing etc. The availability of such services has become more desirable in the wake of the indigenisation policy of the government under which Nigerians come to acquire certain business enterprises hitherto owned and managed by expertiates.

## 3.2 HISTORICAL PERSPECTIVE OF EQUIPMENT LEASING IN NIGERIA

Leasing which has only recently assumed a critical role in the financing of capital asset acquisition and hence industrial development in NIgeria commenced in its modern form in the United States of America in the early 1950s and the rest of the world thereafter.

The historical development of equipment leasing in NIgeria has a positive correlation with that of Merchant Banking. This is because Merchant banks do not only take the credit for introducing leasing into the country but also remain the dominant equipment lessors to date.

Leasing in Nigeria dates back to the early 1960s when some British firms wrote cross-border leases for some of their subsidiaries operating in the country. This mode of leasing became illegal and ceased with the introduction of exchange control regulations and laws during the Nigeria Civil War. The focus was thus oriented to developing indigenous leasing transactions.

Benthworth Finance Company (now BFN) and Nigerian Acceptances LImited (now NAL Merchant Bank) consumated the first local leasing deals in Nigeria.

The growth of the Nigerian leasing industry had been more or less gradual throughout the 1970s and early 1980s. The slow growth pace is evidenced by the fact that total volume of equipment leases written in the country remained far below the N100 Million mark until 1984. The aggregate volume of leases at cost was N25 Million in 1981, increased to N61 Million in 1982 and N75 Million in 1983. Among others, unawareness and the attendant non-appreciation of the merits of equipment leasing largerly accounted for the slow pace in the growth of the industry in Nigeria.

The formation of Equipment Leasing Association of NIgeria (ELAN) in JUne 1983 represented a corner stone in the development of equipment leasing in Nigeria as the existence of the body has fuelled the growth and development of the industry.

## 3.3 EQUIPMENT LEASE FINANCING AND MERCHANT BANKS IN NIGERIA

Even though leasing has only recently assumed a critical role in the financing of capital asset acquisition and hence industrial development in Nigeria. The historical development of equipment leasing in Nigeria has a positive correlation with that of Merchant Banking. This is because Merchant Banks do not only take the credit for introducing leasing into the country but also remain the dorminant equipment lessors to date. Also, the growth of equipment lease financing has been influenced by the increase in number of lessors in the country, who are predominantly Merchant Banks. The number of lessors who are members of ELAN has increased from 22 members in 1988 to 102 members as at the end of December, 1993. Comprising of Commercial Banks, Finance Houses, Leasing Companies and Merchant Banks who are the dorminant lessors.

TABLE 3.3A ASSET LEASED TO INDUSTRIES BY MERCHANT BANKS

N'000

| ASSETS ACQUIRED DURING THE YEAR / INDUSTRY | 1991 | 1992 | % INCREASE/(DECREASE) |
|---|---|---|---|
| Manufacturing | 352,319 | 468,306 | 32.92% |
| Transport | 77,611 | 242,769 | 212.80% |
| Agriculture | 17,381 | 43,130 | 148.14% |
| Services | 148,195 | 45,367 | (69.39%) |
| Government | 26,375 | 8,637 | (67.25%) |
| Others | 32,957 | 87,597 | 165.79% |
| T O T A L | 654,838 | 892,806 | 36.34% |

Source: 1992 Annual Reports and Accounts, Equipment Leasing Association of Nigeria (ELAN).

TABLE 3.3B LEASED ASSETS ACQUIRED BY MERCHANT BANKS

| LEASED ASSETS ACQUIRED DURING THE YEAR ASSET | N'000 1991 | 1992 | % INCREASE/(DECREASE) |
|---|---|---|---|
| Plant/Machinery | 394,547 | 487,313 | 23.51% |
| Cars | 157,895 | 78,733 | (50.14%) |
| Commercial Vehicles | 75,780 | 205,048 | 170.58% |
| Computers and office equipment | 9,373 | 706 | (92.47%) |
| Ships/Aircraft | 2,775 | 85,502 | 2,981.15% |
| Other unclassified items | 14,468 | 35,504 | 145.40% |
| T O T A L | 654,838 | 892,806 | 36.34% |

Source: 1992 Annual Reports and Accounts, Equipment Leasing Association of Nigeria (ELAN).

From Table 3.3A it can be seen that the total lease volume of Merchant Banks in Nigeria has increased from a figure of N645M in 1991 to N892M in 1992 i.e. by 36.34%. Also, manufacturing sector has benefitted the most enjoying 53.80% (i.e N468M) of the total leased assets acquired in 1992. Also between 1991 and 1992 the total leased asset acquired for the manufacturing has increase by 32.92%.

From Table 3.3B it can be seen that lease financing of plant and machinery, the engine of industrial production has been on the rise over the years and enjoys 60.25% (i.e. N394M) of the total leased assets acquired in 1991 and 54.58% (i.e. N487M) of the total leased assets acquired in 1992. Also between 1991 and 1992 the lease financing of plant and machinery has increased by 23.51%.

Finally, it has shown that despite the credit policy of the Federal Government and lack of professional experts who will [illegible]r the activities of both lessors and lessees, Merchant Banks have prove to be the dorminant lessors both in number and naira amount invested for lease financing.

## 3.4 EQUIPMENT LEASING ASSOCIATION OF NIGERIA (ELAN)

The Equipment Leasing Association of Nigeria (ELAN) was formed on the 29th June, 1983 by the then six merchant Banks operating in the country, with its secretariat at the National Engineering Centre, 4th Floor, 1, Engineering Close, Off Idowu Taylor Street, Victoria Island, Lagos.

The six founding memebrs include:-

a) International Merchant Bank LImited

b) Continental Merchant Bank Limited

c) ICON Limited (Merchant Bankers)

d) NAL Merchant Bank Limited

e) Nigeria Merchant Bank LImited

f) Nigerian-American Merchant Bank Limited

Apart from the promotion and protection of the interest of members, the Association saw, among other things, the need to establish a formal forum to discuss ideas and current developments in the leasing industry as their leasing activities expanded.

Over the years the list of membership has grown spontaneously. It has grown from six at its inception in 1983 to thirty-five as at end of 1989 and has continued to grow. The phenomenal growth in membership has also meant an unprecedented growth in the volume of leasing business.

The objectives of ELAN include:

1. To promote and protect the interest of members of the association in the exercise of their business as equipment lessors.

2. To promote honourable pratice in the conduct of their business by members of the association.

3. To affiliate with and procure the affiliation of financial and kinderal institutions and bodies within the Federal Republic of Nigeria or elsewhere.

4. Acting as an organ of communication for and to represent members of the Association in all or any of their relationships with government departments, local and other public authorities, Trade Association, The Press, radio and television, and any other bodies or organisations and to afford facilities for conferring with and making known the views of members of the association in regard of actual or proposal legislation or any other matters directly or indirectly affecting business interest.

5. To disseminate information, data and statistic among members of the association and to print, publish, issue and circulate papers, periodicals, books, circulars and other literary matters and to promote and organise meetings, conferences, lectures and other activities such as may seem to the association condusive to the attainment of any of its objectives.

6. To do all such other things as are incidental or condusive to the attainment of the above objectives or any of them.

In pursuing its objectives and intended growth for the future, ELAN plans the following on-going activites:

1. Development of lease legislation
2. Development of Documentation for lease transactions.
3. Seminars and training workshops.
4. Public education on leasing matters.
5. Publication of a Newsletter.
6. Representing ELAN at local and international activites.

## 3.5 METHOD OF DATA COLLECTION

International Merchant Bank Plc is chosen as the object of the study, as such the inputs into this research work are collected principally through two main sources namely;

1. Primary sources
2. Secondary sources

### 1. PRIMARY SOURCES:

The primary data are those data that are originated by the researcher for the purpose of the investigation at hand. The main instruments used for the primary source of data collection were as follows:

A. THE CONTEXT ANALYSIS METHOD

This involves an analysis of documented records of transactions, established policies and strict rules and guidelines designed by the Bank. These records are kept in the documentray section of the bank's library, credit files, business development files and some are in the form of video cassettes. This allowed the author to collect first hand information required.

B. THE INTERVIEW METHOD

This is a verbal discussion the author held with some senior executives of International Merchant Bank Plc and officials of other Merchant Banks who are involved in packaging equipment lease finances. Also, frineds and classmates working in other banks were not left out in the discussions.

2. SECONDARY SOURCES

The secondary data are statistics not gathered for the immediate study at hand but for some other purposes.

There are two types of secondary data. They are internal secondary data and external secondary data.

Internal data are those found within the organisation for which the research is being done, while external data are those obtained from outside sources.

The secondary data for this research were extracted from various textbooks, business journals, magazines and Newspapers, Central Bank of Nigeria publications (such as the Bullion, Economic and Financial Review), CBN guidelines to banks, International Merchant Bank Plc publications and Annual Reports, Seminar papers, write ups by individual, journal from Equipment Leasing Association of Nigeria (ELAN) and MBA projects on related areas of study.

## 3.6 METHOD OF DATA ANALYSIS

The data collected are arranged, measured and calculated in such a way to show the general concept of equipment lease finnacing and how it is practised generally in Nigeria by Merchant Banks and International Merchant Bank Plc in particular, which is the case study of the write-up.

# CHAPTER FOUR

# PRESENTATION AND DATA ANALYSIS

## 4.1 INTERNATIONAL MERCHANT BANK PLC (IMB) AND EQUIPMENT LEASE FINANCING

### IMB CORPORATE PROFILE

International Merchant Bank Plc (IMB) is among the oldest leading merchant banks in Nigeria. With over twenty years of experience in merchant banking, it has grown to become a major force in the provision of excellent banking and other financial servies to customers through a network of five branches located in key commercial centres of the country.

The bank commenced operations as a 100% fully owned subsidiary of the First National Bank of Chicago (FNBC) in 1974 when it was incorporated as First National Bank of Chicago Nigeria Limited. FNBC was at the time, one of the top ten wholesale banks in the United States of America, with offices located in major money centres of the world.

In line with the prevailing policy at the time, FNBC, in 1976 relinquished 60% of its ownership in the bank to the Federal government with whom it became joint venture partners Accordingly., the bank changed its name to International Merchant Bank of Nigeria Limited with technical management servies provided by FNBC under the terms of an agreement that expired in 1982. This arrangement held until 1991 when FNBC divested its shares through a sale of its equity holding. The bank became a public limited company (PLC) in 1992 and currently has 10% of its shares in the hands of its employees.

IMB has grown tremendously over the years in all the key indices for measuring bank competiveness From a staff strength of 15 in 1974 when it opened its offices at 20St Gregory's Road in South-West Ikoyi, the bank has in its employment today more than 400 people distributed across the country in its offices located in Lagos, Aba, Kano, Port Harcourt, Kaduna and Abuja. Acknowledge for its experience in the provision of the full range of merchant banking services the bank has over the years, developed some of the best bankers in the industry as evidenced by the more than 20 CEO's furnished to the industry so far. The depth of the skill base in the bank remains a distinguishing hallmark that competitors acknowledge readily.

In 1982, barely eight years after incorporation, IMB Emerged as the leading merchant Bank in the country in terms of assets, profitability and innovativeness. Since then the Bank has been growing from strength to strength. Presently the bank has a total assets of N2.179 billion as at 31st December, 1993 and a paid up share capital of N87.0 million as at the same date.

IMB has been keenly involved in the growth and development of the banking industry. The bank participates actively in the provision of the much needed product and management skills to other banks. For instance, it has technical management services agreements with some banks and other financial institutions to provide them with technical knowhow and expertise. This requires a level of commitment and responsibility that only banks of IMB's stature and maturity can undertake.

With its corporate headquarters located at No.1 Akin Adesola Street in Victoria Island Lagos, its unique building strategically located by the Atlantic Ocean, is a major architectural landmark of corporate Lagos. This same thoughtfulness regarding form and function is also evident in the choice of branch locations throughout the country.

The bank will continue to pursue those strategies identified as relevant for its continuing competitiveness and leadership in the industry. These strategies will drive its future growth and consolidation.

IMB LEASING UNIT

From the early days of leasing in Nigeria, International merchant Bank Plc (IMB) has remained at the forefront, providing excellent leasing services to numerous customers with over 19 years of experience in the leasing business and its leadership position in the industry, the bank is well equipped to meet the needs for small or large asset acquisition today and in the future.

IMB leasing unit consists of a crop of seasoned and well trained professionals versed in the intricacies of packaging a lease facility and dedicated to ever improving services to its customers. At IMB, leases are design to fit the peculiar needs of each customer.

IMB pioneered the syndicated lease in the market and were the first bank to take advantage of the NERFUND financing scheme, the facility was structured as a lease. This way, the Bank has been breaking the grounds in bringing up-to-date leasing services to its customers, striving to carry on the tradition on unrivalled excellence for which IMB is known.

The Bank offers direct lease facilities which enables its customers procure through their needed capital equipment which they use, even though ownership resides with the Bank. Also, a report released by the Equipment leasing Association of Nigeria has indicates that IMB were first in terms of rental income received in 1989. This is a clear testimony of the quality of lease portfolio and the bank credit culture which process premium on quality of leases as opposed to volume.

IMB's services also covers refinancing options for assets already procured by its customers to release funds for working capital that would otherwise have been trapped in assets.

Finally, IMB's portfolio is diverse including mobile, specialised and conventional equipment such as aircrafts, trawlers, motor vehicles, computers and its peripherals, industrial machines and other equipment which the customers require financing for. As at 31st December, 1993 the Bank has a total equipment on lease volume of N220.4 million.

SOME OF THE LEASING FACILITIES GRANTED BY IMB (NIGERIA) PLC

| NO. | COMPANY NAME | TYPE OF EQUIPMENT ON LEASE | FACILITY AMOUNT (N'000) |
|---|---|---|---|
| 1. | Cotton Ginning Ltd | Ginnery Plant | 13,281 |
| 2. | Leventis Technical Ltd | Vehicles/Generator | 5,988 |
| 3. | Mandilas Nigeria Ltd | Vehicles | 30,527 |
| 4. | SCOA Nigeria Ltd | Vehicles | 35,200 |
| 5. | Seven-up Limited | Vehicles/Trucks | 24,000 |
| 6. | Premier Plant Limited | Trucks | 10,000 |
| 7. | President Ind. Limited | Plant/Machines | 13,000 |
| 8. | Tower Allumimium Limited | Plant/Machines | 1,709 |
| 9. | United Spinning Limited | Plant/Machines | 15,000 |
| 10. | Westminister Dredging Ltd | Vehicles | 7,500 |
| 11. | Zenith Plastic Limited | Vehicles/Generator | 4,300 |
| 12. | W.W. Whyte Limited | Tankers/Vehicles/Equipment | 11,100 |
| 13. | Horizon Fibres Limited | Plant/Machines | 6,000 |
| 14. | Chemical and Allied Products Limited (CAPL) | Computers | 1,892 |
| 15. | HFP Limited | Vehicles | 15,000 |
| 16. | Citraco Limited | Plant | 10,000 |
| 17. | Exquisite Ind Limited | Vehicles | 8,135 |
| 18. | Kene Paper Mill Limited | Print | 13,331 |

| NO. | COMPANY NAME | TYPE OF EQUIPMENT ON LEASE | FACILITY AMOUNT (N'000) |
|---|---|---|---|
| 19. | Upright Technical Ltd | Vehicles | 3,500 |
| 20. | Alcon Nigeria Ltd | Vehicles | 2,500 |
| 21. | Cijo Nigeria Limited | Vehicles | 1,059 |
| 22. | East Atlantic Ltd | Vehicles | 1,371 |
| 23. | Mighty Transport Ltd | Vehicles | 3,700 |
| 24. | Nigeria Engr. Works Ltd | Generator/Vehicles | 1,000 |
| 25. | RVSG (Eagle) | Plant | 9,180 |
| 26. | Gongoni Co. Ltd | Machines | 2,000 |

SOURCE: International Merchant Bank (Nig) PLC equipment leasing portfolio report, March 1994

TABLE 4.1A LEASE TRANSACTION OF IMB PLC AS COMPARED TO TOTAL ASSETS

| YEAR | TOTAL ASSETS (N'000) | VALUE OF EQUIPMENT ON LEASE (N'000) | LEASED ASSETS AS A % OF TOTAL ASSETS |
|---|---|---|---|
| 1986 | 947,153 | 19,016 | 2.01% |
| 1987 | 1,732,339 | 75,936 | 4.24% |
| 1988 | 1,854,222 | 118,735 | 6.40% |
| 1989 | 1,953,986 | 127,949 | 6.55% |
| 1990 | 2,212,286 | 189,418 | 8.56% |
| 1991 | 1,968,641 | 174,622 | 8.87% |
| 1992 | 2,169,081 | 137,493 | 6.34% |
| 1993 | 2,179,688 | 220,441 | 10.11% |

Source: Documented Records on leasing obtained from International Merchant Bank Plc (IMB).

TABLE 4.1B LEASE TRANSACTION OF IMB PLC AS COMPARED TO TOTAL LOANS AND ADVANCES

| YEAR | TOTAL LOANS AND ADVANCES (N'000) | VALUE OF EQUIPMENT ON LEASE (N'000) | LEASED ASSETS AS A % OF TOTAL LOANS AND ADVANCES |
|---|---|---|---|
| 1986 | 404,276 | 19,016 | 4.70% |
| 1987 | 614,919 | 75,936 | 12.35% |
| 1988 | 643,099 | 118,735 | 18.46% |
| 1989 | 686,231 | 127,949 | 18.65% |
| 1990 | 752,723 | 189,418 | 25.16% |
| 1991 | 520,517 | 174,622 | 33.55% |
| 1992 | 383,371 | 137,493 | 35.86% |
| 1993 | 476,855 | 220,441 | 46.23% |

Source: Documented Records on leasing obtained from International Merchant Bank Plc (IMB).

From Table 4.1A it can be clearly seen that IMB's leased assets as a % of total assets have been rising steadily through the years. From 2.01% of total assets in 1986 to 10.11% of total assets in 1993 representing a value of equipment on lease of N220.4 million as at 31st December, 1993.

Also, from Table 4.1B it has shown that IMB's leased assets as a % of total loans and advances has also been rising steadily through the years. From 4.70% of total loans and advances in 1986 to 46.23% of total loans and advances in 1993 i.e. occupying N220.4 million of the total loans and advances volume of N467.8 million as at 31st December, 1993.

The tremendous growth of equipment lease transaction of the Bank especially from 1986 to 1993 is associated with its commitments to business in providing capital resources across various sectors of the economy through leasing arrangements.

### 4.1.1 EQUIPMENT LEASING - POLICY ISSUES

PURPOSE

Leases are booked by lessors for three primary reasons:

1. to acquire high quality risk assets;
2. to increase return on assets (ROA) and
3. to aid tax planning and management

QUALIFYING ASSETS

i) The asset must be an earning asset for the lessee.

ii) The equipment must have a market value that is greater than the book value at any point during the life of the lease.

iii) Efforts should be made to lease only moveable equipment which can be used by a broad base of companies. Specialised equipment should not be leased except where an alternative source of repayment is assured which is not dependent upon the use of the leased equipment.

PURCHASE PRICE

i) New Equipment should not be greater than Cost Insurance and Freight costs plus import duty paid. These are to be verified through the Bills of Entry and Treasury Receipts for duty paid or due.

Where equipment is purchased from a local dealer, the purchase price must not be greater then the general market price. This is to be verified by contacting competitive sources.

ii) In a sale-and-lease back arrangement, the purchase price should be no more than 85 per cent of the fair market price of the asset.
In a sale-and-lease back arrangement the lease is conditional upon the issurance of a Certificate of Acceptance by the Federal Ministry of Industries. The lessee will give an undertaking that in the event of a certificate being issued for a lower value than the sale price, the lessee will reduce the lease through a reimbursement of the difference. The amount so paid will be applied to the lease as rentals in an inverse order of maturities.

RESIDUAL VALUE

The residual value should be the lower of:

a) the tax-written-down value at the end of the lease; and

b) an estimated market value of the equipment at the end of the lease;

c) amount so agreed between the lessee and the bank.

PRICING

i) The interest rate used in the calculation of rentals is the price that is quoted to the lessee and stated in the offer letter.

ii) The yield on a lease must not be less than the Bank's projected after tax return on shareholders funds (ROI) for the year. The Bank's projected ROI will be determined during the budgeting process.

iii) Rental is a function of the interest rate and the expected yield. Whenever the prime rate of the lessor is changed, the interest rate and therefore the lease rentals are to be recalculated.

iv) RENTALS will be paid MONTHLY or QUARTERLY in advance or arrears.

PENALTY INTEREST

Interest on past due rentals will be calculated from the due date at the rate of 3 per cent per annum above the lessor's prime rate.

A lease may not be arranged for any asset covered by a debenture or charge held either by the lessor or any other lender.

REPORTS

The following reports should be prepared:

a) Outstanding Leases Report

Period: Monthly - as at end of each month.

Contents:

i) Lessee

ii) Original Lease Amount

iii) Commercement Date

iv) Maturity Date

v) Outstandings

This report will be distributed to:

i) Departmental Heads

ii) Loan Review and Audit

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b) Past Due Rentals Report

Period: Monthly - as at end of months.

Contents:

i) Lessee

ii) Outstanding on lease

iii) Amount past due

iv) Last rental received

This report will be distributed to:

i) Departmental Heads

ii) Loan Review and Audit

FILES

Every lessee must have a Credit file in Credit Administration which should contain:

i) Copy of Commitment

ii) Copy of Lease Agreement

iii) Copy of Title of Equipment

iv) Copy of Insurance Policy

v) Copy of Maintenance Agreement

vi) Other relevant Documents

### 4.1.2 ANALYSIS OF A LEASE PROPOSAL

There are various types of leasing transactions, but we restrict ourselves to the two principal types.

These are finance and operating leases

IAS 17 defines a finance lease as a lease under which "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".

In this type of leasing arrangement, rentals payable during the lease period, which is non-cancellable, are sufficient to cover the initial cost of capital to the lessor and in addition, provide a reasonable return on investment of such funds. On the other hand, an operating lease is a lease other than a finance lease. Hence, in an operating lease transaction all the risks and rewards incident to ownership are not necessarily transferred by the lessor to the lessee. Generally, an operating lease is for a short term, the lessor is at liberty to take possession of the leased equipment and lease to someone else if he so desires. It is especially the case with the leasing of motor vehicles, computers, generating sets and most other moveable assets.

Having this distinction at the back of our minds, we now concentrate on credit issues inherent in a finance lease and the analysis thereof:

1. PRELIMINARY ENQUIRIES

The marketing for a finance lease transaction can commence from various sources:

(a) The lessor can approach the potential lessee for a leasing relationship by direct marketing of lessor's services.

(b) It may be the other way round whereby the lessee makes the initial contact.

(c) Enquiries may be obtained from suppliers of the equipment, hence the word "sales aid" leasing.

(d) Other third parties e.g. financial consultants, brokers etc. From the time the lessor obtains an enquiry for a leasing facility, he (lessor or account officer) wants to ensure that the lessee meets the basic criteria and general credit policy of his organisation. These may be in the form of satisfying such criteria as:

(i) his reason for wanting to lease an equipment. is it for expansion purposes? Is it as a way to raise working capital? etc.

(ii) the cost of equipment. Some lessors may not be interested in leasing an equipment which cost below certain amount of money because of the low returns.

(iii) the expertise or otherwise of the prospective lessee in the use of that equipment.

(iv) the ability of the potential lessee to meet rental payments in view of his tract record e.g. profit in prior years.

(v) may be advisable to try other sources of financing if not qualified for leasing.

As much as this list is not exhaustive, it is after the lessee has satisfied these basic criteria that the account officer can now request for additional information. These information may include but not limited to the following:

(i) A formal letter of application for the facility specifically stating the amount requested for.

(ii) Copy of Certificate of Incorporation.

(iii) Copy of Memorandum and Articles of Association.

(iv) Audited Accounts for at least the past three years.

(v) Cash flow projections to cover the tenor of the lease facility.

(vi) Brief write-up on the shareholders, directors and top management of the company.

(vii) Brief description of the nature of business to include the industry trend and company's market shares, sources of raw materials, manufacturing process, major suppliers and/or customers.

(viii) Current invoice to support the cost of equipment to be leased.

(ix) Detailed technical specifications of the equipment including year of manufacture, make, model, serial number, engine and chassis numbers etc. Most of these information may be found in the feasibility study of a start-up project.

(x) As most lessees treat leasing transaction as off balance sheet items in their audited reports, it may be necessary to request for all existing banking relationships of the potential lessee, including lease obligations, if any. This information is subject to verification by way of credit checks and/or informal inquiries from your colleagues in the other banks. Any reluctance on the part of the prospective lessee to provide such information should make you start getting worried about his credit worthiness.

(xi) A visit to the factory and/or office premises of the prospective lessee may give a first-hand impression of his operations, its staff and general surroundings.

It should be obvious to you if what you see will make him qualify for the size of operations and cost of equipment he intends to lease from you.

It after most if not all the above have been met that the account officer may proceed on the analysis of the lease proposal. With the information provided, the account officer wants to be satisfied with the following, which are not necessarily in order of preference:

(a) The reason for the leasing request must be clearly understood and acceptable to the account officer. He also should be satisified as to whether leasing will adequately meet such prospective lessee's needs.

(b) A prospective lessee must have a proven tract record. It is reasonable to assume that a company that has performed creditably well in the past will continue to do so in the future, all things being equal. Hence the need for audited report for at least the past three years. An equipment can be leased for a start-up project if the promoters can demonstrate previous experience in the same business operation.

(c) The price of equipment which is the subject of the transaction must be suitable to the account officer in terms of:

(i) Type - whether moveable or immovable, new or used.

(ii) Use - since the repayment is from cash flow generated from the use of equipment, the acccount officer must be satisfied that the equipment will be put to use so as to produce adequate income. What is the use of leasing ten Peugeot cars at N150,000.00 each to a company for the use of its executive when they are producing at less than 10% of capacity utilisation with very high overhead?

(iii) Location - accessibility to the location of a leased equipment is essential for frequent checks and claim of title to ownership when and if the need arises.

(iv) Maintenance and Servicing - in view of the fact that the lessor is not in the business of operating the piece of equipment, the account officer must be satisfied that the prospective lessee can maintain the equipment and had made provision for adequate supply of essential spare parts.

A visit to the premises as earlier mentioned is also to ascertain how equipped the workshop is and the calibre of maintenance staff.

Generally speaking, the lessee and not the lessor identifies the equipment to be leased. The suitability of the equipment to the prospective lessee's need is his primary responsibility and he may be asked to execute a delivery and acceptable certificate to ascertain that the equipment was received in good and working condition at the time of delivery. Sometimes, the lessor may want to make an independent enquiry to ascertain the suitability of the equipment. This is especially so when the lessee is proposing to acquire an equipment with new technological devises with substantial improvement over the old one he is used to.

(d) The Memorandum and Articles of Association of the prospective lessee is required to ascertain that the use to which the equipment is to be put is permitted by rules governing the objects of the company. In other words, the company must be able to enter into a leasing transaction and such authority may need to be granted in a formal Board Resolution with mandate given to authorized signatories to execute the lease agreement on behalf of the company.

(e) Copies of the Certificate of Incorporation is to verify the time and for how long th company has commenced operation.

(f) It is very essential that adequate information on the shareholders and top management is obained to ascertain their capability and level of expertise in such line of business. This information will include their age, qualification, positions within the organisation, reponsibilities and relevant experience.

(g) As earlier mentioned, brief description of the nature of business should include the following:

i) Industry trend and company's market share thereof.

ii) Sources of raw materials - locally sourced or highly dependent on importation of raw materials

- In view of the recent scarcity of foreign exchange, what impact will this have on cahslow?
- Any plans to intergrate backward in the future?
- Any suitable substitute available locally?
- Any government ban on imported raw materials e.g. wheat, malt etc

iii) Brief description of the manufacturing process will help account officer appreciate the nature of business and educate management.

iv) Information on the major suppliers and/or customers will help account officer determine the marketability of the company's products and what the future holds for such products in line with current tastes and preferences, consumer's purchasing power and likely government regulations that may affect the products.

(h) FINANCIAL ANALYSIS

One of the most critical aspect of the credit analysis of a leased proposal, as in other credit facilities, is the evaluation of the audited report of the prospective lessee. The audited report must be as current as possible. It is also necessary to examine the management account up to the last quarter of the date of its evaluation.

The account officer must be satisfied with the external auditors and the audit report should be unqualified. Any reservation expressed by the external auditors should be taken very seriously to ensure that it does not adversely affect the status of the report. The copy of audited accounts must be signed by the external auditors and the directors of the prospective lessee to ascertain that it is acceptable to both parties. Generally, in most banks, the financial data of a company is rearranged and sumarised in what is called a spread sheet. Information contained in a spread sheet varies from one institution to another. However, a typical spread sheet should describe the company's performance in light of such broad headlines as:

1. Revenue and profitability
2. Liquidity and asset efficiency
3. Capitalisation and Leverage.

(i) CASH FLOW PROJECTIONS

An equipment leasiing facility is basically a cash flow loan. rental payments are expected to be made out of future earnings generated from the use of the equipment being leased. The prospective lessee should be able to prepare a cash flow projection to cover all least the tenor of the lease facility. Such projections must be reasonable and achievable.

(j) RISK ANALYSIS AND MITIGANTS

It is an acceptable fact of life that there is no business without its own inherent risks however rosy the cash flow may look. It is therefore the duty of the account officer to identify those risks, that are foreseeable. He is also expected to analyse hoow those identifiable risks can be mitigated in view of the prevailing circumstances.

(k) CREDIT CHECK

A credit check or reference is any information you can obtain from any reliable source to ascertain the integrity of the lessee and his ability to service previous financial obligations. The longer the relationship of the prospective lessee and the provider of the reference, the more reliable such reference. Any information in the newspaper or on TV may be useful, among others.

(l) GUT FEELING

After a careful review of all the points highlighted above, it is suggested that the account officer takes a deep breath and ask himself this question - Do I really believe in the lessee's ability to service this lease obligations after all said and done? If you suddenly skip a heart beat or experience an unexpected cold sweat all over your body, may be your gut feeling disagrees with your assessment of the prospective lessee. Always remember that the relationship is non-cancellable, for a considerable length of time and your rental payments depend entirely on his ability to put that equipment to the best use.

You have to believe in his project, [illegible] credit-wo[illegible] you finnaly recommend such to the management for approval

Also, the account [illegible] remember that his own credibility and even career is at stake. All the best as him commit part of the shareholder's fund to a [illegible]tionship that he is convinc[illegible]l be rewarding to all concerned.

4.2 CONDUCTING PHYSICAL INSPECTION OF LEASED ASSETS

Leased equipment should be inspected semi-annually for "A" rate credits and quarterly for lower grade credits.

Frequency of inspection shall be dependent [illegible] type of assets. [illegible]y disposable items should be inspected more frequently.

Lessee should b[illegible]ied of inspection plan i.e.:-

1. The date and time of the inspection
2. T[illegible]al to inspect the assets.

OBJECTIVES OF PERIODIC INSPECTIONS

1. To physical[illegible]ect the state of each equipment.

2. To ensure that the make, models, chasis and engine numbers (for vehicles ar[illegible]rating sets) and any ot[illegible]fication numbers or marks on the leased equipment conforms with [illegible] sale and lease agreements.

3. To ensure that the lessor's identification tags are displayed on the equipment in accordance with the provision of the leased agreement.

4. To physically inspect the state of repair or disrepair of the equipment as the case may be.

5. To physically count the number of equipment available for inspection and ensure that it tallies with the lessor's record.

6. To ensure that the insurance premium are paid by the lessee on the leased asset and the current insurance certificate obtained.

7. To ensure that the lessee fully comply with the maintenance agreement on the equipment as regards maintenance payments.

8. To confirm that where the equipment is affixed to any land or building, it will be possible to remove the equipment without material damage to the equipment, the land or building.

9. To confirm that the lessee has not altered or permit the alteration of the equipment.

10. To confirm that the lessee is not violating any other conditions as contained in the lease agreement relating to the use of the equipment.

# CHAPTER FIVE

## SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

### 5.1 SUMMARY

Merchant banking is a prominent feature in attaining the industrial development aspiration of any country of the world. So, also, is equipment leasing, a function that is performed by most of these Merchant Banks. The growth of equipment lease-financing in Nigeria is largely influenced by the effective performance of Merchant banks in providing medium and long term finances to a large number of industries in the country.

Today, leasing has been embraced as a most varitable means of corporate financing in the face of substantial cost outlay on capital equipments and stringent manner that restrict imports, all brought about by the poor state of the Nation's economy. Equipment leasing has thus brought relief to firms who are strapped of capital to invest in capital projects. Merchant Banks are therefore seen as the provider of medium, long-term and permanent capital which is very crucial to the industrialization of the Nigerian economy.

Also, the following factors have been identified as the main reasons for the growth of leasing business in Nigeria:

- Abolition of import licencing scheme.
- Significant naira depreciation.
- Favourable government policy on import substitution.
- Escalating cost of equipment.
- Liquidity squeeze
- Foreign exchange scarcities.
- Investment allowance on agricultural equipment.
- Increasing awareness of the merits of leasing products.
- Handsome capital allowance available for lessors.
- No extra or additiona; collateral is required.
- Easier documentation process.
- Leasing represents a good hedge against inflation.
- Quicker write-off of an equipment.

In addition, the following factors were also identified to be the main reasons militating against the growth of leasing industry in Nigeria:

- Difficulties lessors encounter in providing certificate of acceptances especially for consortium or syndicated leases.
- Lack of relevant legislations to guide practitioners i.e. absence of leasing law.
- Dearth of expertise in the industry.
- Limited awareness of the benefits and offerings of the products.
- Non-uniformity in the practice of leasing
- Dearth of relevant local literature on equipment leasing.

International Merchant Bank Plc has in 1982 emerged the leading Merchant bank in the country in terms of assets, profitability and innovativeness. Since then the Bank contribution to the economy has been tremendious especially in the leasing industry. In 1989 the Bank was rated first in terms of rental income received in that year. It has since then remain one of the dominant lessors in the country. In 1993, the bank has 46.23% of its total assets invested in equipment leasing.

Also, leasing activities in the country has shown that manufacturing industries are the dorminant lesses among various sectors of the economy as they accounted for over 53% and 52% in 1991 and 1992 respectively of the total leased assets by Merchant banks. Plant/machinery, the engine of industrial production, has received high preference over the years as against other assets acquired by Merchant Banks due to the crucial role they play in the Nigeria economy.

The formation of the Equipment Leasing Association of Nigeria (ELAN) in 1983 has represented a cornerstone in the development of equipment leasing in Nigeria as the existence of the body has fuelled the growth and development of the industry.

Finally, it is pertinent, however, to note that some of the above listed constraints notably those relating to relevant legislation, availability of literature and expertise in the industry as well as lease education are currently being tacked by ELAN. Remarkable progress has been made in the area of creating awareness of the benefits and offerings of leasing as a financing alternative. It is envisaged that with the current vigour and tempo of pursuit by ELAN most of the above constraints listed earlier on will be eliminated in the nearest future and thus pave way for further development and growth in the industry.

## 5.2 CONCLUSION

There is a growing optimism that equipment leasing has very bright prospects in the economy in the foreseeable future. Considering the huge market which Nigeria represents in the sub-saharan African, manufacturing companies in the country have compelling motivation to continue to increase their productive capacities to meet the ever increasing demand for their various products.

Furthermore, given the current poor state of the economy and the attendant harsh economic realities, leasing represents the most reliable financing option in the advancement of the Nigerian economy. It is quite obvious that leasing is a potent tool for rapid industrialization.

This thought is buttressed by the opening paragraph of the 1987 World leasing Yearbook which states thus: "The development of manufacturing and service industries in developed and less developed countries alike owe much to the lease financing technique and it is the development of flexible leasing technique which will be the key to future growth". This statement which reflects the responses to a worldwide survey on the impact of leasing shows that the favourable role this financing can play in the development of NIgerian economy can hardly be over-emphasised.

## 5.3 RECOMMENDATIONS

In order to ensure further growth and development of the young industry, I would like to make the following recommendations as follows:

1. Enactment or formulation of precise regulations concerning uniform accounting and taxation policies on leasing.

2. Formulation of clear cut policies by Federal Inland Revenue Board and streamlining procedures for the procurement of Certificate of Acceptances for claiming capital allowances on leased assets (be it lease syndication of discrete equipment or jointly owned assets, leverage lease or direct lease).

3. Continuation of ELAN's effective and intensive lease education and information programmes and to open branches in all the 30 States of the Federation who will be responsible to organise seminars at local levels, so that the public become more enlightened to the lease finance business.

4. Enforcement of legislation that would permit uniform treatment of leasing and disclosure requirements by both lessors and lessees in order to obviate any incidence of multiple lessors for one and the same equipment especially in a sale and lease back arrangement.

5. Prevelence of healthy competition in the industry particularly with the rapidly increasing number of new entrants arising from the emergence of new banks.

6. Merchant banks should not discriminate among the lessees so that not only the giant multinationals benefits but also the locally small-scale businesses could also benefit.

7. Merchant banks should try as much as possible to transact leasing business with the end user of the equipment, since the asset being financed is primarily the security.

8. Lastly, now that the costs of equipment have more than quadrupled in the recent years, high capital intensive assets such as Aircrafts, Ship and the likes can hardly be sufficiently and adequately funded by one lessor single-handedly. Considering that lease financing has been the key to the development of manufacturing and other industrial sectors, it is now necessary for group lessors to lease such big ticket assets if we must ensure continued developpment of our economy in this era of economic hardship.

As a result of the silence of the Federal Inland Revenue Board or lack of coherent policy on the issue of joint interests in leased assets mostlessors shy away from lease syndication except those that would permit ownership of discrete equipment. To date International Merchant Bank Plc (IMB) is the only lessor that has received formal approval from the Federal Ministry of Industries and the Federal Inland Revenue Board for the lease it syndicated for United Spinners and in which lessors had joint ownership interests.

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