

MASTER OF BUSINESS ADMINISTRATION

MANAGEMENT CENTER
INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

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INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA
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FINANCE LEASES IN MALAYSIA:

PROBLEM AND ISSUE

(FINANCING, ACCOUNTING AND TAX IMPLICATION)

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ABSTRACT

Leasing is a significant source of finance for business of all sizes especially SMI and it creates a significant contribution to the Malaysian economy. This paper describes developments in the leasing industry during 1970s to 2000 and focuses on problems and issues of finance leases faced by lessors in Malaysia. This review examines and analyzes finance, accounting and tax implication on finance leases in Malaysia. The review takes the form of literature search, the writer's leasing experience since 1984, seminars organized by ELAM and relevant laws and regulations.

The number of leasing companies grew from 9 in 1979 to 149 in 1984 but reduced to 34 in 2001. Leasing as a form of financing, nowadays, has declined in popularity as compared to other form of financing, namely industrial hire purchase. Since the introduction of IAS 17 and MASB 10, a finance lease in the lessee's book is no longer treated as off balance sheet financing. These accounting standards require that lease transactions must be presented in accordance with their substance and financial reality and not merely with legal form.

The lessee who are large firms are concerned with the economic and taxation implications when assessing whether to use leasing as a source of finance. For lessors, without good tax planning and foresight on a lease transaction, which is lucrative, it may ultimately turn out to be a loss. A lease transaction can, therefore, achieve a profit before tax but suffer a loss after tax. Hence, taxation is one of the most important aspects of leasing in Malaysia.

APPROVAL PAGE

**FINANCE LEASES IN MALAYSIA:
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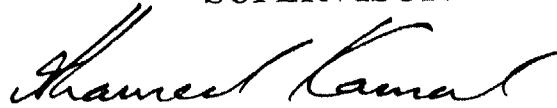
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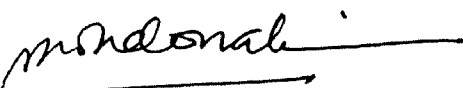
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DECLARATION

I hereby declare that this project paper is the result of my own investigations, except where otherwise stated. Other sources are acknowledged by reference notes and a bibliography is appended.

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CHAPTER ONE

INTRODUCTION

1.1 Objective of Review

The objective of this review is to highlight problems and issues, of the present and the past, which the leasing industry is facing to the students and academician as well as to prospective lessees and lessors. The subject on leasing particularly its technique and concept can be learned by reading textbooks but what happened in practice are normally known to those who are involved in the leasing industry. The writer of this paper, currently a Senior Manager, Accounting, Showa Leasing (M) Sdn Bhd, reviewed the issues and problems for this purpose.

This review will give an insight to anyone interested to use leasing as a form of financing as well as to help prepare those interested to invest in finance leases. To those involved in the leasing industry, this will be a reminder to them to be extra careful when entering into new leasing contract. They should be more aware of the pitfalls and learn how to minimize or avoid pitfalls. In addition, it is hoped that the issues and problem readdress here will provide a basis for authorities concerned to improve and harmonize the relevant regulation so that the industry will further develop.

1.2 Review Methodology

This review takes the form of literature search, the writer's leasing experience since 1984, the papers presented in seminar organized by Equipment Leasing Association

of Malaysia (ELAM) and relevant laws and regulations. The Malaysian Leasing Forum 1984, ELAM seminars and surveys help writer described the history of leasing between 1970s to 1980s. The role of Asset Financing and Leasing Association of Malaysia (AFLAM) and outlook of leasing industry were obtained from AFLAM 2000/2001 report. Relevant paragraphs from IAS 17 and MASB 10 are extracted to show how the requirement affects the leasing industry. The law, particularly Income Tax Act and Income Tax Leasing Regulation 1986 is the significant source of reference. The tax implications is demonstrated in workshop and seminar organized and presented by Equipment Leasing Association of Malaysia (ELAM) and KPMG.

The writer has been with two leasing companies for almost eighteen (18) years. The issues and problems faced in the industry are encountered by him during his employment. The writer is also involved in the issue of separate sources of income and the basis of allocation of interest and common expenses disputed by IRB. He had prepared the analysis of accounting record for his employer's Tax agent, KPMG and the lawyer, Lee Hishamuddin & Co. against IRB for appeal to the Special Commissioners of Income Tax – Rayuan No. PKR 18/97.

The other reference materials not mentioned above are included in a list of bibliography stated after the last chapter of this paper.

1.3 Approach of Review

The approach to this review is to look firstly at the definition of finance leases and its advantages to the lessee and the lessor. This is followed by describing the history of leasing in Malaysia and explaining the role of Asset Financing and Leasing

Association of Malaysia, AFLAM, formerly known as ELAM. The accounting issue and its implication are highlighted along with the relevant requirement of IAS 17 and MASB 10. Lastly, the tax issue and its implication on leasing are discussed with particular reference to Income Tax Leasing Regulations 1986 (ITLR 1986).

1.4 Significance of Review

Tax

The leasing business is fraught with numerous tax implications. For lessors, without good tax planning and foresight on lease transaction, which is lucrative may ultimately, turn out to be a loss. A lease transaction can, therefore achieve a profit before tax but suffer a loss after tax (refer illustration no. 1 and 7).

Financing

Leasing industry was flooded with companies running leasing business between late 1970s to 1984. The number of leasing companies grew from 9 in 1979 to 149 in 1984 but dropped to 34 in 2001 (*Source: AFLAM Annual 2001/2001 Survey*). Nowadays, leasing as a form of financing decline in popularity as compared to other form of financing, namely industrial hire purchase.

Accounting

“Lessee should recognize finance leases as assets and liabilities in their balance sheets at amounts equal at the inception of the lease to the fair value of the leased property or, if lower, at the present value of the minimum lease payments.”

(Paragraph 15, MASB 10)

Since the introduction of IAS 17 and MASB 10, a finance lease in the lessee's book is no longer treated as off balance sheet financing. These accounting standards require that lease transactions must be presented in accordance with their substance and financial reality and not merely with legal form. Since the leased assets are included in the lessee's balance sheet, return on capital employed is not inflated. Similarly, if future lease rental is recorded as liability, the level of obligations of the lessee is not understated. Hence, the leverage ratio will not be reduced (refer illustration no. 2(a)). This will reflect a true picture of lessee's financial to the stakeholders. This requirement is not an advantage to lessee. The lessor also could no longer use this as an advantage item to attract lessee.

In order to understand the above better and to know more of other issues and problems, the following chapter gives us an idea as to what is leasing and what are the benefits that finance leases offer to lessees and lessors.

CHAPTER TWO

FINANCE LEASES

2.1 Definition

Lease is an agreement whereby the lessor conveys to the lessee the right and the benefit to use an asset for an agreed period of time in return for a payment or series of payments.

Leasing is an attractive alternative to purchasing. Many small businesses now lease various kinds of assets, such as motor vehicles, computer, office furniture, manufacturing machinery, heavy equipment and other items of productive use. Leasing may provide a small business with lower initial and monthly costs, allowing the business to conserve its capital. Lease payment, if made in the course of business is deductible for income tax purposes. The two types of leases are operating lease and finance lease. Any lease, which is not a finance lease, is to be regarded as an operating lease. The operating lease is normally structured for shorter period whereas finance lease is for longer duration.

Finance lease is a kind of lease that is normally uses by a business in acquiring equipment that would otherwise be purchased. The typical financial lease calls for periodic payments, usually monthly. The term of the lease approximates the useful or economic life of the equipment and the lessee acquires the equipment at the end of the lease period. The lease is non-cancelable and the lessee usually maintains and repairs the equipment throughout the lease term. The lease secures recovery of capital and

fair return to the lessor. In short, the lessee enjoys most of the benefits of ownership and also most of the obligations, but does not own the equipment.

2.2 Advantages

The advantages of financial leases to the lessees are as follows: -

- (a) Collateral free – collateral for leasing is the equipment itself together with the directors' guarantees. In most cases, landed property or other assets are not required as collateral. This will facilitate the application process.
- (b) Cash flow protection – leasing eliminates the need for huge outlay of cash as compared to outright purchase. It is an additional source of capital that leaves working capital sources intact.
- (c) Conserves line of credit – line of credit approved by the bank is kept for emergency use and other important needs when a business opts for leasing.
- (d) Financial reasons – effective interest rate is lower. Hence, the present value of after-tax leasing cost is lower as compared to cost of purchase.
- (e) Low monthly payments – lease rental is lower than conventional financing as term of lease can be customized to meet the budget.
- (f) Tax advantages – lease rental is fully deductible business expense. Furthermore, the deduction is spread over a shorter period as compared to capital allowance (if asset is owned by outright purchase) where the period of claim is longer.
- (g) Hundred per cent financing – it is less restrictive form of financing that will protect and preserve cash flow. The down payment money, which is normally required by other form of margin financing, is therefore available for working capital needs.
- (h) Flexible lease period – lease period is varied ranging from two years and above.

- (i) Option to buy – at the end of lease term, the lessee may decide to own the asset by paying a nominal value, being the market value reduce by rebate of rental. However, in practice this option is not specifically stated in the leasing agreement so that it will not resemble the sale agreement as define by ITLR 1986.
- (j) Hedge against inflation – lessee is paying rental based on today's prices of equipment out of tomorrow's profit.

The advantages of financial leases to the lessors are as follows: -

- (a) Tax advantage – accelerated depreciation allowance enable lessors to build up capital allowance reserve to shelter the income from leasing source. This tax saving is then pass on to the lessees in the form of lower lease payment.
- (b) Additional income – beside income from lease financing the lessor also at the beginning of secondary period will receive renewal rent income for new lease term. However, if the lessee choose to terminate the agreement, the equipment will be sold at market value and the proceed, less rental rebate is to be paid to the lessor. The net proceed is the additional income to the lessor (refer item A13 of illustration no. 1).
- (c) Risk-taking lessors – traditionally, bank looks more to the general credit worthiness of a business requesting the loan than to the equipment itself as collateral. Leasing companies on the other hand look mostly to the equipment as collateral. Hence, a leasing company would be more likely to lease to a new business entity lacking a financial track record.
- (d) Resale value of repossessed equipment – The nature of leasing market emphasizes equipment's collateral value. This led to many leasing companies specializes in leasing only certain types of equipment and gives them access to and

understanding of resale markets. The risk of the lessor is minimized, as they are able to resell quickly repossessed equipment. Hence, this will encourage lessor to depend more on the equipment value than on the general credit of the lessee.

- (e) Deposit leases – deposit leases are not the leases where lessors hold deposit paid by lessee. This is a form of margin financing extended by lessor to lessee. For instance, lessor pays 80% of equipment's cost while lessee pays the remainder 20% to supplier. Nevertheless, the owner of the equipment is still the lessor who gains advantage of claiming 100% capital allowance.

In delivering the benefit to both lessee and lessor, leasing industry went through a few economic cycles and experienced its share of fortune as well as challenges. The following chapter will describe the history of leasing.

CHAPTER THREE

ASSET FINANCING AND LEASING ASSOCIATION OF MALAYSIA (AFLAM) formerly known as EQUIPMENT LEASING ASSOCIATION OF MALAYSIA (ELAM)

3.1 History of Leasing in Malaysia

Leasing started in Malaysia in 1970 while UK, Japan, Australia and US had already developed during that period. The leasing industry at that time was still at infancy stage. The modes of financing acquisition of equipment for business firm, at that time, were through self-generated fund, overdraft, bank loan and hire purchase. The traditional HP, however, was not flexible and caters mostly small capital equipment with shorter duration period. Leasing therefore proved to be an attractive form of financing especially for small and medium sized business that had no strong financials or good collateral.

In 1974, United Orient Leasing Co. Berhad was the first leasing company to be incorporated in Malaysia, although some form of leasing agreement had already been signed by finance companies. Thereafter, leasing was carried out not only by finance and leasing companies but also by merchant banks and traditional credit and hire purchase companies. Commercial banks are not allowed to carry out leasing business in Malaysia.

In 1979, there were only nine leasing companies in operation. During that year, several categories of goods were removed from the list of HP Act 1967. The Central Bank had put pressure on finance companies to increase their lending to priority

sectors. As a result, HP transactions involving Non-Act goods such as heavy equipment became too expensive. To large extent, this had encouraged the growth of leasing as an alternative form of financing.

The structure of the industry at that time can be classified into three broad categories of lessors:

Leasing companies: The major one include United Orient Leasing Company Berhad, Arab Malaysia Credit Bhd, Pembangunan Leasing Corporation Sdn Bhd, Amanah International Finance Sdn Bhd, MBF Leasing Sdn Bhd, D & C Leasing (M) Sdn Bhd, BBMB Leasing Bhd, UMBC Leasing (M) Sdn Bhd, and Sogelease (M) Sdn Bhd. The Japanese joint-venture leasing companies in Malaysia are Crown Leasing Corporation (M) Sdn Bhd, Showa Leasing (M) Sdn Bhd, Sime Diamond Leasing (M) Sdn Bhd and United Orient Leasing Company Bhd. All of them are members of the Equipment Leasing Association of Malaysia.

Finance companies: Traditionally, finance companies have been marketing HP to finance mainly consumer items such as cars. They started leasing because there is a maximum rate chargeable for HP whereas leasing there is no such ceiling imposed by any regulation at that time.

Merchant banks: There were 12 merchant banks in Malaysia. Most of them are joint ventures between local and foreign financial institution and engaged in leasing as sideline. Merchant banks' activities in leasing are restricted. They must have at least 30% of their income in the form of fees. Furthermore they are funded by short-term funds in the money market, the interest for which fluctuates greatly. This makes it

risky to finance fixed rate medium and longer-term leases, which are locked in the lease rental payment.

The period of growth for leasing industry was between 1979 to 1982. There was no specific act controlling the industry whereas HP Act governs a HP transaction. The Malaysian courts had held that leasing agreements are valid and enforceable just like any other commercial contracts unless such agreements are shown to be void or illegal or against public policy. The legal nature of a lease contract equivalent to that of a contract of bailment, which is statutorily defined by section 101 of the Contract Act, 1950 (revised 1974). As for the lessee, they benefit from off balance sheet financing until the introduction of IAS 17 (refer illustration no. 2(b))

In 1979, The Equipment Leasing Association of Malaysia (ELAM) was formed to spearhead consolidation and rationalization in the industry. This highlighted a significant development in the leasing industry.

The number of leasing companies grew from *9 in 1979 to about 149 at the end of 1984 (source: ELAM Annual Survey)*. This figure excludes credit and leasing companies who were not members of ELAM. The reason for too many leasing companies was because of non-financial group of companies forming leasing subsidiary so as to maximize tax advantage. They extended leasing business to third party after absorbing in-house business within the group. Also, the fallacy commonly held by companies who were not familiar with the leasing industry is that leasing offers the prospects of high profitability. It was true that in 1970s there was high

profitability but in later years that was not the case. Since 1982, the market had taken a turn from a 'sellers market' to a 'buyers market'.

3.2 Leasing Industry in 1980s

Bank Negara through Banking and Financial Institution Act 1989 (BAFIA) in 1984 has regarded leasing companies as non-bank financial intermediaries. The leasing companies are required to submit statistical economic data on quarterly basis. In gazette notification No. 1484 dated 2 June 1986, the Ministry of Trade & Industry has laid down that a company may **not use** the word "**leasing**" as part of its name unless the prior approval of the Minister has been obtained. This applies only to new companies seeking registration with the Registrar of Companies and affects the entry of new leasing companies into the industry, whether local or foreign incorporated.

ELAM in its annual surveys states that leasing companies encountered various problems during this period. **Competition** was serious as there were too many leasing companies operated since late 70s to early 80s. The independent leasing companies considered the banks' subsidiaries and associates as posing serious threat to them.

During the period many lessors were reported to face with **double or multiple financing**. Unscrupulous lessee who currently had leasing facility obtained financing from another leasing company on the same asset. This was done by lessees with the collusion of "suppliers" of equipment who later channel the fund to the lessees. Another way is that the lessee offers the existing lease equipment as "collateral" by arranging sale and lease back with another lessor. This is a fraud under Malaysian Law as the lessor is unaware of this situation. If the account is in default both lessors

encounters problem in repossessing the asset. The transaction is similar to financing without collateral. This risk happened because of lack of prudence on the part management, as the market was so competitive. **Repossession** was inevitable, as there were many delinquents' accounts during this period. As a measure against double financing, ELAM had set up a Registry of Leased Assets (**ROLA**) at the beginning of 1988.

Another problem is that the leased asset is regarded as fixture, and becoming a part of the land. To prevent **reputed ownership** from operating, the lessor obtains the landowner's acknowledgement that the equipment belongs to the lessor. The lessor also provides the equipment with plates indicating the equipment belongs to the lessor.

The **off balance sheet** financing previously advantageous to the lessee was no longer allowed with the introduction of IAS 17 in January 1987. Members in the leasing industry discussed the consequence of the issues before and after the IAS 17 were introduced. The **residual value** was also high during this period, which is costly for the lessee to acquire the asset at the end of lease period. Leasing of **non-qualifying assets** and restriction on **non-commercial vehicle** and the **withdrawal of ADA** by Minister of Finance also put lessor on the disadvantage position.

Funds for leasing companies come mainly from commercial banks and merchants banks, through direct borrowing, revolving credits or overdraft. It was increasingly difficult for independent leasing companies to borrow from the banks as the latter

regard the leasing companies as competitors to their leasing subsidiaries. The freezing on foreign borrowing at that time also add on to this problem.

Another problem that tarnished the image of leasing industry was **double funding** by leasing companies. In a situation where funding was difficult, some leasing companies have actually pledged the leasing papers (agreement) with more than one bank. This was actually obtaining funds on the same security. To overcome this lender now accepts only the original rather than the certified true copies.

The cost of funds was **high** with the **interest rate** range between *8.7 to 12.80 per cent* (source: *V.1 Interest Rate: Banking Institutions, Bank Negara*). With higher cost of fund and lower effective rate for leasing income (due to stiff competition) the net interest margin earned were squeezed. When the interest rate was on an increasing trend and the fund obtained was on the floating rate basis, the leasing companies were adversely affected as lease rental income was locked at a fixed rate.

3.3 Leasing Industry in 1990s

Though leasing companies are regarded as schedule institution under Banking and Financial Institution Act 1989 (BAFIA) but in practice leasing decisions are guided by the Income Tax Leasing Regulation 1986. Problems on disposal value of leased asset, early termination and “lease becoming sale agreement” surfaced. The most crucial, is the **issue of separate sources of income and the basis of allocation of interest and common expenses**. The issue was debated by the industry including tax and accounting professions who disagree with IRB ruling.

However, despite the above issue, **lease receivable assets** stood as high as *RM2.5 billion in 1991* and reached *RM2.9 billion in 1996*. In 1999, when the economy slowdown due to currency turmoil which began in July 1997, the lease receivable assets went down to *RM1.5 billion*. (Source: *IV.3 Leasing and Factoring Companies: Statement of Assets and Liabilities, Bank Negara*).

3.4 Role of AFLAM (previously known as ELAM)

The objective of Asset Financing and Leasing Association of Malaysia (AFLAM) is to encourage, promote and protect the interest of its members in carrying out their business as asset financiers, equipment leasing companies, equipment rental companies or firms, manufacturer, importers, exporters and dealers of equipment. AFLAM communicates on behalf of its members and represent them in dealing with governments departments and authorities. This could be seen in the tax and accounting issues where AFLAM made representation to IRB and Accounting Association. It disseminates information, publishes periodicals and organizes conference and seminar among its members.

*AFLAM, in its 2000/2001 annual report state that over the years, the portfolio of leasing companies has changed. **Leasing** as a form of financing **decline in popularity** as compared to other forms of financing, namely **industrial hire purchase**. Leasing has become unattractive when **investment incentives** are extended to business in certain industries. With the **tax problems and issues** and two economic **recessions**, the popularity of leasing declined.*