



CANADIAN FINANCE & LEASING ASSOCIATION  
ASSOCIATION CANADIENNE DE FINANCEMENT ET DE LOCATION

# *CFLA Backgrounder*

## ON THE ASSET-BASED FINANCING, EQUIPMENT & VEHICLE LEASING INDUSTRY IN CANADA

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15 Toronto Street, Suite 301, Toronto, Ontario M5C 2E3  
Telephone: (416) 860-1133 - Toll-free: 1(877) 213-7373 - Fax: (416) 860-1140  
Email: [info@cfla-acfl.ca](mailto:info@cfla-acfl.ca) - Internet: [www.cfla-acfl.ca](http://www.cfla-acfl.ca)

## WHAT IS ASSET-BASED FINANCING?

Asset-based financing is the financing of equipment, vehicles and related assets by way of specific asset-based priority financing, that is, the financing of particular equipment and vehicles and related items or services, primarily by way of lease, but also by secured loan or conditional sales contract.

The specific assets financed secure the borrower's unconditional obligation to make payments over the term of the agreement. In this way, users of equipment and vehicles can use the value of the asset as security to finance its acquisition. This form of financing relies on cash-flow-based credit analysis. Because the financing company retains legal ownership of the asset until the lease end, it allows a business or person to qualify on generated cash flow rather than on a net worth lending formula basis as typically offered by traditional lenders.

Funding for this industry comes from commercial markets, notably from pension funds, insurance companies and banks. In addition, well-capitalised manufacturing and servicing companies with substantial earnings have decided to leverage their own equity base and core competencies rather than using third parties. This has led to many manufacturers establishing their own financing arms or partnering with those who manage it for them.

The services of the leasing industry are complementary to traditional banking and other financial lending in providing incremental capital to increase the pool of available credit in Canada and provide a vital competitive alternative in the financial services sector.

## ASSET-BASED FINANCING, PRODUCTIVITY AND ECONOMIC GROWTH IN CANADA

*"The rise in asset-based financing from 1992 to 2002 improved living standards in Canada by 2.3% (or about 8% of the 26.8% increase in Canada's living standards over that period)."*

*"Asset-based financing, investment and economic growth in Canada",  
an economic research study by The Centre for Spatial Economics, December 2004*

*"This unique study ("Asset-based financing, investment and economic growth in Canada") overwhelmingly demonstrates the importance of asset-based financing to Canada's economic growth by supporting greater product financial choice and innovation. The industry contributes a disproportionate share to higher living standards."*

Dr. Jack Mintz, President of the C.D. Howe Institute and  
Deloitte Professor of Taxation at the Rotman School of Management,  
University of Toronto

*"The key to raising the standard of living of Canadians is to improve productivity. By facilitating the acquisition of productive assets by Canadian businesses and consumers, the asset-based financing and leasing industry is enabling Canadians to work smarter."*

Joe LaLeggia, Chairman, Canadian Finance & Leasing Association

## TABLE OF CONTENTS

<b>THE ASSET-BASED FINANCING, EQUIPMENT &amp; VEHICLE LEASING INDUSTRY ...</b>	<b>1</b>
How did asset-based financing and leasing start? .....	1
The International market .....	2
The Canadian market .....	2
The “invisible” industry .....	5
<b>ASSET-BASED FINANCING, PRODUCTIVITY AND ECONOMIC GROWTH IN CANADA</b>	
Key findings .....	5
Policy Implications .....	5
<b>WHAT IS ASSET-BASED FINANCING &amp; LEASING?</b>	
.....	<b>5</b>
What is asset-based financing? .....	5
What is a lease? .....	5
Equipment: finance vs. operating leases .....	6
Vehicles: closed-end vs. open-end leases .....	6
Equipment and vehicles commonly leased .....	7
The M.U.S.H. Sector .....	8
<b>THE UNIQUE NATURE OF LEASING .....</b>	<b>8</b>
Leasing is not lending .....	8
Why do businesses lease - A small business example .....	8
The strengths of leasing .....	9
• <i>Efficient use of capital</i> .....	9
• <i>Fixed-rate financing</i> .....	10
• <i>Expertise</i> .....	10
• <i>Customer service</i> .....	10
• <i>Speed</i> .....	11
• <i>Flexibility</i> .....	11
• <i>Equipment and vehicle upgrading</i> .....	11
• <i>Off-balance sheet financing</i> .....	11
• <i>Simpler security arrangements</i> .....	12
• <i>Lower transaction costs</i> .....	12
• <i>Little cash required</i> .....	12
• <i>Sales tax deferral</i> .....	12
<b>SUMMARY OF EQUIPMENT/VEHICLE FINANCING OPTIONS .....</b>	<b>13</b>
<b>TEN QUESTIONS TO ANSWER <i>BEFORE</i> SIGNING A LEASE</b>	
<b>HOW TO CONTACT CFLA .....</b>	<b>13</b>
<b>CFLA FURTHER REFERENCE DOCUMENTS</b>	

## THE ASSET-BASED FINANCING, EQUIPMENT & VEHICLE LEASING INDUSTRY

The Canadian Finance & Leasing Association (CFLA) is the non-profit association that represents the interests of those active in the asset-based financing, equipment and vehicle leasing industry in Canada. The 235 members of CFLA cross the financial services spectrum from manufacturer finance companies and independent leasing companies, to banks, insurance companies, trust companies and investment dealers. The customers of this industry are Canadian small, medium and large business as well as consumers.

As described in greater detail on page • of this *Backgrounder*, asset-based financing is the financing of equipment and vehicles and of related items or services, primarily by way of lease, but also by secured loan or conditional sales contract. **Cash-flow-based credit analysis** is a primary financial innovation of this industry. Because a leasing company retains ownership of the leased equipment or vehicle, at least until the end of the lease, it enables a lessee to qualify for use of the asset leased based on its generated cash flow rather than the lessee's credit history, assets or capital base.

Funding for this industry comes from commercial markets, notably from pension funds, insurance companies and banks. In addition, well-capitalised manufacturing and servicing companies with substantial earnings have decided to leverage their own equity base and core competencies rather than using third parties. This has led to many manufacturers establishing their own financing arms or partnering with those who manage it for them.

The CFLA members' list reveals that many are manufacturer finance companies. Sometimes called "captives", these companies include Caterpillar Financial, Cisco Systems Capital, DaimlerChrysler Financial Services, Dell Financial Services, Ford Credit, GMAC, IBM Global Finance and John Deere Credit.

These captive finance companies are an integral part of the production and sales cycle of their manufacturer parent. They are a key part of the relationship linking the manufacturer to the dealer and distributor to the customer.

Interestingly, captives start off offering to finance their parents' products but once they understand the business, many expand their horizons to finance not only similar products made by other manufacturers but to finance products their parent company does not manufacture at all.

Asset-based financing and leasing are not intended to replace traditional bank financing but to complement it, to offer a competitive alternative, providing incremental capital to increase the pool of available credit in Canada.

### How did asset-based financing and leasing start?

According to the International Finance Corporation, the private sector arm of the World Bank<sup>1</sup>, leasing can be traced back thousands of years, although it has evolved considerably over the last fifty or so. The industry has grown from being a manufacturer-selling technique into a specialized financial service with the formation of the first independent leasing company in 1952 in the United States. The industry extended to Europe and Japan in the 1960s, then to Canada, and has been spreading throughout developing countries since the mid-1970s. By 1994, leasing had been established in over 80 countries.

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<sup>1</sup> *Leasing in Emerging Markets*, Lessons of Experience Series, The World Bank, Washington D.C., 1996

More recently, we have witnessed the significant growth of independent financing companies of all sizes from the very large operating in dozens of countries, to a myriad of small and medium-sized businesses specializing in the financing of particular kinds of equipment and vehicles.

CFLA members are pioneering joint venturing, out-sourcing, partnering other services out or creating alliances for financial risk-sharing. In many ways, they are symbolic of changes the financial services sector is undergoing. Their innovative products and services are a driver of change in financial services.

### The international market

To put this industry's growth in some perspective, just over twenty-five years ago, in 1978, annual plant and equipment leasing volumes world-wide (excluding vehicles and real estate) were about US\$40 billion. By 1986, plant and equipment leasing had grown to almost US\$175 billion and by 2004, world-wide annual plant and equipment leasing volumes had grown to US\$511.66 billion. In 2004, Canada ranked seventh in the world in annual plant and equipment leasing.<sup>2</sup>

According to both the United Nations and the World Bank, in 1994 an eighth of the world's private investment was financed through leasing; a third of the OECD countries<sup>3</sup>, private investment is financed through leasing; in both middle and low-income countries, leasing doubled between 1988 and 1994.<sup>4</sup>

### The Canadian market

In 1998, the federal (MacKay) Task Force on the Future of the Canadian Financial Services Sector reported that the assets of the asset-based financing and leasing industry in 1997 totaled \$50 billion<sup>5</sup>. By 2004, the value of the assets of the industry had increased over 100% to \$103.1 billion.

At December 31, 2004, the industry's portfolio of assets (owned and managed) was estimated to be worth **\$103.1 billion**<sup>6</sup>. The value of assets financed by

- equipment financing companies = \$48.4 billion
- business vehicle fleet financing companies = \$8.0 billion
- consumer vehicle financing companies = \$46.9 billion.

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<sup>2</sup> According to the London Financial Group Global Leasing Report, published in the *World Leasing Yearbook 2005* (Euromoney Publications, Colchester, U.K.), the global annual (2004) leasing volume for plant and equipment (excluding vehicles and real estate) was US\$511.66 billion. On the basis of annual lease volume, the top ten countries are the United States, Japan, Germany, France, Italy, the United Kingdom, Canada, Spain, Australia and Switzerland.

<sup>3</sup> The 30 member states of the OECD (Organisation for Economic Co-operation) include Canada, the United States, the member countries of the European Union, Japan, Korea, Australia, the Czech Republic, Poland, Hungary and Mexico.

<sup>4</sup> *Leasing - Lessons of Experiences*, The United Nations Economic Commission for Europe. A conference room paper prepared within the framework of the Regional Advisory Services Programme of the Coordinating Unit for Operational Activities of the United Nations Economic Commission for Europe for the Project Group on *Financial Policies for Strengthening SMEs through Microcredit and Credit Guarantee Schemes of the Southeast European Cooperative Initiative (SECI)*, Geneva, June 1997, at page 4.

<sup>5</sup> *Report of the Task Force on the Future of the Canadian Financial Services Sector*, September 1998, at page 43.

<sup>6</sup> *Annual Survey of Asset-based Financing and Leasing in Canada*, The Centre for Spatial Economics, Milton, Ontario, 2005, at page 11.

Our best estimate is that about 60% of the industry's customers are small and medium-sized businesses (SME).

According to Statistics Canada, business spending on machinery and equipment in 2005 is expected to rise to \$99.8 billion.<sup>7</sup> Around 25% of annual new business investment in machinery, equipment and commercial vehicles is financed by this industry,<sup>8</sup> which is a significant advance from 5% or less, just 15 years ago.

On the vehicle financing side, over the five years 1998-2003 nearly 8 million new passenger and light trucks were sold in Canada<sup>9</sup> - over 40% were leased. In 2004, of the 1,534,400 total passenger and light vehicle sales in Canada,<sup>10</sup> approximately 43% (about 660,000) were acquired by way of lease (88% by consumers and 12% by business customers - vehicles for management, sales forces, maintenance/repair services, general transportation and deliveries.)<sup>11</sup>

In addition, it should be noted that about one-third of larger trucks on the road are single owner-operated. A classic SME, a high percentage of trucks are leased.

### **The "invisible" industry**

*The Financial Post 500* list, the self-styled "most authoritative guide to corporate performance in Canada" is published in June of each year. When the 1987 top 100 financial institutions are compared with the 2004 list (released in June 2005), it reveals that 35 financial institutions listed in 1987, mainly trust companies, do not appear today. They were replaced principally by credit unions.

Interestingly, in 1987 there were four asset-based financing or leasing companies listed<sup>12</sup> among the top 100 financial institutions in Canada. By 2004, the number was still four<sup>13</sup> Absent from the latest listing were multi-billion dollar financing institutions like Caterpillar Financial Services, The CIT Group, GE Capital, and IBM Global Finance – Canada - all very active in Canada and most candidates for the top 50 financing institutions in this country. These companies figure among the top 25 equipment financing/leasing companies in the United States<sup>14</sup>.

*The Financial Post* also failed to mention any of the non-North American vehicle manufacturer finance companies, notably Honda Finance, Nissan Finance, Toyota Credit, and VW Credit, nor did it refer to large independent business vehicle financing institutions active in Canada such as PHH Vehicle Management Services or ARI Financial Services.

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<sup>7</sup> *Private and Public Investment in Canada, Intentions 2005*, Statistics Canada (61-205-XIB), *The Daily*, February 23, 2005

<sup>8</sup> See footnote #5, at p. 12

<sup>9</sup> Desrosiers Automotive Consultants Inc., Richmond Hill, Ontario

<sup>10</sup> Desrosiers Automotive Reports, *Market Snapshots*, Richmond Hill, Ontario, November 2005  
<http://www.desrosiers.ca/pdfs/sales.pdf>

<sup>11</sup> See footnote #5 at pp. 25-26

<sup>12</sup> *The Financial Post 500* for 1987 (published in the Summer 1988) listed four asset-based financing and leasing companies: General Motors Acceptance Corporation of Canada (17<sup>th</sup>), Ford Credit Canada Ltd. (24<sup>th</sup>), Chrysler Credit Canada Ltd. (32<sup>nd</sup>) and GE Capital Equipment Finance Inc. (100<sup>th</sup>).

<sup>13</sup> *The Financial Post 500* for 2004 (published in June 2005) only listed four asset-based financing and leasing companies: General Motors Acceptance Corporation of Canada, DaimlerChrysler Financial Services, Ford Credit Canada Limited and John Deere Credit Inc.

<sup>14</sup> *The Monitor 100* (<http://www.monitordaily.com/>) the 100 Largest Equipment Finance/Leasing Companies in the U.S. in 2004, Monitor Leasing & Financial Services, Ardmore, Pennsylvania.

The evolution of financing institutions has outpaced the capacity of the tracking systems to understand what is really going on. What is important to note here for SMEs is that there are significantly more sources of credit, capital and financing available than they may know about.

## ASSET-BASED FINANCING, PRODUCTIVITY AND ECONOMIC GROWTH IN CANADA

*Asset-based financing, investment and economic growth in Canada*<sup>15</sup>, a recently published groundbreaking study prepared by The Centre for Spatial Economics, a respected, independent group of economists who are also retained by the federal Department of Finance, has found that:

***“the rise in asset-based financing from 1992 to 2002 improved living standards in Canada by 2.3% (or about 8% of the 26.8% increase in Canada’s living standards over that period).”***<sup>16</sup>

This study presented the following key findings and policy implications.

### Key findings

**Investment drives productivity** – economic research states that machinery and equipment investment directly contributes to labour productivity gains by increasing the amount of productive capital available for workers to use. Research also suggests that machinery and equipment investment is either directly the agent of technological change, or else an important facilitator in the diffusion of new technology.

**Productivity raises living standards** – in order to boost living standards either labour productivity needs to rise, or people need to work harder, or more people need to become employed, or more people of working age need to enter society relative to total population. Canadian living standard gains rely primarily on labour productivity growth.

**Financial system development promotes investment** – research conducted by the OECD supports the notion that financial system development promotes capital spending and that countries with weaker financial systems are unable to effectively channel domestic or global savings towards new investment opportunities.

**Asset-based financing adds significantly to the financial system** – the analysis in this report finds that asset-based financing was responsible for a 2.3% increase in Canada’s living standards over the decade 1992 to 2002 (or about 8% of the total increase in Canada’s living standards over that decade). Asset-based financing makes a significant positive contribution to increasing national living standards.

### Policy Implications

**Financial innovation** – financial choice and innovation need to be encouraged in order to maintain a healthy and growing financial system. A dynamic financial system is one of the key factors in promoting investment, raising productivity and, therefore, improving our standard of living.

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<sup>15</sup> *Asset-based financing, investment and economic growth*, The Centre for Spatial Economics, Milton, Ontario, December 15, 2004 [http://www.cfla-acfl.ca/files/public/CFLA-Final\\_Economic\\_Report-PDF-Dec04.pdf](http://www.cfla-acfl.ca/files/public/CFLA-Final_Economic_Report-PDF-Dec04.pdf)

<sup>16</sup> See footnote #15, at p. 62

**Tax policy** – government policy in Canada does not encourage investment in machinery and equipment to the degree that the economic research suggests would be optimal. Therefore, a strategy of improving the economic climate for machinery and equipment investment should pay significant dividends in terms of stronger economic growth, higher productivity and living standards for Canadians for many years to come. This could be done in a horizontally equitable manner by encouraging all forms of investment spending because of the potential complementary nature of machinery and non-machinery investment in boosting economic growth and productivity.

## **WHAT IS ASSET-BASED FINANCING & LEASING?**

Asset-based financing is the financing of equipment, vehicles and related assets by way of specific asset-based priority financing, that is, the financing of particular equipment and vehicles and related items or services, primarily by way of lease, but also by secured loan or conditional sales contract.

The specific assets financed secure the borrower's unconditional obligation to make payments over the term of the agreement. In this way, users of equipment and vehicles can use the value of the asset as security to finance its acquisition. This form of financing relies on cash-flow-based credit analysis. Because the financing company retains legal ownership of the asset until the lease end, it allows a business or person to qualify on generated cash flow rather than on a net worth lending formula basis as typically offered by traditional lenders.

### **What is a lease?**

There are many definitions and interpretations of a lease. Accounting, tax, legal and financial advisers all have different perspectives on leasing, as do government regulators and the users of leased vehicles and equipment. In the end, however, it all comes down to a very simple concept.

A lease is an agreement where the owner conveys to the user the right to use equipment and vehicle in return for a number of specified payments over an agreed period of time. The owner of the equipment or vehicle is referred to as the "lessor", the user as the "lessee".

A lessor can be an individual or a corporation. In most cases, lessors are corporations specializing in financial services. They can be privately-owned or publicly-traded companies, manufacturing companies or dealer/distributors, subsidiaries of domestic or foreign banks, trust companies or insurance companies.

A lease is not the same as a bank loan. It is a different financing product structured differently. A lease is an asset-based financing product with the equipment and vehicle leased usually the only collateral security for the transaction. A traditional bank loan to acquire an asset is generally secured by security greater than simply the asset itself. In other words, under a lease the equipment and vehicle is generally the only collateral while a bank has much broader powers to secure wider security and normally does so.

### **Finance vs. operating equipment leases**

Very generally speaking, there are two kinds of leases for equipment. A "capital" or "finance" lease is usually used to finance the use of equipment for the major part of its useful life and there is a reasonable assurance that the lessee will obtain ownership by the end of the lease

term. An "operating" lease usually finances the equipment for less than its useful life and at the end of the lease term, the lessee can return them to the lessor without further obligation.

In both cases, the leasing company typically purchases the equipment from the manufacturer or distributor and then provides use of that equipment to the lessee under the terms and conditions of the lease.

The distinction between an operating lease and a capital or finance lease can be important for a number of reasons.

From a business perspective, a **capital or finance lease** is generally used to finance assets for the major part of its useful life such that the lessee ultimately acquires title to the asset. Lease contract payments enable the lessor to recover its entire investment in the asset over the term of the lease, together with the desired yield on that investment without relying on the re-sale value of the asset.

The largest portion of such payments consist generally of the straight write-down of the repayment of the cost of the asset, much of the balance is composed of the interest cost to the lessor for the funds used to finance the cost of the asset and administrative costs. The lessor's profit is the final component part.

For accounting purposes, a capital or finance lease is capitalised in the lessee's financial statements as a liability and reported as a financial receivable in the lessor's financial statements.

In contrast, an **operating lease** is generally defined as a lease that is not a capital or finance lease. As noted above, an operating lease usually finances the equipment or vehicle for less than its useful life and at the end of the lease term, the lessee can return the equipment or vehicle to the lessor without further obligation when it may be re-leased or sold.

In an operating lease, the residual value of the equipment when the lease comes to an end is very important to the lessor safeguarding its financial position. The lessor purchases the equipment or vehicle for the lessee. The lessor structures the lease to ensure that it recoups its costs and makes its profit from the payments made by the lessee under the lease and the sale of the equipment at the end of the lease either to the lessee or to a third party.

Broadly speaking, in an operating lease, there are three chief financial component parts of a lease: the down payment, the monthly lease payment over the lease term and the residual or lease-end value of the equipment. The lessor plans for the total of these three components to reimburse the lessor for the cost of purchasing the equipment and providing a profit through its financing.

For accounting purposes, an operating lease is not capitalised in the accounts of the lessee. Lease payments are an expense for the lessee and are revenue for the lessor. In this way, unlike a traditional loan or a finance lease, an operating lease offers an "off-balance" sheet financing alternative.

### Vehicles: closed-end vs. open- end leases<sup>17</sup>

In a **Closed-End Lease**, the customer makes a set number of lease payments during the term of the lease and returns the vehicle to the leasing company at the end of the lease term. The customer is not required to make any additional payments unless there is physical damage to the vehicle, such as excess wear and tear, or the number of kilometres you have driven is higher than the kilometre limit set out in the lease.

At the end of the lease, the options are:

- return the vehicle
- buy the vehicle (if there is a purchase option)
- lease a new vehicle

Most auto manufacturer finance company leases are the close-end type.

In an **Open-End Lease**, the customer makes a set number of lease payments during the term of the lease and returns the vehicle to the leasing company at the end of the lease term. Then an adjustment will be made. The customer will be required to make an additional payment covering the difference between the actual value of the vehicle at the end of the lease and the residual value stated in the lease contract (that is, the estimated wholesale value of the vehicle at the end of the lease term.) If, however, the value of the vehicle is more than the residual value stated in the lease, then the customer is entitled to the difference.

For example, if the residual value in the lease is \$8,000.00, and the leasing company can only sell the vehicle for \$7,500.00, the customer will have to pay \$500.00. If the vehicle is sold for \$8,500.00, the leasing company will pay the customer \$500.00.

Most leases for vehicles used for business purposes are the open-end type.

### Equipment and vehicles commonly leased

- |  |   |
|--|---|
| • Agricultural equipment                   | • Aircraft                                    |
| • Passenger cars                           | • Buses                                       |
| • Trucks, trailers & recreational vehicles | • Computers (hardware, software)              |
| • Construction equipment                   | • Forestry equipment                          |
| • Hotel & restaurant equipment             | • Manufacturing/processing equipment          |
| • Materials handling equipment             | • Medical-health services equipment           |
| • Mining & petroleum equipment             | • Railway rolling stock                       |
| • Office furniture, fixtures & equipment   | • Ships & water vessels                       |
| • Store furniture, fixtures & equipment    | • Telecommunications & broadcasting equipment |

Just about anything can be leased. It is simply a way of obtaining the use of equipment or vehicles, an alternative to paying cash, taking a loan, issuing debentures and other forms of financing.

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<sup>17</sup> From *Turning the Lights on Leasing, A Consumer's Guide to Vehicle Leasing*, a joint publication of CFLA, the Canadian Vehicle Manufacturers Association, the Canadian Automobile Dealers Association and the Association of International Automobile Manufacturers of Canada. On the Web in English at <http://www.cfla-acfl.ca/content/lights.html#key> and en francais: <http://www.cfla-acfl.ca/content/feux.html>

Today, businesses lease a wide variety of equipment or vehicles for use in their manufacturing, marketing and administration. The table above is not a comprehensive list of equipment or vehicles leased by Canadian businesses, rather it is intended to illustrate the wide variety of equipment or vehicles commonly leased.

### **The M.U.S.H. Sector**

The practice of leasing is not confined to the business world. Municipalities, universities, school boards, hospitals and government bodies frequently lease the equipment they need to fulfil their respective missions. Cutbacks in public funding and increasing restraints on capital budgets present obvious difficulties in the acquisition of essential equipment. From computer hardware and software for administrative and educational uses to school buses, garbage trucks, police cars and sophisticated medical equipment, these are the kinds of essential equipment leased by public sector bodies. The federal and provincial governments too are major lessees of a wide range of equipment.

## **THE UNIQUE NATURE OF LEASING**

### **Leasing is not lending**

Commercial lending and leasing are different products, each with an important role to play in offering alternative forms of financing to Canadian businesses and consumers. Leasing is not simply a form of passive lending. It is a separate, very pro-active commercial discipline. It is an asset management-based business.

### **Why do businesses lease? - A small business example**

There is seldom a single answer to this question. It depends very much on the situation of the lessee, the user of the underlying equipment or vehicle.

The usual leasing transaction of interest to a business would likely target a particular core asset that will directly contribute to revenue production. For a small or medium-sized business ("SME"), typically, it would be a "small-ticket" transaction for specific equipment or vehicles between \$15,000 and \$100,000. Obtaining the use of new equipment or of new vehicles is an important way for SMEs to grow their businesses and enhance productivity. Such new equipment or new vehicles are building blocks or discrete projects that allow for relatively simple business planning: matching projected incremental revenue to the business generated by the new equipment or new vehicles to incremental expenses and to incremental productivity --- on a step-by-step basis.

By way of illustration, consider the possible example of a \$50,000 telephone system for a call centre or a machine tool for a small business. Often, an entrepreneur will know the particular equipment needed by the business. The manufacturer or a dealer/distributor is contacted. Normally the equipment sales representative of the manufacturer or dealer meets the customer on the customer's premises or at the distributor's offices. With the long hours put in by entrepreneurs, "house calls" can be very helpful.

The sales representative will likely have been trained to understand how to structure the financing. The sales representative usually has an in-depth knowledge of the equipment in question and the business of the customer. This knowledge base is very helpful in structuring practical financing for SMEs.

A business customer will usually be offered a leasing package that will include not only the cost of the equipment but also the cost of delivery, installation, servicing and insurance. The leasing decision is usually part of a highly-automated process that can be concluded very rapidly, often at the point-of-sale.

The single question of greatest interest to most lessees is the amount of the monthly payment. A lease payment schedule can be tailored to the customer's anticipated revenue stream (example - a lower monthly lease payment in year one of the lease with a sliding scale increasing the amount of the monthly payment over the lease term). The lease payment schedule is fixed at the start of the lease such that the lessee will know the amounts and due dates throughout the lease term.

If, during the term of the lease, the customer decides that a new model of the equipment would be to the advantage of to the business, the lessor will generally negotiate the replacement of the old technology with the new one, rolling the costs into a new lease with a new payment schedule.

Under Canadian Generally Accepted Accounting Principles (GAAP), an operating lease is not capitalised on the financial statements of the lessee. Lease payments are considered an expense for the lessee. In contrast, typical bank financing or finance lease are capitalised and recorded as a debt liability on the borrower's financial statement thereby affecting the debt/equity ratios impacting the business. This "off-balance" sheet feature --- obtaining the use of needed equipment or vehicles by way of an operating lease --- can be a real advantage, particularly to SMEs.

### **The strengths of leasing**

Leasing is not necessarily the right solution for everyone or for every situation. Although leasing is a higher-spread business, it can offer significant practical benefits to the lessee. From a customer's perspective, there are a number of features that make leasing an attractive business choice.

**Efficient use of capital** Many businesses consider leasing to be the most efficient and effective use of available capital. One thing is certain. There is a far greater understanding today that most businesses make money by *using* equipment or vehicles not by owning them. Cash tied up in fixed assets are no longer available to finance inventory and the profit producing activities of production, distribution and marketing.

Equipment and vehicles generally do not normally increase in value over time. Owning depreciating equipment is not always the logical answer. With the increasing speed of technology obsolescence, there may be little equity potential in owning equipment.

**Fixed-rate financing** Leasing typically offers long term financing *at a fixed rate* over the financing term. In this way the customer is insulated from spikes in interest rates that occur in the Canadian economy from time to time.

While small and medium enterprise (SME) loans are often tied to the prime rate, most leases are written as fixed rate transactions. The "prime rate" is an irrelevant measurement in leasing. Generally, the "prime rate" is a short-term floating rate index that is adjusted as market conditions dictate. At best, "prime" is a short-term, variable corporate rate. For greater certainty for both lessor and lessee (particularly SMEs), the advantage of fixed rate transactions is that they are not subject to any fluctuations in rate during the term. If leases typically have

service terms of 24, 36, or 48 months, it is *essential* to match these terms with fixed rates. Funds are not borrowed for such periods at prime. For benchmarking purposes, government bond rates for similar periods (i.e. a two-year Government of Canada bond rate is more relevant to set a fixed cost for financing a 24-month lease). Government bond rates are generally recognised as a more accurate benchmarking of longer term borrowing costs.

**Expertise**

An asset management-based business requires specialized industry and equipment/vehicle expertise. With operating leases in particular, lessors must be able to accurately estimate residual values several years hence at lease-end when the equipment or vehicle must be re-leased or sold on the secondary market.

Because of this critical requirement, leasing companies frequently specialize in a limited range of equipment or vehicles. This is another important difference between bank lending and leasing. The expertise developed of the lessee's industry and on specific equipment or vehicles allows lessors a greater advisory role to lessees on appropriate equipment or vehicles to use in a specific business.

Similarly, on the disposal side, unlike traditional lenders, leasing companies are experts in the re-marketing of equipment and vehicles and the optimisation of their values. The growing after market in second tier equipment is a by-product of this management expertise.

**Customer service**

Lessors offer a variety of levels of service depending on the type of equipment or vehicle leased. This level of service can range from simply procuring the equipment or vehicle, to maintenance and agreeing to exchange it periodically for more up-to-date versions.

Lessors are frequently responsible for the equipment or vehicles leased from the time of purchase to disposal. The hands-on day-to-day management and maintenance of equipment and vehicles by CFLA members for their clients is an important customer service.

Unlike with a loan, the leasing company continues to have a stake in the actual product purchased throughout the lease.

**Speed**

Speed is an essential ingredient of asset-based financing. Critical to the recent strong competitive emergence of leasing, most evident in vendor programs, is the speed with which leasing decisions can now be made. New technology is key to this phenomenon. Increasingly in financial services, you are only as good as your technology. The speed and reach of new technology to capture information and to rapidly analyse that information has revolutionized the management of risk. Leasing decisions, among others, are now made in minutes, often at the point-of-sale.

The essence of the formula for success with vendor program financings: a high volume, low touch, quick turnaround business.

**Flexibility**

Flexibility is an innovative hallmark of asset-based financing and is particularly true in the small ticket leasing market, the market comprised primarily of SMEs.

Leasing is generally a far more flexible means of using equipment or vehicles than traditional lending. This flexibility is a significant operational advantage in a number of situations where, the lease payments can be tailored to a customer's revenue streams and offers a level of flexibility in timing and payment schedules unmatched in the traditional lending sector. (For example, ski lift operators using equipment six months a year can make seasonal payments on its equipment. Similarly, other seasonal businesses such as school bus operators can take advantage of the unique flexibility that leases offer.)

**Equipment/vehicle upgrading** If, during the term of the lease, a lessee decides that a new model or different type of equipment or of vehicle would be to the advantage to the business, the lessor will generally negotiate the replacement of the old technology with the new one, rolling the costs into a new lease with a new payment schedule. Leasing provides a flexible means for businesses to respond on a timely basis to the productivity and competitive challenges of technological obsolescence and product innovation.

**"Off-balance sheet financing** Under Canadian Generally Accepted Accounting Principles (GAAP), an operating lease is not capitalised on the financial statements of the lessee, whether public or private sector lessee. As noted above, lease payments are considered an expense for the lessee. In contrast, typical bank financing or finance lease are capitalised and recorded as a debt liability of the borrower/lessee on its financial statement thereby affecting the debt/equity ratios impacting the business. This "off-balance" sheet feature --- obtaining the use of needed equipment or vehicles by way of an operating lease --- can be a real advantage, particularly to SMEs.

**Simpler security arrangements** Because the lessor retains ownership of the equipment or vehicle leased and because the asset leased is generally the collateral for the transaction, leasing involves simpler legal security arrangements. Less strict requirements for historical balance sheets means that lessees can access financing more easily than conventional bank loans.

**Lower transaction costs** Lease transaction costs are generally lower. The costs of assigning collateral, of legal documentation and of slower processing times for traditional bank borrowing can be significant, particularly for SMEs where many of the conventional financing costs are fixed and not based on the size of the loan.

**Little cash required** Leasing can typically finance a higher percentage of the capital cost of a piece of equipment or of a vehicle than bank borrowing, often with little or no initial down payment required. This allows the lessee to preserve its cash or bank facilities to meet working capital needs.

**Sales tax deferral** For non-production equipment, that is, equipment or vehicles not considered as part of the core production of a business --- for example, photocopiers in an office (rather than in a photocopy shop) or trucks --- if acquired by way of a loan, the total of the Federal Goods and Services Tax and harmonized taxes (GST) and of the Provincial Sales Tax (PST) must be paid upfront by the customer (although the GST will be refunded eventually). The total sales tax plus the down payment can be a significant upfront amount.

In obtaining the use of non-production equipment or vehicles by way of lease, the sales taxes are levied generally on each monthly lease payment over the full term of the lease rather than as a single lump sum, upfront payment. In this way,

under a lease, the payment of sales taxes is more effectively tied to the revenue-producing use of the leased equipment or vehicle.

## SUMMARY OF EQUIPMENT/VEHICLE FINANCING OPTIONS <sup>18\*</sup>

CRITERIA	CASH PURCHASE	LOAN	CAPITAL LEASE	OPERATING LEASE
<b>Initial capital required</b>	<i>Significant</i> 100% of cost	<i>Variable</i> Down payment usually at least 25%	<i>Minimal</i> May be only 1 or 2 months advance payments	<i>Minimal</i> May be only 1 or 2 months advance payments
<b>Effect on existing banklines</b>	<i>Some</i> Loss of liquidity	<i>Reduction</i> Decreases available credit line	<i>Possibly none</i> Leases frequently represent sources of additional credit	<i>Likely none</i> Leases frequently represent sources of additional credit
<b>Effect on operating capital</b>	<i>Significant</i> High front-end costs	<i>Variable</i> Impact from down payment	<i>Minimal</i> Low front-end cost	<i>Minimal</i> Periodic payments
<b>Payments</b>	<i>Significant</i> Entire cost of equipment paid up-front	<i>Variable</i> Payments may move with changes in interest rates	<i>Fixed</i> No increase during the term of lease (Floating rates often also available)	<i>Fixed</i> No increase during the term of lease (Floating rates often also available)

## TEN QUESTIONS TO ANSWER *BEFORE SIGNING A BUSINESS LEASE* <sup>19</sup>

1. How am I planning to use this equipment/vehicle and for how long will I need it?
2. Does the lessor understand my business and the role of this transaction in it?
3. What is the total lease payment, and are there any other costs I could incur before the lease ends?
4. What happens if I want to change the lease or end it before the term expires?
5. How am I responsible if the equipment/vehicle is damaged or destroyed?
6. What are my obligations for the equipment/vehicle in terms of insurance, taxes, and maintenance during the lease term?
7. Can I upgrade the equipment/vehicle or add equipment under this lease?
8. What are my options at the end of the lease?
9. How do I return the equipment/vehicle?
10. Are there any costs at the end of the lease?

<sup>18</sup> Adapted and expanded from the AT&T Capital Leasing Services *Equipment Financing Guide*

<sup>19</sup> Source: Canadian Finance & Leasing Association and the Equipment Leasing Association of America

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## HOW TO CONTACT CFLA

### Canadian Finance & Leasing Association

15 Toronto Street, Suite 301  
Toronto, Ontario M5C 2E3

Telephone : (416) 860-1133

Toll-free 1(877) 213-7373

Fax : (416) 860-1140

Email : [info@cfla-acfl.ca](mailto:info@cfla-acfl.ca)

Visit the Website: [www.cfla-acfl.ca](http://www.cfla-acfl.ca) or [www.canadianleasing.ca](http://www.canadianleasing.ca)

For specific information on financing offered by CFLA members, consult the [CFLA "Financing/Leasing Search" directory](#) on the Website

## CFLA FURTHER REFERENCE DOCUMENTS

[Leasing Glossary](#)

[PPSA Leasing Glossary](#)

[HotLinks Page](#)

["Asset-based Financing and Leasing in Canada - An Overview"](#) by David Powell, President & CEO, CFLA, as published in the World Leasing Year Book 2005

[World Leasing Yearbook 2003 Current Legal Issues for Leasing in Canada](#) by Kevin McGrath, Partner, Borden Ladner Gervais LLP, published in the annual World Leasing Yearbook in the United Kingdom.

[Turning The Lights On Leasing: Consumer Guide To Vehicle Leasing](#)