

Lease Accounting Practice of Leasing Companies in Bangladesh: A Lessor's Disclosure Perspective

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Abstract: *As the development process in financial sector proceeds, Non-Bank Financial Institutions (NBFIs) became prominent alongside the banking sector. The major business of most NBFIs in Bangladesh is leasing. Lease accounting is a form-driven standard. The Institute of Chartered Accountants of Bangladesh (ICAB) recently adopted a revised accounting standard No. BAS 17: (Leases) on 18 November 2003 effective from January 1, 2004. This article highlighted the present state of accounting for lease in Bangladesh, an analytical review of disclosure requirement of BAS: 17 and extent of compliance with the disclosure requirement of BAS: 17 from the lessor's point of view. Findings of this report indicate that the degree of correspondence between the standard per BAS 17 and actual reporting by the leasing companies in Bangladesh is not satisfactory.*

Keywords: *Lease Accounting, Lessor, Non-bank financial institutions.*

Introduction

Non-Bank Financial Institutions (NBFIs) play a significant role in meeting the diverse financial need of various sectors of an economy and thus contribute to the economic development of the country as well as to the deepening of the country's financial system. According to Goldsmith (1969), financial development in a country starts with the development of banking institutions. As the development process proceeds, NBFIs become prominent alongside the banking sector. The major business of most NBFIs in Bangladesh is leasing, though some are also diversifying into other lines of business like term lending, housing finance, merchant banking, equity financing, venture capital financing etc. Lease financing, term lending and housing finance constituted 94 percent of the total financing activities of all NBFIs up to June 2006. Industrial Promotion and Development Company (IPDC) was the first private sector NBFIs in Bangladesh, which started its operation in 1981. Since then the number has been increasing and in December 2006 it reached 29. Of these, one is government owned, 15 are local (private) and the other 13 are established under joint venture with foreign participation.

Leasing in Bangladesh, like in many of its peer countries, owes its origin to the efforts of the International Finance Corporation (IFC), Washington. At the instance of IFC, the first leasing company in Bangladesh, Industrial Development Leasing Company of Bangladesh Ltd. (IDLCL)

was set up in 1984 and commenced its operations in 1986, with a 20% shareholding from Korea Development Leasing Corporation.

For several years, IDLC remained the sole leasing company in Bangladesh. However, the real momentum began in the 1990s. In 1997, there were 15 leasing companies in the country. Besides, some of the banks and financial institutions also added leasing divisions to their existing operations.

The issue of accounting for leases has had a bull's-eye on its back for decades. Lease accounting is a form-driven standard. Minor changes to the provisions of a lease contract will result in an accounting outcome that suits the parties to the transaction without affecting, in a significant way, the underlying economics. Thus, lease accounting has been one of the most, if not the most, gamed accounting pronouncements of all times.

The Institute of Chartered Accountants of Bangladesh (ICAB) recently adopted a revised accounting standard no. BAS 17: (Leases) on 18 November 2003. The new standard is applicable for all leases entered on or after January 1, 2004: from this, it is understood that the statement will not affect past leases. However, for practical considerations, it will be advisable for companies to switch over to the new method in respect of all lease transactions, including those which are running.

Corporate disclosure through the financial reporting system has been a widely discussed and research issue for a very long time in the past. It also seems that with the passing of time the controversial issues in financial reporting would continue to draw attention from academics, research institutions and the profession. Allen L. White (2002) in his research, "Redefining Corporate Disclosure" observed the crisis in confidence over corporate financial reports and raises questions that go well beyond a company's financial sustainability. Recently, most of the companies engaged in lease financing, is trying to switch over to the new method in respect of all lease transactions, including those which are running as per the requirement of BAS: 17. Now it is important that whether this information is disclosed in the financial statement.

In this article we have tried to highlight the present state of accounting for lease in Bangladesh, an analytical review of disclosure requirement of BAS: 17 and extent of compliance with the disclosure requirement of BAS: 17 from the lessor's point of view.

Leasing and Lease Accounting

Definition

Leasing is understood in different ways in different countries and hence there is no one generally accepted definition of leasing. The practice of leasing implies special consideration to legal questions, accounting methods and in many countries to taxation (Podder, 2004). However, the basic definition could be - A lease is an arrangement

- Between an lessor and lessee;
- Where the lessee gets the right to use a specific asset;
- For a stated period in exchange for a stated payment.

Paragraph 3 of BAS 17 defines lease - "a lease is an agreement whereby the lessor conveys to the lessee in return for payment or series of payments the right to use an asset for an agreed period of time."

Classification of Leases

A lessee and a lessor should classify a lease at the inception of the lease as a finance lease or an operating lease.

A **finance lease** is a lease that transfers in substance all the risks and rewards incident to ownership of an asset. Title may or may not eventually be transferred. The risks incident to ownership of an asset mentioned above include variations in return due to changing economic conditions, and losses resulting from the idleness of the capacity of the asset or technological obsolescence. The rewards incident to ownership of an asset include the economic benefits obtained from the direct use of the asset during its useful life, the appreciation in value of the asset and proceeds realized on disposal of the asset.

An **operating lease** is a lease other than a finance lease. An operating lease is usually characterized by the following distinct features:

- (i) The lease is cancelable by the lessee prior to its expiration.
- (ii) The lessor provides services, maintenance and insurance.
- (iii) The sum of all the lease payments by the lessee does not necessarily fully provide or the recovery of the asset's cost.

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract. Examples of situations which would normally lead to a lease being classified as a finance lease are:

- (a) the lease transfers ownership of the asset to the lessee by the end of the lease term;
- (b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;
- (c) the lease term is for the major part of the economic life of the asset even if title is not transferred;
- (d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
- (e) the leased assets are of such a specialized nature that only the lessee can use them without major modifications.
- (f) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
- (g) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equaling most of the sales proceeds at the end of the lease); and
- (h) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

The purpose of the special accounting treatment for leases is to ensure that the economic owner of the leased asset (the lessor or lessee) capitalize the leased asset. The party (either lessor or lessee) who takes the main risks in and reaps the main rewards from the use of the leased asset accounts for the leased asset in balance sheet.

In addition to preparing the financial statement according to BAS 17, the listed leasing companies of Bangladesh are strictly required to disclose some information stated in paragraph 39 and 48 of BAS 17. Moreover, these organizations are further required to disclose information relating to allowance for doubtful debts on lease receivables as per Bangladesh Bank FID Circular No: 14 dated June 26, 2000 and Circular No: 8 dated August 8, 2002. The prima facie objective of this paper is to identify the extent of fulfillment of these disclosure requirements in preparation of financial statements of listed leasing companies in Bangladesh.

Objective of the Study

The main objective of the study is to examine the extent of compliance of BAS/IFRS – 17 in preparation of financial statements of listed leasing companies in Bangladesh.

To achieve the main objective, the study covers the following specific set of objectives:

- i) To identify the nature of lease financing in Bangladesh;
- ii) To describe the regulatory framework of lease accounting (for lessor) in Bangladesh.
- iii) To suggest some policy measures for the improvement of financial reporting of lease accounting.

Background of the Study

Accounting for lease transactions has a number of complexities, which deliver partly from the range of alternative structuring available to the parties. For example, in many cases leases can be configured to allow manipulation of the tax benefits, with other features such a term and interest rate adjusted to achieve the intended economics of the arrangement. Leases can be used to transfer ownership of the leased asset, and they can be used to transfer some or all of the risks of ownership. In any event, the accounting objective is to have the economic substance of the transaction dictate the accounting treatment.

The accounting for lease transactions is one of the best examples of the application of the principle of substance over form¹, as set forth in the IASC's² *Framework for the Preparation and Presentation of Financial Statements*. If the transaction effectively transfers ownership to the lessee, the substance of the transaction is that of a sale and should be recognized as such even though the transaction takes the form of a lease.

Before revision, BAS 17 required that lessor recognize finance income based on a pattern reflecting a constant rate of return, but they were permitted to compute that return on either the net investment outstanding (i.e. the book investment), or the net cash investment (which would be a different amount). The revised standard eliminated the second alternative and requires that net (book) investment serve as the basis for the constant rate of return computation.

This study was not intended to give an in-depth understanding on lease accounting practice rather it emphasized on reporting aspects of lease accounting practice by listed leasing companies in Bangladesh. The underlying theme of the study was developed based on disclosure issues required under paragraph 39 and 48 of BAS 17. Disclosure requirements under these two paragraphs are cited, in brief, as below-

Paragraph 39 of BAS 17

BAS 17, paragraph 39, requires enhanced disclosures compared to the original standard. Lessors under **finance lease** are required to disclose, in addition to disclosure under BAS 32³, the following:

- (a) a reconciliation between the gross investment in the lease at the balance sheet date, and the present value of minimum lease payments receivable at the balance sheet date. In addition, an entity shall disclose the gross investment in the lease and the present value of minimum lease payments receivable at the balance sheet date, for each of the following periods:
 - (i) not later than one year;
 - (ii) later than one year and not later than five years;
 - (iii) later than five years.
- (b) unearned finance income.
- (c) the unguaranteed residual values accruing to the benefit of the lessor.
- (d) the accumulated allowance for uncollectible minimum lease payments receivable.
- (e) contingent rents recognized as income in the period.
- (f) a general description of the lessor's material leasing arrangements

Paragraph 48 of BAS 17

For lessors under operating leases, BAS 17, paragraph 48, has prescribed the following expanded disclosure:

- (a) the future minimum lease payments under non-cancelable operating leases in the aggregate and for each of the following periods:
 - (i) not later than one year;
 - (ii) later than one year and not later than five years;
 - (iii) later than five years.
- (b) total contingent rents recognized as income in the period.
- (c) a general description of the lessor's leasing arrangements

Literature Review

Leasing has grown tremendously in popularity and today is the fastest growing form of capital investment. Because of the increased significance and prevalence of lease arrangements, the need for uniform accounting and complete informative reporting of these transactions has intensified (Keiso, 2005). As a result of emergence an gradual acceptance of leasing as an alternative financing and acquisition (buy) arrangement or as a credit and investment activity, financial manager in the growing and challenging organization and policy makers and entrepreneurs of the developed as

well as developing countries should be acquainted with and should think over the practice and techniques of leasing and lease financing (Bhuiyan et al, 1997).

The tremendous popularity of leasing is quite understandable, as it offers great flexibility, often coupled with a range of economic advantages over ownership. For the lessor, there will be a regular stream of lease payments, which include interest that often will be at rates above commercial lending rates, and at the end of the lease term, usually some residual value (Epstein et al, 2003).

The objective of setting standard on lease accounting practices is– “To prescribe, for leases and lessors, the appropriate accounting policies and disclosures to apply in relation to finance and operating lease” (BAS -17).

In the emerging era of heightened interest of global investors in the capital market of Bangladesh, it is imperative that financial statements correctly reflect the financial position of firms. Jahur et al (2002) concludes in their paper therefore, capitalization of leases with a required set of disclosure as per BAS 17; leases should be made in order to presenting a true and vivid picture of financial and operational performance of the lessee. Companies are thereby to provide ea correct picture to the parties interested in particular concern and to facilitate inter-firm comparisons as well.

Uddin, Salim (2005) in his paper “IFRS/IAS vis-à-vis Lease Accounting: Bangladesh Perspective” has identified that absence of accounting standards for lease transactions was the main reason for deviation of actual practice of lease accounting from improved method advocated by BAS. They also opined that in Bangladesh, capitalization controversy exists because the provisions of Companies Act 1994 and Income Tax Ordinance 1984 and Bangladesh lease accounting practices are not in accordance with the capitalization.

Methodology

The success of any analysis ultimately depends on the availability of appropriate data (Gujarati, 2003). We devoted due attention to collect appropriate data to make the findings meaningful and useful.

Sample size

The study follows non-statistical sampling according to convenience of the data collection.

Listed leasing company in BD	Sample of the study	Percentage
14	10	71%

This study covers almost 71% of the population. Moreover, we included prospectus of three non-listed companies⁴ which were going to be listed within a short period. Hence the findings of this paper can be generalized effectively.

Sources of data

This study is both theoretical and empirical ones. Both primary and secondary data were used for the purpose of the study. We used cross sectional information –i.e. information regarding financial disclosure reported by different listed leasing companies in their financial statements

for the year ended 31 December 2005. Bangladesh Accounting Standard (BAS) 17 was the fundamental text to form the background of this study. Moreover, different local and international published articles were also reviewed to strengthen theoretical backgrounds of the study. Different standard text books on accounting dealt with lease accounting had also been gone through.

In depth interview method was used to gather information through unstructured questionnaire from high officials of different reputed listed leasing companies of Bangladesh. These officials were selected on the basis of following two criteria:

- i) ease of accessibility, and
- ii) expertise and experience in financial reporting.

Data Analysis

Information collected from both primary and secondary sources were processed manually. Finally all companies were scored against an assigned value (if complied then score 1 otherwise score 0). No value was assigned for any circumstantial requirement e.g. contingent rent.

Findings of the Study

Nature of the lease and lease accounting

Traditionally, the companies leased a variety of assets depending on their business and economic environment. For example, in Austria financial leases on real estate accounted for about one-fourth of the growth of the leasing industry where as elsewhere this is rare. In Western Europe about one third of the leasing business is devoted to automobile leasing, and another third to industrial machinery. Automotive portion in Australia is a bit bigger. In Canada the industrial portion is smaller but the aircraft portion is larger. In Japan, however, computers and office machines represent more than two thirds of the market and about one fifth relates to industrial machines (Podder, 2004). In Bangladesh, lease of machinery and equipment is larger. Among these assets most common are office equipment, lab equipment, diagnosis equipment, construction equipment, lift, escalator, generator, machinery including garments machinery, capital machinery, vehicle like truck, taxi, cargo, motor car, bus, van, transport material, CDMA phone set, books and so on.

Accounting for leases BAS: 17 has been introduced by ICAB as copy of the BAS:17 for leases effective from 1st January, 2004. Until 2003, there was no lease accounting standard in Bangladesh and all lease were treated as operating for accounting purpose. Accounting followed the legal form of leasing arrangements where the title of the asset lies with the lessor. With the adoption of BAS: 17 by ICAB, all the leasing and financing companies have been converted the leases from operating to finance method of accounting for lease.

According to BAS: 17, there are a number of items that are required to be disclosed in the financial statement by the listed leasing and financing companies. For the purpose of the study, it can be said that on an average all the sample companies have disclosed at least 20% of total requirements and the average score of disclosure is 41.67% (Appendix-3). Among them Phoenix Finance & Investment Ltd has got the highest score. This company has disclosed 80% of the total information that is prescribed by BAS: 17. Besides, 2 companies have provided 60%, 6 companies have provided 40% and 3 companies has complied with only 20% of total disclosure requirements (Appendix-3).

The degree of compliance with the disclosure requirements by the companies have discussed according to specific item in detail in the following:

Reconciliation between the gross investment and the present value of minimum lease payment

Reconciliation between the gross investment and the present value of minimum lease payment at the balance sheet date is required to disclose in the classified form according to specific periods. Differences in the amount of gross investment and the present value of minimum lease payment arises when the lessor include any amount for unguaranteed residual value in the gross investment.

Out of 12 Companies, no company made disclosure about the reconciliation requirement per paragraph 39(a). Neither these companies provided any note regarding this provision. Only the Prime Finance and Investment Co. noted that assets acquired under finance lease is accounted for by recording the asset at the lower of present value of minimum lease payment under the lease agreements and the fair value of the asset. Most of these leasing companies implemented this provision only by preparing a note regarding how the closing balance of gross investment was derived after relevant adjustments in beginning balance.

Unearned Finance Income

According to the definition of IAS:17 paragraph 3, unearned finance income is the difference between: (a) the aggregate of the minimum lease payment under a finance lease from the standpoint of the lessor and any un guaranteed residual value according to the lessor; and (b) the present value of (a) above, at the interest rate implicit in the lease.

In this study, most of the companies have disclosed this information. Out of 12 companies 10 companies have disclosed about their unearned finance income. Only Midas Finance and First Lease Co. did not disclose this information either in balance sheet or in notes and disclosure section.

Unguaranteed Residual Value

Unguaranteed Residual Value is that portion of residual value of the leased asset, the realization of which by the lessor is not assured or guaranteed solely by a party related to the lessor.

This is another important issue to be disclosed by the leasing companies in their financial statement according to paragraph 39(c) of BAS: 17. This information has been disclosed by 3 companies only. The companies are Phoenix Finance & Investment Ltd, Prime Finance and Investment Co. and Bangladesh Finance and Investment Company Ltd.

Accumulated allowance for uncollectible minimum lease payment receivable

There may have some possibility that a few number of lessee companies would not pay annual rent. But it cannot be estimated before the end of the year. For this reason, Lessor Companies need to provide provision for uncollectible minimum lease payment receivable. This requirement is consistent with the Matching principle of accounting. This disclosure is also the requirement per FID Circular No. 14 dated June 26, 2000 and Circular No. August 3, 2002 issued by Bangladesh Bank.

Only IDLC and Peoples leasing company did not disclose this information. All other companies have disclosed this information stating that "The Company provided a minimum appropriate provision for classified loan and lease finance as per Bangladesh Bank FID Circular No. 14 dated June 26, 2000 and Circular No. August 3, 2002." Absence of any calculation unable this study to justify the appropriateness of the amount.

Contingent Rent

Contingent rent is that portion of lease payment that is not fixed in the amount but is based on a factor other than just the passage of time (e.g., Percentage of sale, amount of usage, price indices, market rate of interest).

No information is disclosed about contingent rent in the financial statement by the companies. Moreover, the study came to know through questionnaire survey that there is no practice of contingent rent by the leasing companies in Bangladesh.

A General Description of the lessor's material lease arrangements

Two terms "general description" and "materiality" are vague here. Neither any definition nor the scopes of these terms are mentioned in this standard. In fact the level of "materiality" is very difficult to standardize. Thus the chance is open for leasing companies to escape this provision arguing that they didn't enter any "material" lease agreement. Companies should disclose information of leasing arrangements which are material to the company in terms of monetary volume as per this section otherwise they must disclose that they didn't enter any material leasing arrangement. The reasonable basis of materiality should also be disclosed.

Phoenix Finance & Investment Ltd has disclosed the number of total contracts and amount of net lease receivable which featuring Tk.10,000,000 or more per contract. None of the companies disclosed even this type of information.

Conclusion and Policy Direction

The main purpose of this study was to find out the nature of the practice of the compulsory disclosure about the lease transaction as per BAS: 17 in corporate annual reports of Leasing Companies in Bangladesh. It can be said that, though BAS:17 has been adopted by ICAB for leases effective from 1st January, 2004, level of disclosure in annual report by the companies is not satisfactory. As 60% of the total sample companies complied with only 40% of total requirements, we can say that Leasing Companies in Bangladesh have not yet aware of the importance of disclosing this issue. The practice of these companies may lead to fraudulent financial reporting and fail to enhance the reliability of the published information.

The reason for this phenomenon may be attributed to the absence of proper monitoring by the regulatory bodies and lack of awareness by the both companies and users of information. The situation remaining same day by day because neither there is any provision for penalty for non-compliance with the statutory requirements nor any practice of providing award for best practice. It can be inferred from this fact that stakeholders of leasing companies want detail disclosures of important information of lease transactions from the annual report. So the companies should give attention to these matters when preparing the annual reports. It will be the duty of the regulatory bodies to ensure standard practice by providing different mechanism for the provision of penalty and encourage best practice. Moreover, the meaning of different terms of BAS:17 should be clearly understandable both to the user and preparer (accountant) of the corporate report.. In Bangladesh, the main problem of corporate disclosure is that most of the users are naive and they lack accounting education and experience. As a result, they cannot understand the corporate reports issued to them (Ahmed and Kabir 1995).

However this conclusion is subject to certain limitations. This study is based on sample; the sample may include some bias in selection. Thus the conclusions be considered as tentative. Moreover the study is based on Bangladeshi annual reports only. Hence the conclusion arrived at should not be generalized globally. As a way forward, longitudinal study based on total population including inter company comparison is needed to highlight trends in disclosures by the leasing companies. □

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Appendix

Appendix-1: Check list to test compliance of disclosure requirement according to BAS 17 Name of the organization

Disclosure requirement of Lessor for Finance Lease

Paragraph	Disclosure required	Comment
39(a)	a reconciliation between the gross investment in the lease at the balance sheet date, and the present value of minimum lease payments receivable at the balance sheet date & the gross investment in the lease and the present value of minimum lease payments receivable at the balance sheet date, for each of the following periods: (i) not later than one year; (ii) later than one year and not later than five years; (iii) later than five years.	
39 (b)	unearned finance income.	
39 (c)	the unguaranteed residual values accruing to the benefit of the lessor.	
39 (d)	the accumulated allowance for uncollectible minimum lease payments receivable.	
39 (e)	contingent rents recognized as income in the period.	
39 (f)	a general description of the lessor's material leasing arrangements	

Appendix-2: Table showing the results of checklist as per paragraph 39 BAS 17

Para	Disclosure required	% of compliance	% of non compliance
39(a)	a reconciliation between the gross investment in the lease at the balance sheet date, and the present value of minimum lease payments receivable at the balance sheet date.	0%	100%
39(b)	Unearned finance income.	83%	17%
39(c)	The unguaranteed residual values accruing to the benefit of the lessor.	25%	75%
39(d)	the accumulated allowance for uncollectible minimum lease payments receivable.	83%	17%
39(e)	contingent rents recognized as income in the period.	N/A	N/A
39(f)	a general description of the lessor's leasing arrangements.	8%	92%

Appendix-3: Score Board

Name of the leasing company	Standardized score	Score Obtained	Deviation from Standardized score	% of deviation
Bangladesh Finance and Investment Company .Ltd.	5	3	2	40%
First Lease International	5	1	4	80%
Industrial Development Leasing Company of Bangladesh Ltd.	5	2	3	60%
International Leasing & Financial Service	5	2	3	60%
Islamic Finance and Investment Ltd	5	2	3	60%
Lankabangla Finance Ltd.	5	2	3	60%
MIDAS Financing Ltd.	5	1	4	80%
Phoenix Finance and Investments Ltd	5	4	1	20%
Peoples Leasing and Financial Services Ltd	5	2	3	60%
Prime Finance & Investment Ltd	5	3	2	40%
United Leasing	5	1	4	80%
Uttara Finance	5	2	3	60%
Average result	5	2.08	2.92	58.33%

Endnotes

1. Substance over form emphasizes the economic substance of an event though its legal form may provide a different result.
2. International Accounting Standard Committee.
3. BAS:32–Financial Instruments: Disclosure and Presentation.
4. Three non-listed companies are (a) Lanka Bangla Finance Ltd. (b) Islamic Finance and Investment Ltd., and (c) Phoenix finance & Investments Ltd.