

Edgar Filing: MICROFINANCIAL INC - Form 10-K

MICROFINANCIAL INC
Form 10-K
April 15, 2003

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2002

OR

[] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934

COMMISSION FILE NO.

MICROFINANCIAL INCORPORATED
(Exact name of Registrant as Specified in its Charter)

MASSACHUSETTS
(State or other jurisdiction of
Incorporation or Organization)

04-2962824
(I.R.S. Employer
Identification No.)

10M COMMERCE WAY, WOBURN, MA
(Address of Principal Executive Offices)

01801
(zip code)

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE:
(781) 994-4800

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

TITLE OF EACH CLASS -----	NAME OF EACH EXCHANGE ON WHICH REGISTERED -----
Common Shares, \$0.01 par value per share	New York Stock Exchange

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:
NONE
(Title of Class)

Edgar Filing: MICROFINANCIAL INC - Form 10-K

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes No

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant, computed by reference to the closing price of such stock as of June 28 2002, was approximately \$63,960,000.

As of March 31, 2003, 13,141,800 shares of the registrant's common stock were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

NONE

TABLE OF CONTENTS

DESCRIPTION	PAGE NUMBER
PART I	
Item 1. Business.....	2
Item 2. Properties.....	6
Item 3. Legal Proceedings.....	6
Item 4. Submission of Matters to a Vote of Security Holders.....	9
PART II	
Item 5. Market for Registrant's Common Equity and Related Stockholder Matters.....	10
Item 6. Selected Financial Data.....	11
Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.....	13
Item 7a. Quantitative and Qualitative Disclosures about Market Risk.....	19
Item 8. Financial Statements and Supplementary Data, Including Selected Quarterly Financial Data (Unaudited).....	20
Item 9. Changes In and Disagreements with Accountants on Accounting and Financial Disclosure.....	20
PART III	
Item 10. Directors and Executive Officers of the Registrant.....	20
Item 11. Executive Compensation.....	22
Item 12. Security Ownership of Certain Beneficial Owners and Management.....	27
Item 13. Certain Relationships and Related Transactions.....	29
Item 14. Controls and Procedures.....	30

Edgar Filing: MICROFINANCIAL INC - Form 10-K

PART IV

Item 15. Exhibits, Financial Statement Schedules, and Reports on Form 8-K..... 31

SIGNATURES..... 34

CERTIFICATIONS..... 35

PART I

ITEM 1. BUSINESS

GENERAL

MicroFinancial Incorporated ("MicroFinancial" or the "Company") was formed as a Massachusetts corporation on January 27, 1987. The Company, which operates primarily through its wholly-owned subsidiary Leasecomm Corporation, is a specialized commercial finance company that leases and rents "microticket" equipment and provides other financing services in amounts generally ranging from \$400 to \$15,000, with an average amount financed of approximately \$1,500 and an average lease term of 44 months. Leasecomm Corporation started originating leases in January 1986. The Company has used proprietary software in developing a sophisticated, risk-adjusted pricing model and in automating its credit approval and collection systems, including a fully-automated, Internet-based application, credit scoring and approval process.

The Company provides financing to lessees which may have few other sources of credit. The Company primarily leases and rents low-priced commercial equipment which is used by these lessees in their daily operations. The Company does not market its services directly to lessees, but sources leasing transactions through a nationwide network of over 1,000 independent sales organizations and other dealer-based origination networks ("Dealers").

The majority of the Company's leases are currently for authorization systems for point-of-sale, card-based payments by, for example, debit, credit and charge cards ("POS authorization systems"). POS authorization systems require the use of a POS terminal capable of reading a cardholder's account information from the card's magnetic strip and combining this information with the amount of the sale entered via a POS terminal keypad, or POS software used on a personal computer to process a sale. The terminal electronically transmits this information over a communications network to a computer data center and then displays the returned authorization or verification response on the POS terminal.

As of September 30, 2002, the Company's credit facility failed to renew. As a result, in October 2002, the Company made the decision to suspend new contract originations until a source of funding is obtained. The Company is currently working with a capital advisory firm in an effort to obtain a new line of credit in order to resume funding activity. The Company remains hopeful that a new funding facility can be in place in a reasonable period of time.

LEASING, SERVICING AND FINANCING PROGRAMS

The Company originates leases for products that typically have limited distribution channels and high selling costs. The Company facilitates sales of such products by making them available to Dealers' customers for a small monthly lease payment rather than a high initial purchase price. The Company primarily

Edgar Filing: MICROFINANCIAL INC - Form 10-K

leases and rents low-priced commercial equipment to small merchants. The majority of the Company's leases are currently for POS authorization systems; however, the Company also leases a wide variety of other equipment including advertising and display equipment, coffee machines, paging systems, water coolers and restaurant equipment. In addition, the Company also acquires service contracts and contracts in certain other financing markets. The Company opportunistically seeks to enter various other financing markets.

The Company's residential financings include acquiring service contracts from Dealers that provide security monitoring services, primarily.

The Company originates and services leases, contracts and loans in all 50 states of the United States and its territories. As of December 31, 2001 and 2002, leases in California, Florida, Texas, Massachusetts and New York accounted for approximately 42% of the Company's portfolio. Only California accounted for more than 10% of the total portfolio as of December 31, 2001 and 2002 at approximately 14%. None of the remaining states accounted for more than 4% of such total.

2

TERMS OF EQUIPMENT LEASES

Substantially all equipment leases originated or acquired by the Company are non-cancelable. In a typical lease transaction, the Company originates leases referred to it by the Dealer and buys the underlying equipment from the referring Dealer upon the funding of an approved application. Leases are structured with limited recourse to the Dealer, with risk of loss in the event of default by the lessee residing with the Company in most cases. The Company performs all processing, billing and collection functions under its leases.

During the term of a typical lease, the Company is scheduled to receive payments sufficient, in the aggregate, to cover the Company's borrowing costs and the costs of the underlying equipment, and to provide the Company with an appropriate profit. Throughout the term of the lease, the Company charges late fees, prepayment penalties, loss and damage waiver fees and other service fees, when applicable. Initial terms of the leases in the Company's portfolio generally range from 12 to 48 months, with an average initial term of 44 months as of December 31, 2002.

The terms and conditions of all of the Company's leases are substantially similar. In most cases, the contracts require lessees to: (i) maintain, service and operate the equipment in accordance with the manufacturer's and government-mandated procedures; (ii) insure the equipment against property and casualty loss; (iii) pay all taxes associated with the equipment; and (iv) make all scheduled contract payments regardless of the performance of the equipment. The Company's standard lease forms provide that in the event of a default by the lessee, the Company can require payment of liquidated damages and can seize and remove the equipment for subsequent sale, refinancing or other disposal at its discretion. Any additions, modifications or upgrades to the equipment, regardless of the source of payment, are automatically incorporated into, and deemed a part of, the equipment financed.

The Company seeks to protect itself from credit exposure relating to poor-quality Dealers by entering into limited recourse agreements with its Dealers, under which the Dealer agrees to reimburse the Company for payment of defaulted amounts under certain circumstances, primarily defaults within the first month following origination, and upon evidence of Dealer errors or misrepresentations in originating a lease or contract.

RESIDUAL INTERESTS IN UNDERLYING EQUIPMENT

Edgar Filing: MICROFINANCIAL INC - Form 10-K

The Company typically owns a residual interest in the equipment covered by a lease. At the end of the lease term, the lease typically converts into a month-to-month rental contract. If the lease does not convert, the lessee either buys the equipment at a price quoted by the Company or returns the equipment. If the equipment is returned, the Company may either sell the equipment, or place it into its used equipment rental or leasing program.

SERVICE CONTRACTS

In a typical transaction for the acquisition of service contracts, a homeowner will purchase a security system and simultaneously sign a contract with the Dealer for the monitoring of that system for a monthly fee. The Dealer will then sell the right to payment under that contract to the Company for a multiple of the monthly payments. The Company performs all processing, billing and collection functions under these contracts.

DEALERS

The Company provides financing to obligors under microticket leases, contracts and loans through its Dealers. The Company had over 1,000 different Dealers originating 50,106 Company leases, contracts and loans in 2002. One dealer accounted for approximately 10.6%, 4.5%, and .22% of all originations during the years ended December 31, 2000, 2001, and 2002, respectively. Another dealer accounted for approximately 4.89%, 7.38%, and 10.98% of all originations during the years ended December 31, 2000, 2001, and 2002, respectively. No other dealer accounted for more than 10% of the Company's origination volume during the years ended December 31, 2000, 2001, or 2002.

3

The Company does not sign exclusive agreements with its Dealers. Dealers interact with merchants directly and typically market not only POS authorization systems, but also financing through the Company and ancillary POS processing services.

USE OF TECHNOLOGY

The Company's business is operationally intensive, due in part to the small average amount financed. Accordingly, technology and automated processes are critical in keeping servicing costs to a minimum while providing quality customer service.

The Company has developed LeasecommDirect(TM), an Internet-based application processing, credit approval and Dealer information tool. Using LeasecommDirect(TM), a Dealer can input an application directly to the Company via the Internet and obtain almost instantaneous approval automatically over the Internet through the Company's computer system, all without any contact with any employee of the Company. The Company also offers Instalease(R), a program that allows a Dealer to submit applications by telephone, telecopy or e-mail to a Company representative, receive approval, and complete a sale from a lessee's location. By assisting the Dealers in providing timely, convenient and competitive financing for their equipment or service contracts and offering Dealers a variety of value-added services, the Company simultaneously promotes equipment and service contract sales and the utilization of the Company as the finance provider, thus differentiating the Company from its competitors.

The Company has used its proprietary software to develop a multidimensional credit-scoring model which generates pricing of its leases, contracts and loans commensurate with the risk assumed. This software does not produce a binary "yes or no" decision, but rather, determines the price at which the lease, contract

Edgar Filing: MICROFINANCIAL INC - Form 10-K

or loan can be profitably underwritten. The Company uses credit scoring in most, but not all, of its extension of credit.

UNDERWRITING

The nature of the Company's business requires two levels of review: the first focused on the ultimate end-user of the equipment or service and the second focused on the Dealer. The approval process begins with the submission by telephone, facsimile or electronic transmission of a credit application by the Dealer. Upon submission, the Company, either manually or through LeasecommDirect(TM) over the Internet, conducts its own independent credit investigation of the lessee through its own proprietary database and recognized commercial credit reporting agencies such as Dun & Bradstreet, Experian, Equifax and TransUnion. The Company's software evaluates this information on a two-dimensional scale, examining both credit depth (how much information exists on an applicant) and credit quality (past payment history). The Company is thus able to analyze both the quality and amount of credit history available with respect to both obligors and Dealers and to assess the credit risk. The Company uses this information to underwrite a broad range of credit risks and provide financing in situations when its competitors may be unwilling to provide such financing. The credit-scoring model is complex and automatically adjusts for different transactions. In situations where the amount financed is over \$6,000, the Company may go beyond its own data base and recognized commercial credit reporting agencies to obtain information from less readily available sources such as banks. In certain instances, the Company will require the lessee to provide verification of employment and salary.

The second aspect of the credit decision involves an assessment of the originating Dealer. Dealers undergo both an initial screening process and ongoing evaluation, including an examination of Dealer portfolio credit quality and performance, lessee complaints, cases of fraud or misrepresentation, aging studies, number of applications and conversion rates for applications. This ongoing assessment enables the Company to manage its Dealer relationships, including ending relationships with poorly performing Dealers.

Upon credit approval, the Company requires receipt of signed lease documentation on the Company's, standard or other pre-approved, lease form before funding. Once the equipment is shipped and installed, the Dealer invoices the Company, and thereafter, the Company verifies that the lessee has received and accepted the equipment. Upon the lessee authorizing payment to the Dealer, the lease is forwarded to the Company's funding and documentation department for funding, transaction accounting, and billing procedures.

4

BULK AND PORTFOLIO ACQUISITIONS

In addition to originating leases through its Dealer relationships, the Company, from time to time, has purchased lease portfolios from Dealers. The Company purchases leases from Dealers on an ongoing basis in packages ranging from \$20,000 to \$200,000. While certain of these leases initially do not meet the Company's underwriting standards, the Company often will purchase the leases once the lessee demonstrates a payment history. The Company will only acquire these smaller lease portfolios in situations where the company selling the portfolio will continue to act as a Dealer following the acquisition. The Company has also completed the acquisition of six large POS authorization system lease and rental portfolios: two in 1996, one in 1998, one in 1999, one in 2000 and the acquisition of the rental and lease portfolio of Resource Leasing in 2001. The acquisition, completed in September of 1999, consisted of 2,148 leases with fundings of \$3.2 million. The acquisition, completed in April of 2000, consisted of 7,085 rental contracts and 1,996 lease contracts, together totaling fundings of \$5.5 million. On January 3, 2001, the Company acquired the rental

Edgar Filing: MICROFINANCIAL INC - Form 10-K

and lease portfolio of Resource Leasing Corporation ("Resource") along with certain other assets. The acquisition consisted of 7,862 rental contracts and 326 lease contracts.

SERVICING AND COLLECTIONS

The Company performs all servicing functions on its leases, contracts and loans, including its securitized leases, through its automated servicing and collection system. Servicing responsibilities generally include billing, processing payments, remitting payments to Dealers and investors in the Company's securitization programs (the "Securitizations"), preparing investor reports, paying taxes and insurance and performing collection and liquidation functions.

The Company's automated lease administration system handles application tracking, invoicing, payment processing, automated collection queuing, portfolio evaluation and report writing. The system is linked with bank accounts for payment processing and provides for direct withdrawal of lease, contract and loan payments. The Company monitors delinquent accounts using its automated collection process. The Company uses several computerized processes in its customer service and collection efforts, including the generation of daily priority call lists and scrolling for daily delinquent account servicing, generation and mailing of delinquency letters, and routing of incoming customer service calls to appropriate employees with instant computerized access to account details. The Company's collection efforts include one or more of the following: sending collection letters, making collection calls, reporting delinquent accounts to credit reporting agencies, and litigating delinquent accounts when necessary and obtaining and enforcing judgments. The Company also has started to use a collectability scoring model to determine if the benefits from further collection efforts will outweigh the costs associated with those efforts.

COMPETITION

The microticket leasing and financing industry is highly competitive. The Company competes for customers with a number of national, regional and local banks and finance companies. The Company's competitors also include equipment manufacturers that lease or finance the sale of their own products. While the market for microticket financing has traditionally been fragmented, the Company could also be faced with competition from small- or large-ticket leasing companies that could use their expertise in those markets to enter and compete in the microticket financing market. The Company's competitors include larger, more established companies, some of which may possess substantially greater financial, marketing and operational resources than the Company, including a lower cost of funds and access to capital markets and to other funding sources which may be unavailable to the Company.

EMPLOYEES

As of December 31, 2002, the Company had 203 full-time employees, of whom 7 were engaged in credit activities and Dealer service, 136 were engaged in servicing and collection activities, 1 was engaged in marketing activities, and 59 were engaged in general administrative activities. Management believes that its

relationship with its employees is good. No employees of the Company are members of a collective bargaining unit in connection with their employment by the Company.

Edgar Filing: MICROFINANCIAL INC - Form 10-K

AVAILABILITY OF INFORMATION

The Company will provide without charge to each of its stockholders upon the written request of such person, a copy of the Company's Annual Report on Form 10K for its fiscal year ended December 31, 2002, including the financial statements and the financial statement schedules, required to be filed with the Securities and Exchange Commission. Requests for such document should be directed to Richard F. Latour, Chief Executive Officer, at 10M Commerce Way, Woburn, Massachusetts 01801.

ITEM 2. PROPERTIES

The Company's corporate headquarters and operations center are located in leased space of 44,659 square feet of office space at 10M Commerce Way, Woburn Massachusetts 01801. The lease for this space expires on December 14, 2003. The Company also leases 5,133 square feet of office space for its West Coast office in Newark, California, under a lease that expires on May 1, 2005. The Company also leases 21,656 square feet of office space in Waltham, Massachusetts, under a lease that expires on July 31, 2004.

On January 3, 2001, the Company acquired certain assets and assumed certain liabilities of Resource Leasing Corporation. As a result of this transaction, the Company occupied 15,399 square feet of office space in Herndon, Virginia.

The Company is no longer utilizing the facilities in Newark, California and Herndon, Virginia. Also, the Company is in the process of moving its headquarters from Waltham, Massachusetts to its facility in Woburn, Massachusetts.

ITEM 3. LEGAL PROCEEDINGS

Management believes, after consultation with counsel, that the allegations against the Company included in the lawsuits described below are subject to substantial legal defenses, and the Company is vigorously defending each of the allegations. The Company also is subject to claims and suits arising in the ordinary course of business. At this time, it is not possible to estimate the ultimate loss or gain, if any, related to these lawsuits, nor if any such loss will have a material adverse effect on the Company's results of operations or financial position.

A. The Company filed an action in the United States District Court for the District of Massachusetts against Sentinel Insurance Company, Ltd., ("Sentinel"), Premier Holidays International, Inc., ("Premier") and Daniel DelPiano ("DelPiano") arising from Premier's October, 1999, default on its repayment obligations to the Company under a Twelve Million Dollar (\$12,000,000) loan. Judgment has been entered in this case against Sentinel, which had issued a business performance insurance policy guaranteeing repayment of the loan, in the amount of Fourteen Million Dollars (\$14,000,000). This judgment has not been satisfied. Sentinel is currently undergoing liquidation proceedings, and a claim in this amount has been filed with the bankruptcy court. Premier has asserted a counterclaim against the Company for Seven Hundred Sixty Nine Million Three Hundred Fifty Thousand dollars (\$769,350,000) in actual and consequential damages, and for Five Hundred Million Dollars (\$500,000,000) in punitive damages, plus interest, cost and attorney's fees. The counterclaim is based upon an alleged representation by the Company that it would lend Premier an additional Forty-Five Million Dollars (\$45,000,000), when all documents evidencing the Premier loan refer only to the Twelve Million (\$12,000,000) amount actually loaned and not repaid. The Company denies any liability on the counterclaim, which the Company is vigorously contesting. The Company's motion for summary judgment seeking dismissal of the counterclaim and the award of full damages on the Company's claims was denied by Court Order, without a written decision. The Company's motion for the appointment of a special master was also

Edgar Filing: MICROFINANCIAL INC - Form 10-K

denied without a written decision. Because of the uncertainties inherent in litigation, we cannot predict whether the outcome will have a material adverse effect.

6

B. On January 29, 2002, Leasecomm was served with an Amended Complaint ("Complaint") in an action entitled *People v. Roma Computer Solutions, Inc.*, et al., Ventura County Superior Court Case No. CIV207490. The Complaint asserts two claims, one for violation of the California Business Professions Code Section 17500 (false advertising), and the other for violation of the California Business and Professions Code Section 17200 (unfair or unlawful acts or practices). The claims arise from the marketing and selling activities of other defendants, including Roma Computer Solutions, Inc., and/or Maro Securities, Inc. The Complaint seeks to have Leasecomm held liable for the acts of other defendants, alleging that Leasecomm directly participated in those acts and received proceeds and the assignment of lease contracts as a result of those acts. The Complaint requests injunctive relief, rescission, restitution, and a civil penalty. The Company has filed an Answer denying the claims. Because of the uncertainties inherent in litigation, we cannot predict whether the outcome will have a material adverse affect.

C. On May 8, 2000, Plaintiff Efraim Bason brought an action in the Supreme Court of the State of New York, County of Nassau, seeking compensatory damages in the amount of \$450,000 and punitive damages under various legal theories for Leasecomm's refusal to promptly release him from an equipment lease to which he claims his name was forged (the "Bason Complaint"). The Bason Complaint alleged that Leasecomm's failure to promptly release him from the lease, and subsequent negative reports to credit agencies, ruined his credit and prevented him from securing certain financing that he allegedly needed to purchase merchandise which he claims he could have then re-sold at a \$450,000 profit. Leasecomm has subsequently settled this matter with Court approval.

D. On January 29, 2002, Leasecomm was served with an Amended Complaint ("Complaint") in an action entitled *Rae Lynn Copitka v. Leasecomm Corp.*, et al., Travis County (Texas) District Court Case No. GN-102292. The Complaint asserts that the original action, filed mid-2001 by a single plaintiff should proceed as a class action. In the original action, Ms. Copitka sought to rescind her finance lease with Leasecomm and to recover economic damages arising from prior payments under the lease. Ms. Copitka alleges that her proposed class includes all persons in Texas who have executed Leasecomm finance leases for "virtual terminal" type credit card software during the years 1998, 1999, 2000, and 2001. On November 25, 2002 Leasecomm and E-Commerce Exchange agreed to settle the case with Ms. Copitka and a class of residents of Texas who leased Quickcommerce or QuickcommercePro software licenses from Leasecomm. The Travis County District Court entered its order approving the class settlement and entered its final judgement in the case on January 24, 2003. Leasecomm has satisfied its obligations under the Settlement, and the time to appeal has expired.

E. On April 3, 2000, a purported class action suit was filed in Superior Court of the State of California, County of San Mateo against Leasecomm and MicroFinancial as well as a number of other defendants with whom Leasecomm and MicroFinancial are alleged to have done business, directly or indirectly. The complaint seeks certification of a subclass of those class members who entered into any lease agreement contracts with Leasecomm for the purposes of financing the goods or services allegedly purchased from other defendant entities. The class action complaint alleges multiple causes of action, including: fraud and deceit; negligent misrepresentation; unfair competition; false advertising; unjust enrichment; fraud in the inducement and the inception of contract; lack of consideration for contact; and breach of the contractual covenant of good faith and fair dealing.

Edgar Filing: MICROFINANCIAL INC - Form 10-K

The Court granted final approval of the class action Settlement on December 2, 2002. Leasecomm has satisfied its obligations under the Settlement, and the time to appeal has expired. The Court retains jurisdiction to oversee any issues that may arise regarding administration of the settlement.

F. In October, 2002, the Company was served with a Complaint in an action in the United States District Court for the Southern District of New York filed by approximately 170 present and former lessees asserting individual claims. The Complaint contains claims for violation of RICO (18 U.S.C. sec. 1964), fraud, unfair and deceptive acts and practices, unlawful franchise offerings, and intentional infliction of mental anguish. The claims purportedly arise from Leasecomm's dealer relationships with Themeware, E-Commerce Exchange, Cardservice International, Inc., and Online Exchange for the leasing of websites and virtual terminals. The Complaint asserts that the Company is responsible for the conduct of its dealers in trade shows,

7

infomercials and web page advertisements, seminars, direct mail, telemarketing, all which are alleged to constitute unfair and deceptive acts and practices. Further, the Complaint asserts that Leasecomm's lease contracts as well as its collection practices and late fees are unconscionable. The Complaint seeks restitution, compensatory and treble damages, and injunctive relief. The Company filed a Motion to Dismiss the Complaint on January 31, 2003, and expects that the Motion will be argued sometime after May 6, 2003. Because of the uncertainties inherent in litigation, we cannot predict whether the outcome will have a material adverse effect.

G. On March 31, 2002, plaintiffs Robert Hayden and Renono Wesley filed a Complaint against Leasecomm Corporation alleging a violation of California Business & Professions Code Section 17200. The Complaint was filed on behalf of Hayden and Wesley individually, on behalf of a class of people similarly situated, and on behalf of the general public. The case is venued in San Francisco Superior Court. Specifically, plaintiffs allege that Leasecomm's practice of filing suits against lessees in Massachusetts courts constitutes an unfair business practice under California law. On March 12, 2003, the San Francisco County Superior Court granted Leasecomm's Motion to dismiss this action.

H. On August 22, 2002 plaintiff Aaron Cobb filed a Complaint against Leasecomm Corporation and MicroFinancial, Inc. and another Entity known as Galaxy Mall, Inc. alleging breach of contract; Fraud, Suppression and Deceit; Unjust Enrichment; Conspiracy; Conversion; Theft by Deception; and violation of Alabama Usury Laws. The Complaint was filed on behalf of Aaron Cobb individually, and on behalf of a class of persons and entities similarly situated in the State of Alabama. More specifically, the Plaintiff purports to represent a class of persons and small business in the State of Alabama who allegedly were induced to purchase services and/or goods from any of the Defendants named in the Complaint. The case is venued in Bullock County, Alabama. On March 31, 2003 the trial court entered an Order denying the Company's Motion to Dismiss. This Order is currently being reviewed and in all likelihood will be appealed to the Alabama Supreme Court. The appeal must be filed within 45 days of the entry of the Order. Should the appeal not be filed or should the Company otherwise be unsuccessful with its appeal the discovery in this case would commence with the first efforts being directed toward the Class Certification issues. The Company continues to deny any wrongdoing and plans to vigorously defend this claim. Because of the uncertainties inherent in litigation, the company cannot predict whether the outcome will have a material adverse affect.

Edgar Filing: MICROFINANCIAL INC - Form 10-K

I. In March, 2003, an action was filed by a shareholder against the Company in United States District Court asserting a single count of common law fraud and constructive fraud. The complaint alleges that the shareholder was defrauded by untrue statements made to him by management, upon which he relied in the purchase of Company stock for himself and for others. The complaint seeks damages in an unspecified amount. Because of the uncertainties inherent in litigation, we cannot predict whether the outcome will have a material adverse effect.

J. In March, 2003, a purported class action was filed in Superior Court in Massachusetts against Leasecomm and one of its dealers. The class sought to be certified is a nationwide class (excluding certain residents of the State of Texas) who signed identical or substantially similar lease agreements with Leasecomm covering the same product. The complaint asserts claims for declaratory relief, rescission, civil conspiracy, usury, breach of fiduciary duty, and violation of Massachusetts General Laws Chapter 93A, Section 11 ("Chapter 93A"). The claims concern the validity, enforceability, and alleged unconscionability of agreements provided through the dealer, including a Leasecomm lease, to acquire on line credit card processing services. The complaint seeks rescission of the lease agreements with Leasecomm, restitution, multiple damages and attorneys fees under Chapter 93A, and injunctive relief. Because of the uncertainties inherent in litigation we cannot predict whether the outcome will have a material adverse effect.

Leasecomm has been served with Civil Investigative Demands by the Offices of the Attorney General for the states of Kansas, Illinois, Florida, and Texas, and for the Commonwealth of Massachusetts. Those Offices of the Attorney General, in conjunction with the Northwest Region Office of the Federal Trade Commission, the Offices of the Attorney General for North Carolina and North Dakota, and the Ventura County, California, District Attorney's Office, have informed Leasecomm that they are seeking to coordinate their investigations (collectively, the "Government Investigators"). At this time, the principal focus of the

8

investigations appears to be software license leases (principally virtual terminals) and leases from certain vendor/dealers whose activities included business opportunity seminars. Leasecomm has further been informed that the investigations cover certain lease provisions, including the forum selection clause and language concerning the non-cancellability of the lease. In addition, the investigations include, among other things, whether Leasecomm's lease termination, or rollover, provisions, are legally sufficient; whether a Leasecomm lease is an enforceable lease; whether there were potential problems with its leases of which Leasecomm had knowledge; whether the leases are enforceable in accordance with their terms; whether three day right of rescission notices were required and, if required, whether proper notices were given; whether any lease prices were unconscionable; whether the lease of a software license is the lease of a service, not a good; whether any lease of satellites or computers are leases to consumers which must comply with certain consumer statutes; whether electronic fund transfer payments pursuant to a lease violate Reg. E; whether any Leasecomm billing and collection practices or charges are unreasonable, or constitute unfair or deceptive trade practices; whether Leasecomm's course of dealings with its vendors/dealers makes Leasecomm liable for any of the activities of its vendors/dealers. In April, 2002, Leasecomm and the Government Investigators entered into provisional relief and tolling agreements which provide for Leasecomm to take certain interim actions, temporarily stop the running of the statute of limitations as of January 29, 2002, and require advance notice by Leasecomm of its withdrawal from the provisional relief agreement and advance notice by each of the Government Investigators of its intention to commence legal action. The tolling agreement

Edgar Filing: MICROFINANCIAL INC - Form 10-K

has been extended several times and is set to expire in May, 2003.

In February, 2003, Leasecomm received a Civil Investigative Demand from the Office of the Attorney General, State of Washington, to which a response is currently due in April, 2003. The Civil Investigative Demand concerns an investigation of monitoring agreements between Priority One, Inc. and various State of Washington consumers, as to which Leasecomm appears to be the assignee of the right to receive monthly payments.

Since the investigations are in process, and no legal action has been commenced against Leasecomm, there can be no assurance as to the eventual outcome.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of the security holders of the Company during the fourth quarter of its fiscal year ended December 31, 2002.

9

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

(a) Market Information

The Company's common stock, par value \$0.01 per share (the "Common Stock"), is listed on the New York Stock Exchange under the symbol "MFI."

BY QUARTER -----	2001				2002			
	FIRST QUARTER	SECOND QUARTER	THIRD QUARTER	FOURTH QUARTER	FIRST QUARTER	SECOND QUARTER	THIRD QUARTER	FOURTH QUARTER
Stock Price								
High.....	14.00	17.00	16.75	14.00	10.50	10.93	9.30	4.4
Low.....	10.50	11.00	12.40	9.48	6.40	7.24	4.01	.9

(b) Holders

At March 14, 2003, there were approximately 825 stockholders of record of the Common Stock.

(c) Dividends

The Company paid the following quarterly cash dividends on the Common Stock.

	YEAR ENDED DECEMBER 31, 2001	YEAR ENDED DECEMBER 31, 2002
First Quarter.....	\$0.045	\$0.050
Second Quarter.....	\$0.050	\$0.050
Third Quarter.....	\$0.050	\$0.050

Edgar Filing: MICROFINANCIAL INC - Form 10-K

Fourth Quarter..... \$0.050 --

During the fourth quarter of 2002, the Board of Directors suspended the future payment of dividends to comply with the Company's banking agreements. Provisions in certain of the Company's credit facilities and agreements governing its subordinated debt contain, and the terms of any indebtedness issued by the Company in the future are likely to contain, certain restrictions on the payment of dividends on the Common Stock. The decision as to the amount and timing of future dividends paid by the Company, if any, will be made at the discretion of the Company's Board of Directors in light of the financial condition, capital requirements, earnings and prospects of the Company and any restrictions under the Company's credit facilities or subordinated debt agreements, as well as other factors the Board of Directors may deem relevant, and there can be no assurance as to the amount and timing of payment of future dividends.

(d) Recent Sales of Unregistered Securities

Not applicable

(e) Use of Proceeds from Registered Securities

Not applicable

10

ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth selected consolidated financial and operating data for the Company and its subsidiaries for the periods and at the dates indicated. The selected financial data were derived from the financial statements and accounting records of the Company. The data presented below should be read in conjunction with the consolidated financial statements, related notes and other financial information included herein.

	YEARS ENDED DECEMBER 31,				
	1998	1999	2000	2001	2002
(DOLLARS IN THOUSANDS, EXCEPT PER SHARE DATA)					
Income Statement Data:					
Revenues					
Income on financing leases and loans....	\$47,341	\$55,545	\$ 69,847	\$ 70,932	\$ 53,012
Income on service contracts.....	2,565	6,349	8,687	8,665	9,734
Rental income.....	16,118	21,582	27,638	37,664	37,154
Other income(1).....	18,248	24,802	33,305	36,830	26,922
Total revenues.....	84,272	108,278	139,477	154,091	126,822
Expenses:					
Selling, general and administrative....	27,434	33,827	38,371	44,899	45,535
Provision for credit losses.....	19,075	37,836(2)	38,912	54,092	88,948(3)
Depreciation and amortization.....	5,076	7,597	10,227	14,378	18,385
Interest.....	12,553	10,781	15,858	14,301	10,787
Total expenses.....	64,138	90,041	103,368	127,670	163,655

Edgar Filing: MICROFINANCIAL INC - Form 10-K

Income (loss) before provision (benefit) for income taxes.....	\$20,134	\$18,237	\$ 36,109	\$ 26,421	\$(36,833)
	=====	=====	=====	=====	=====
Net income (loss).....	\$11,924	\$10,728	\$ 20,860	\$ 16,317	\$(22,098)
	=====	=====	=====	=====	=====
Net income (loss) per common share					
Basic(4).....	\$ 1.21	\$ 0.84	\$ 1.64	\$ 1.28	\$ (1.72)
Diluted(5).....	1.19	0.83	1.63	1.26	(1.72)
Dividends per common share.....	0.14	0.16	0.18	0.20	0.15

DECEMBER 31,

1998	1999	2000	2001	2002
------	------	------	------	------

(DOLLARS IN THOUSANDS)

Balance Sheet Data:

Gross investment in leases and loans(6).....	\$280,875	\$ 362,721	\$ 452,885	\$ 438,723	\$367,173
Unearned income.....	(74,520)	(100,815)	(132,687)	(104,538)	(67,574)
Allowance for credit losses.....	(24,850)	(41,719)	(40,924)	(45,026)	(69,294)
Investment in service contracts.....	8,920	14,250	12,553	14,126	14,463
Total assets.....	210,254	265,856	342,602	361,728	295,085
Notes payable.....	130,421	144,871	201,991	203,053	168,927
Subordinated notes payable.....	24,421	9,238	4,785	3,262	3,262
Total liabilities.....	180,771	187,018	246,579	251,172	208,482
Total stockholders' equity.....	29,483	78,838	96,023	110,556	86,603

11

DECEMBER 31,

1998	1999	2000	2001	2002
------	------	------	------	------

(DOLLARS IN THOUSANDS, EXCEPT STATISTICAL DATA)

Other Data:

Operating Data:

Total leases and loans originated(7).....	\$ 153,819	\$ 223,446	\$ 236,763	\$ 155,308	\$111,829
Total service contracts acquired(8).....	8,080	9,105	4,138	6,658	6,773
Total rental contracts originated.....	4,306	220	5,686	12,379	677
Dealer fundings(9).....	105,200	137,300	145,400	111,100	74,000
Average yield on leases and loans(10).....	35.2%	36.8%	38.0%	38.1%	36.9%
Cash Flows From (used in):					
Operating activities.....	\$ 95,973	\$ 114,723	\$ 116,360	\$ 122,280	\$120,628
Investing activities.....	(108,111)	(147,587)	(157,947)	(116,860)	(80,141)
Financing activities.....	10,529	33,123	43,081	(10,104)	(35,139)
Total.....	(1,609)	259	1,494	(4,684)	5,348

Selected Ratios:

Edgar Filing: MICROFINANCIAL INC - Form 10-K

Return on average assets.....	6.12%	4.51%	6.86%	4.63%	(6.73)%
Return on average stockholders' equity.....	49.43	19.81	23.86	15.80	(22.42)
Operating margin(11).....	46.53	51.79	53.79	52.25	41.09
Credit Quality Statistics:					
Net charge-offs.....	\$ 20,544	\$ 20,967	\$ 37,888(2)	\$ 51,408(2)	\$ 65,081(3)
Net charge-offs as a percentage of average gross investment(12).....	7.47%	6.29%	9.00%	11.20%	15.60%
Provision for credit losses as a percentage of average gross investment(13).....	6.93	11.35	9.24	11.78	21.32
Allowance for credit losses as a percentage of gross investment(14).....	8.58	11.07	8.79	9.94	18.16

(1) Includes loss and damage waiver fees, service fees, interest income, and equipment sales revenue.

(2) The provision for 1999 includes a special provision of \$12.7 million for a loan made to one company, collateralized by approximately 3,500 microticket consumer contracts, and guaranteed by, among other security, an insurance performance bond. MicroFinancial is currently involved in litigation with the Company and the insurance company. Charge-offs against the special reserve were \$6.4 and \$7.1 million for the years ended December 31, 2000 and 2001, respectively.

(3) The provision for 2002 includes an additional provision of \$35.0 million to reserve against certain dealer receivables as well as delinquent portfolio assets. In the past, dealer receivables had been offset, in some instances, against the funding of new contracts. Since the Company has suspended the funding of new deals, Management feels that the collection of these receivables will be more difficult. Although the Company will continue to pursue collections on these accounts, management believes that the cost associated with the legal enforcement would outweigh the benefits realized.

(4) Net income per common share (basic) is calculated based on weighted-average common shares outstanding of 9,859,127, 12,795,809, 12,728,441, 12,789,605, and 12,821,946 for the years ended December 31, 1998, 1999, 2000, 2001, and 2002, respectively.

(5) Net income per common share (diluted) is calculated based on weighted-average common shares outstanding on a diluted basis of 10,031,975, 12,904,231, 12,807,814, 12,945,243, and 12,862,834 for the years ended December 31, 1998, 1999, 2000, 2001, and 2002 respectively.

(6) Consists of receivables due in installments, estimated residual value, and loans receivable.

12

(7) Represents the amount paid to Dealers upon funding of leases and loans, plus the associated unearned income.

(8) Represents the amount paid to Dealers upon the acquisition of service contracts, including both noncancelable service contracts and month-to-month service contracts.

(9) Represents the amount paid to Dealers upon funding of leases, contracts and

Edgar Filing: MICROFINANCIAL INC - Form 10-K

loans.

- (10) Represents the aggregate of the implied interest rate on each lease and loan originated during the period weighted by the amount funded at origination for each such lease and loan.
- (11) Represents income before provision for income taxes and provision for credit losses as a percentage of total revenues.
- (12) Represents net charge-offs as a percentage of average gross investment in leases and loans and investment in service contracts.
- (13) Represents provision for credit losses as a percentage of average gross investment in leases and loans and investment in service contracts.
- (14) Represents allowance for credit losses as a percentage of gross investment in leases and loans and investment in service contracts.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion includes forward-looking statements (as such term is defined in the Private Securities Litigation Reform Act of 1995). When used in this discussion, the words "believes," "anticipates," "expects" and similar expressions are intended to identify forward-looking statements. Such forward-looking statements involve known and unknown risks, uncertainties and other important factors that could cause the actual results, performance or achievements of the Company, or industry results, to differ materially from any future results, performance or achievements expressed or implied by such forward-looking statements. Such risks, uncertainties and other important factors include, among others: the Company's dependence on POS authorization systems and expansion into new markets; the Company's significant capital requirements; the risks of defaults on the Company's leases; adverse consequences associated with the Company's collection policy; risks associated with economic downturns; the effect on the Company's portfolio of higher interest rates; intense competition; increased governmental regulation of the rates and methods used by the Company in financing and collecting its leases and loans; risks associated with acquiring other portfolios and companies; dependence on key personnel; and other factors, many of which are beyond the Company's control. The Company expressly disclaims any obligation or undertaking to disseminate any updates or revisions to any forward-looking statement contained herein to reflect any change in the Company's expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based. In light of these risks and uncertainties, there can be no assurance that the forward-looking information contained herein will in fact transpire.

OVERVIEW

The Company is a specialized commercial finance company that provides "microticket" equipment leasing and other financing services in amounts generally ranging from \$400 to \$15,000, with an average amount financed of approximately \$1,500. The Company primarily leases POS authorization systems and other small business equipment to small commercial enterprises. For the years ended December 31, 2001 and 2002, the Company had fundings to Dealers upon origination of leases, contracts and loans ("Dealer Fundings") of \$111.1 million and \$74.0 million, respectively, and revenues of \$154.0 million and \$126.4 million, respectively.

The Company derives the majority of its revenues from leases originated and held by the Company, payments on service contracts, rental payments, and fee income. The Company funds the majority of leases, contracts and loans through

Edgar Filing: MICROFINANCIAL INC - Form 10-K

its revolving-credit and term loan facilities (the "Credit Facilities") and on-balance sheet securitizations, and to a lesser extent, its subordinated debt program ("Subordinated Debt") and internally generated funds. As of September 30, 2002, the credit facility failed to renew and the Company

13

has been paying down the balance on the basis of a 36 month amortization plus interest. At December 31, 2002, the Company was in default of certain of its debt covenants in its credit facility and securitization agreements. The covenants that were in default with respect to the credit facility, require that the Company maintain a fixed charge ratio in an amount not less than 130% of consolidated earnings, a consolidated tangible net worth minimum of \$77.5 million plus 50% of net income quarterly beginning with September 30, 2000 and compliance with the borrowing base. The covenants that were in default with respect to the securitization agreements, require that the Company maintain a fixed charge ratio in an amount not less than 125% of consolidated earnings and a consolidated tangible net worth greater than \$90 million plus 50% of net income for each fiscal quarter after June 30, 2001. On April 14, 2003, the Company entered into a long-term agreement with its lenders. This long-term agreement waives the defaults described above, and in consideration for this waiver, requires the outstanding balance of the loan to be repaid over a term of 22 months beginning in April 2003 at an interest rate of prime plus 2.0%. The Company received a waiver, which was set to expire on April 15, 2003, for the covenant violations in connection with the securitization agreement. Subsequently, the Company received a permanent waiver of the covenant defaults and the securitization agreement was amended so that going forward, the covenants are the same as those contained in the long-term agreement entered into on April 14, 2003, for the senior credit facility. In October 2002, the Company made the decision to suspend new contract originations until a source of funding is obtained. The Company is currently in the process of pursuing alternative financing sources.

The Company has been advised by the New York Stock Exchange (NYSE) that it is currently not in compliance with the NYSE's continued listing standards. Specifically, the Company does not meet the following requirements based on a consecutive thirty (30) day trading period; average market capitalization of not less than \$15 million and a share price of not less than \$1.00. In accordance with the continued listing criteria set forth by the NYSE, the Company has presented a plan which management believes has the potential to bring the Company back into compliance with the listing standards within the required timeframes. The NYSE is currently reviewing the plan that was submitted on April 1, 2003.

In a typical lease transaction, the Company originates leases through its network of independent Dealers. Upon approval of a lease application by the Company and verification that the lessee has both received the equipment and signed the lease, the Company pays the Dealer the cost of the equipment, plus the Dealer's profit margin. In a typical transaction for the acquisition of service contracts, a homeowner purchases a security system and simultaneously signs a contract with the Dealer for the monitoring of that system for a monthly fee. Upon credit approval of the monitoring application and verification with the homeowner that the system is installed, the Company purchases from the Dealer the right to the payment stream under that monitoring contract at a negotiated multiple of the monthly payments.

Substantially all leases originated or acquired by the Company are noncancelable. During the term of the lease, the Company is scheduled to receive payments sufficient, in the aggregate, to cover the Company's borrowing costs and the costs of the underlying equipment, and to provide the Company with an appropriate profit. The Company enhances the profitability of its leases,

Edgar Filing: MICROFINANCIAL INC - Form 10-K

contracts and loans by charging late fees, prepayment penalties, loss and damage waiver fees and other service fees, when applicable. The initial noncancelable term of the lease is equal to or less than the equipment's estimated economic life and often provides the Company with additional revenues based on the residual value of the equipment financed at the end of the initial term of the lease. Initial terms of the leases in the Company's portfolio generally range from 12 to 48 months, with an average initial term of 44 months as of December 31, 2002. Substantially all service and rental contracts are month-to-month contracts with expected terms of 7 years for service contracts, 15 months for lessees that continue to rent their equipment beyond the original term, and 22 months for other types of rental contracts.

CRITICAL ACCOUNTING POLICIES

In response to the SEC's release No. 33-8040, "Cautionary Advice regarding Disclosure About Critical Accounting Policies," Management identified the most critical accounting principles upon which our financial status depends. The Company determined the critical principles by considering accounting policies that involve the most complex or subjective decisions or assessments. We identified our most critical accounting

14

policies to be those related to revenue recognition and maintaining the allowance for credit losses. These accounting policies are discussed below as well as within the notes to the consolidated financial statements.

The Company's lease contracts are accounted for as financing leases. At origination, the Company records the gross lease receivable, the estimated residual value of the leased equipment, initial direct costs incurred and the unearned lease income. Unearned lease income is the amount by which the gross lease receivable plus the estimated residual value exceeds the cost of the equipment. Unearned lease income and initial direct costs incurred are amortized over the related lease term using the interest method. Amortization of unearned lease income and initial direct costs is suspended if, in the opinion of management, full payment of the contractual amount due under the lease agreement is doubtful. In conjunction with the origination of leases, the Company may retain a residual interest in the underlying equipment upon termination of the lease. The value of such interests is estimated at inception of the lease and evaluated periodically for impairment. Other revenues such as loss and damage waiver fees, service fees relating to the leases, contracts and loans, and rental revenues are recognized as they are earned.

The Company's investments in cancelable service contracts are recorded at cost and amortized over the expected life of the service period. Income on service contracts from monthly billings is recognized as the related services are provided. The Company periodically evaluates whether events or circumstances have occurred that may affect the estimated useful life or recoverability of the investment in service contracts. Rental equipment is either recorded at estimated residual value and depreciated using the straight-line method over a period of 12 months or at the acquisition cost and depreciated using the straight line method over a period of 36 months. Loans are reported at their outstanding principal balance. Interest income on loans is recognized as it is earned.

The Company maintains an allowance for credit losses on its investment in leases, service contracts, rental contracts and loans at an amount that it believes is sufficient to provide adequate protection against losses in its portfolio. The allowance is determined principally on the basis of the historical loss experience of the Company and the level of recourse provided by such lease, service contract, rental contract or loan, if any, and reflects management's judgment of additional loss potential considering current economic

Edgar Filing: MICROFINANCIAL INC - Form 10-K

conditions and the nature and characteristics of the underlying lease portfolio. The Company determines the necessary periodic provision for credit losses taking into account actual and expected losses in the portfolio as a whole and the relationship of the allowance to the net investment in leases, service contracts, rental contracts and loans. Such provisions generally represent a percentage of funded amounts of leases, contracts and loans. The resulting charge is included in the provision for credit losses.

Leases, service contracts, rental contracts and loans are charged against the allowance for credit losses and are put on non-accrual when they are deemed to be uncollectable. Generally, the Company deems leases, service contracts, rental contracts and loans to be uncollectable when one of the following occurs: (i) the obligor files for bankruptcy; (ii) the obligor dies, and the equipment is returned; or (iii) when an account has become 360 days delinquent without contact with the lessee. The typical monthly payment under the Company's leases is between \$30 and \$50 per month. As a result of these small monthly payments, the Company's experience is that lessees will pay past due amounts later in the process because of the small amount necessary to bring an account current (at 360 days past due, a lessee will only owe lease payments of between \$360 and \$600).

The Company has developed and regularly updates proprietary credit scoring systems designed to improve its risk-based pricing. The Company uses credit scoring in most, but not all, of its extensions of credit. In addition, the Company aggressively employs collection procedures and a legal process to resolve any credit problems.

RESULTS OF OPERATIONS

YEAR ENDED DECEMBER 31, 2002 COMPARED TO YEAR ENDED DECEMBER 31, 2001

Total revenues for the year ended December 31, 2002 were \$126.8 million, a decrease of \$27.3 million, or 17.7%, from the year ended December 31, 2001, due primarily to decreases of \$17.9 million, or 25.3%, in

15

income on financing leases and loans and \$9.8 million, or 32.2%, in service fee and other income; offset by an increase of \$559,000, or 1.2% in rental and service contract income over such amounts in the previous year's period. The decrease in income on financing leases and loans was due to the decreased number of leases originated primarily resulting from the Company's decision during the third quarter of 2002 to suspend the funding of new contracts. The decrease in fee income and other income is the result of decreased fees from the lessees related to the collection and legal process employed by the Company. The increase in rental and service contract income is a result of the increased number of lessees that have continued to rent their equipment beyond their original lease term, the acquisition of the rental portfolio of Resource Leasing Corporation, and increased originations in rental and service contracts.

Selling, general and administrative expenses increased by \$636,000 or 1.4%, for the year ended December 31, 2002 as compared to the year ended December 31, 2001. Marketing programs increased by \$1.4 million or 117.2%, due to increased dealer payments made on a portfolio of leases acquired in 2002. Legal services increased by \$2.2 million or 198.2%, primarily due to costs incurred for the different class actions and investigations and in conjunction with the workout on the Company's credit facility and securitization covenant defaults. Compensation expenses decreased by \$2.1 million or 11.3% primarily due to staff reductions.

The Company's provision for credit losses increased by \$34.9 million, or

Edgar Filing: MICROFINANCIAL INC - Form 10-K

64.4%, for the year ended December 31, 2002 as compared to the year ended December 31, 2001, while net charge-offs increased 26.6% to \$65.1 million. This provision was based on the Company's historical policy, based on experience, of providing a provision for credit losses based upon the dealer fundings and revenue recognized in any period and reflects management's judgement of loss potential considering current economic conditions and the nature of the underlying receivables. The Company took an additional provision of \$35 million during the third quarter of 2002 to reserve against certain dealer receivables as well as delinquent portfolio assets. In the past, dealer receivables had been offset, in some instances, against the funding of new contracts. Since the Company has suspended the funding of new deals, the Company feels that the collection of these receivables will be more difficult. Although the Company will continue to pursue collections on these accounts, management believes that the cost associated with the legal enforcement would outweigh the benefits realized.

Depreciation and amortization increased by \$4.0 million, or 27.9%, due to the increased number of rental contracts and amortization of the Company's investment in service contracts.

Interest expense decreased by \$3.5 million, or 24.6%, for the year ended December 31, 2002 as compared to the year ended December 31, 2001. This decrease resulted primarily from the Company's declining cost of funds as well as a decreased level of borrowings.

Dealer Fundings were \$74.0 million during the year ended December 31, 2002, a decrease of \$37.1 million, or 33.4%, compared to the year ended December 31, 2001. This decrease is a result of the Company's decision during the third quarter of 2002 to suspend new contract originations until a new line of credit is obtained. Receivables due in installments, estimated residual values, loans receivable, investment in service contracts, and investment in rental equipment also decreased from \$470.6 million for the year ended December 31, 2001 to \$396.5 million for the year ended December 31, 2002, representing a decrease of \$74.1 million, or 15.7%. Net cash provided by operating activities decreased by \$1.7 million to \$120.6 million during the year ended December 31, 2002, or 1.4%, from the year ended December 31, 2001 because of the decrease in the size of the Company's overall portfolio. Unearned income decreased by \$37.0 million, or 35.4%, from \$104.5 million at December 31, 2001 to \$67.6 million at December 31, 2002. This decrease was primarily due to the 33.4% decrease in dealer fundings during 2002.

YEAR ENDED DECEMBER 31, 2001 COMPARED TO YEAR ENDED DECEMBER 31, 2000

Total revenues for the year ended December 31, 2001 were \$154.1 million, an increase of \$14.6 million, or 10.5%, from the year ended December 31, 2000, due primarily to increases of \$1.1 million, or 1.6%, in income on financing leases and loans; \$10.0 million, or 27.5%, in rental and service contract income, and \$3.2 million, or 11.8%, in service fee and other income over such amounts in the previous year's period. The increase in income on financing leases and loans was due to the increased number of leases originated. The

16

increase in rental and service contract income is a result of the increased number of lessees that have continued to rent their equipment beyond their original lease term, the acquisition of the rental portfolio of Resource Leasing Corporation, and increased originations in rental and service contracts. The increase in fee income and other income is the result of increased fees from the lessees related to the collection and legal process employed by the Company, and the addition of a new line of business of selling equipment out of existing inventory.

Edgar Filing: MICROFINANCIAL INC - Form 10-K

Selling, general and administrative expenses increased by \$6.5 million or 17%, for the year ended December 31, 2001 as compared to the year ended December 31, 2000. Compensation and personnel-related expenses increased by \$3.4 million, due to an increase in overall compensation levels and an increase in the number of employees needed to maintain the Company's portfolio, including the addition of the personnel employed by Resource Leasing Corporation. Management expects that salaries and employee-related expenses, marketing expenses and other selling, general and administrative expenses will continue to increase as the portfolio grows because of the requirements of maintaining the Company's microticket portfolio and the Company's focus on collections. Also, cost of goods sold increased by \$3.6 million, or 100%, due to the Company's acquisition of the assets of Resource Leasing Corporation, and the addition of a new line of business of selling equipment.

The Company's provision for credit losses increased by \$15.2 million, or 39.0%, for the year ended December 31, 2001 as compared to the year ended December 31, 2000. This increase is a result of the Company's historical policy, based on experience, of providing a provision for credit losses based upon the dealer fundings and revenue recognized in any period and reflects management's judgement of loss potential considering current economic conditions and the nature of the underlying receivables.

Depreciation and amortization increased by \$4.2 million, or 40.6%, due to the increased number of rental contracts, including the addition of the Resource Leasing portfolio of rental contracts, and amortization of the Company's investment in service contracts.

Interest expense decreased by \$1.6 million, or 9.8%, for the year ended December 31, 2001 as compared to the year ended December 31, 2000. This decrease resulted primarily from the Company's declining cost of funds, offset by an increased level of borrowings.

Dealer Fundings were \$111.1 million during the year ended December 31, 2001, a decrease of \$34.3 million, or 23.6%, compared to the year ended December 31, 2000. This decrease is a result of the Company's decision during the second quarter of 2000 to increase pricing and tighten its credit approval standards. The new credit policies were put into place in August of 2000. This is an ongoing effort, and is expected to continue going forward. Receivables due in installments, estimated residual values, loans receivable, investment in service contracts, and investment in rental equipment also decreased from \$477.4 million for the year ended December 31, 2000 to \$470.6 million for the year ended December 31, 2001, representing an decrease of \$6.8 million, or 1.4%. Net cash provided by operating activities increased by \$5.9 million to \$122.3 million during the year ended December 31, 2001, or 5.1%, from the year ended December 31, 2000 because of the increase in the size of the Company's overall portfolio as well as the Company's continued emphasis on collections. Unearned income decreased by \$28.2 million, or 21.2%, from \$132.7 million at December 31, 2000 to \$104.5 million at December 31, 2001. This decrease was primarily due to the 23.6% decrease in dealer fundings during 2001.

The terrorist attacks of September 11, 2001 caused a significant loss of life and property. Fortunately, the Company has not experienced any significant losses as a direct result of the September 11 events. There can be no assurance that any potential impact associated with the September 11 events would not have a material adverse effect on the Company's business, financial condition, or results of operations.

LIQUIDITY AND CAPITAL RESOURCES

GENERAL

The Company's lease and finance business is capital-intensive and requires

Edgar Filing: MICROFINANCIAL INC - Form 10-K

access to substantial short-term and long-term credit to fund new leases, contracts and loans. Since inception, the Company has funded

17

its operations primarily through borrowings under its credit facilities, its on-balance sheet securitizations, the issuance of subordinated debt and an initial public offering completed in February of 1999. The Company will continue to require significant additional capital to maintain and expand its volume of leases, contracts and loans funded, as well as to fund any future acquisitions of leasing companies or portfolios.

The Company's uses of cash include the origination and acquisition of leases, contracts and loans, payment of interest expenses, repayment of borrowings under its credit facilities, subordinated debt and securitizations, payment of selling, general and administrative expenses, income taxes and capital expenditures.

The Company utilizes its credit facilities to fund the origination and acquisition of leases that satisfy the eligibility requirements established pursuant to each facility. On August 22, 2000, the Company entered into a new \$192 million credit facility with seven banks, expiring on September 30, 2002. As of September 30, 2002 the credit facility failed to renew and the Company has been paying down the balance on the basis of a 36 month amortization plus interest. Based on the terms of the agreement, interest rates increased from Prime minus 0.25% to Prime plus 0.50% for prime based loans and from LIBOR plus 1.75% to LIBOR plus 2.50% for LIBOR based loans. In addition, based on the covenant defaults described below, the outstanding borrowings on all loans bear an additional 2.00% default interest. On January 3, 2003, the Company entered into a Forbearance and Modification Agreement from the senior credit facility which expired on February 7, 2003. Based on the terms of the Forbearance and Modification Agreement, interest rates increased again on the prime based loans to prime plus 1.00%. At December 31, 2002, the Company had approximately \$126.6 million outstanding under the facility. The Company also may use its subordinated debt program as a source of funding for potential acquisitions of portfolios and leases which otherwise are not eligible for funding under the credit facilities and for potential portfolio purchases. To date, cash flows from its portfolio and other fees have been sufficient to repay amounts borrowed under the credit facilities and subordinated debt, however, in October 2002, the Company made the decision to suspend new contract originations until a source of funding is obtained.

At December 31, 2002, the Company was in default of certain of its debt covenants in its credit facility and securitization agreements. The covenants that were in default with respect to the credit facility, require that the Company maintain a fixed charge ratio in an amount not less than 130% of consolidated earnings, a consolidated tangible net worth minimum of \$77.5 million plus 50% of net income quarterly beginning with September 30, 2000, and compliance with the borrowing base. On April 14, 2003, the Company entered into a long-term agreement with its lenders. This long-term agreement waives the defaults described above, and in consideration for this waiver, requires the outstanding balance of the loan to be repaid over a term of 22 months beginning in April 2003 at an interest rate of prime plus 2.0%. Based on the amortization schedule in the new agreement, the Company is obligated to repay a minimum of \$54 million, plus applicable interest, over the next twelve months. The covenants that were in default with respect to the securitization agreements, require that the Company maintain a fixed charge ratio in an amount not less than 125% of consolidated earnings and a consolidated tangible net worth greater than \$90 million plus 50% of net income for each fiscal quarter after June 30, 2001. The Company received a waiver, which was set to expire on April 15, 2003, for the covenant violations in connection with the securitization agreement. Subsequently, the Company received a permanent waiver of the covenant defaults

Edgar Filing: MICROFINANCIAL INC - Form 10-K

and the securitization agreement was amended so that going forward, the covenants are the same as those contained in the long-term agreement entered into on April 14, 2003, for the senior credit facility.

The Company believes that cash flows from its operations will be sufficient to fund the Company's operations for the foreseeable future, given the satisfactory resolution of the Company's discussions with the lenders involved in the senior credit facility and the securitized notes.

CONTRACTUAL OBLIGATIONS AND COMMERCIAL COMMITMENTS

The Company has entered into various agreements, such as the long-term debt agreements, capital lease agreements and operating lease agreements that require future payments be made. Long-term debt agree-

18

ments include all debt outstanding under the credit facility, securitizations, subordinated notes, demand notes and other notes payable.

At December 31, 2002 the repayment schedules for outstanding long-term debt, minimum lease payments under noncancelable operating leases and future minimum lease payments under capital leases were as follows:

FOR THE YEAR ENDED DECEMBER 31, -----	LONG-TERM DEBT -----	OPERATING LEASES -----	CAPITAL LEASES -----	TOTAL -----
2003.....	\$ 83,677	\$1,776	\$272	\$ 85,725
2004.....	51,397	867	180	52,444
2005.....	34,515	227	55	34,797
2006.....	2,600	--	--	2,600
Thereafter.....	--	--	--	--
	-----	-----	-----	-----
Total.....	\$172,189	\$2,870	\$507	\$175,566
	=====	=====	=====	=====

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

See Note B of the notes to the consolidated financial statements included herein for a discussion of the impact of recently issued accounting pronouncements.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

GENERAL RISKS

MicroFinancial incurred net losses of \$22.1 million for the year ended December 31, 2002. The net losses incurred by the Company during the third and fourth quarters caused the Company to be in default of certain debt covenants in its credit facility and securitization agreements. In addition, as of September 30, 2002, the Company's credit facility failed to renew and consequently, the Company was forced to suspend new origination activity as of October 11, 2002. On April 14, 2003, the Company entered into a long-term agreement with its lenders. This long-term agreement waives the covenant defaults as of December 31, 2002, and in consideration for this waiver, requires the outstanding balance of the loan to be repaid over a term of 22 months beginning in April 2003 at an interest rate of prime plus 2.0%. The Company received a waiver, which was set

Edgar Filing: MICROFINANCIAL INC - Form 10-K

to expire on April 15, 2003, for the covenant violations in connection with the securitization agreement. Subsequently, the Company received a permanent waiver of the covenant defaults and the securitization agreement was amended so that going forward, the covenants are the same as those contained in the long-term agreement entered into on April 14, 2003, for the senior credit facility. To date, the Company has fulfilled all of its debt obligations, as agreed to by the bank group, in a timely manner.

In an effort to improve its financial position, MicroFinancial has taken certain steps including the engagement of a financial and strategic advisory firm, Triax Capital Advisors, LLC. Management and its advisors are actively considering various financing, restructuring and strategic alternatives as well as continuing to work closely with the Company's lenders to obtain long-term agreements. In addition, Management has taken steps to reduce overhead, including a reduction in headcount from 380 to 203. The failure or inability of MicroFinancial to successfully carry out these plans could ultimately have a material adverse effect on the Company's financial position and its ability to meet its obligations when due. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

MARKET-RATE-SENSITIVE INSTRUMENTS AND RISK MANAGEMENT

The following discussion about the Company's risk management activities includes forward-looking statements that involve risk and uncertainties. Actual results could differ materially from those projected in the forward-looking statements.

This analysis presents the hypothetical loss in earnings, cash flows, and fair value of the financial instruments held by the Company at December 31, 2002 that are sensitive to changes in interest rates. The Company has used interest-rate swaps to manage the primary market exposures associated with underlying

19

liabilities and anticipated transactions. The Company used these instruments to reduce risk by creating offsetting market exposures. The instruments held by the Company are not held for trading purposes.

In the normal course of operations, the Company also faces risks that are either nonfinancial or nonquantifiable. Such risks principally include country risk, credit risk, and legal risk, and are not represented in the analysis that follows.

INTEREST RATE RISK MANAGEMENT

The implicit yield to the Company on all of its leases, contracts and loans is on a fixed interest rate basis due to the leases, contracts and loans having scheduled payments that are fixed at the time of origination of the lease. When the Company originates or acquires leases, contracts, and loans it bases its pricing in part on the spread it expects to achieve between the implicit yield rate to the Company on each lease and the effective interest cost it will pay when it finances such leases, contracts and loans through its credit facility. Increases in interest rates during the term of each lease, contract or loan could narrow or eliminate the spread, or result in a negative spread. The Company has adopted a policy designed to protect itself against interest rate volatility during the term of each lease, contract or loan.

Given the relatively short average life of the Company's leases, contracts and loans, the Company's goal is to maintain a blend of fixed and variable interest rate obligations. As of December 31, 2002, the Company's outstanding fixed-rate indebtedness outstanding under the Company's securitizations and

Edgar Filing: MICROFINANCIAL INC - Form 10-K

subordinated debt represented 26.5% of the Company's total outstanding indebtedness. In July 1997, the Company entered into an interest rate swap arrangement with one of its banks. This arrangement expired in July 2000.

The Company's credit facility bears interest at rates, which fluctuate with changes in the prime rate or the 90-day LIBOR. The Company's interest expense on its credit facility and the fair value of its fixed rate debt is sensitive to changes in market interest rates. The effect of a 10% adverse change in market interest rates, sustained for one year, on the Company's interest expense and the fair value of its fixed rate debt would be \$801,000 and \$428,000, respectively.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA, INCLUDING SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

MicroFinancial Incorporated's Financial Statements, together with the related Independent Auditors' Report, appear at pages F-1 through F-31 of this Form 10-K.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Not applicable.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS

NAME AND AGE OF DIRECTORS AND EXECUTIVE OFFICERS

TITLE

NAME AND AGE OF DIRECTORS AND EXECUTIVE OFFICERS	TITLE
Peter R. Bleyleben, 50.....	Chairman of the Board and Director
Brian E. Boyle, 55.....	Director, Member of Audit and Compensation Committees
Torrence C. Harder, 59.....	Director, Chairman of Compensation Committee and Member of Audit Committee
Richard F. Latour, 49.....	Director, President, Chief Executive Officer, Treasurer, Secretary and Clerk
Alan J. Zakon, 67.....	Director, Chairman of Audit Committee and Member of Compensation Committee

20

NAME AND AGE OF DIRECTORS AND EXECUTIVE OFFICERS

TITLE

NAME AND AGE OF DIRECTORS AND EXECUTIVE OFFICERS	TITLE
James R. Jackson, Jr., 41.....	Vice President and Chief Financial Officer
John Plumlee, 51.....	Vice President, MIS
Carol Salvo, 36.....	Vice President, Legal
Mark Belinsky, 41.....	Vice President, Marketing and Sales

BACKGROUNDS OF DIRECTORS AND EXECUTIVE OFFICERS

Edgar Filing: MICROFINANCIAL INC - Form 10-K

Peter R. Bleyleben serves as Chairman of the Board of Directors of the Corporation. He served as President, Chief Executive Officer and Director of the Corporation or its predecessor since June 1987 until January 2002, and Chief Executive Officer until October 2002. He is also a director of UpToDate in Medicine, Inc. Before joining the Corporation, Dr. Bleyleben was Vice President and Director of the Boston Consulting Group, Inc. ("BCG") in Boston. During his more than eight years with BCG, Dr. Bleyleben focused his professional strategic consulting practice on the financial services and telecommunications industries. Prior to joining BCG, Dr. Bleyleben earned an M.B.A. with distinction and honors from the Harvard Business School, an M.B.A. and a Ph.D. in Business Administration and Economics, respectively, from the Vienna Business School in Vienna, Austria and a B.S. in Computer Science from the Vienna Institute of Technology. Dr. Bleyleben's term as a Director expires in 2004.

Brian E. Boyle, the Chief Executive Officer of the Corporation from 1985 to 1987 and Chairman of the MicroFinancial Board from 1985 to 1995, has served as a Director of the Corporation or its predecessor since 1985 and has been a member of the Audit Committee and the Compensation Committee since 1997. He is currently the Vice Chairman and a Director of Boston Communications Group, Inc. ("Communications"), a Boston-based provider of call processing to the global wireless industry. He has also served as Chairman of GoldK, Inc. since 1999 and was the Chief Executive Officer of GoldK, Inc. from 1999 until November 2002. Prior to joining Communications, Dr. Boyle was the Chairman and Chief Executive Officer of Credit Technologies, Inc., a Massachusetts-based provider of credit decision and customer acquisition software, from 1989 to 1993. From 1995 to 1999 he was a Director of Saville Systems, a global telecommunications billing software company, with its United States headquarters in Burlington, Massachusetts, and served as a member of its Compensation Committee from 1995 to October 1999. Dr. Boyle is also a director of several private companies. Dr. Boyle earned his A.B. in Mathematics and Economics from Amherst College and a B.S. in Electrical Engineering and Computer Science, an M.S. in Operations Research, an E.E. in Electrical Engineering and Computer Science and a Ph.D. in Operations Research, all from the Massachusetts Institute of Technology. Mr. Boyle's term as a Director expires in 2003.

Torrence C. Harder has served as a Director of the Corporation since 1986, served as Chairman of the Compensation Committee since 1997 and has been a member of the Audit Committee since 1997. He has been the President and Director of Harder Management Corporation, Inc., a registered investment advisory firm, since its establishment in 1971. He has also been the President and Director of Entrepreneurial Ventures, Inc., a private equity investment firm, since its founding in 1986. Mr. Harder is a Director of RentGrow, Inc., Trade Credit Corporation and UpToDate in Medicine, Inc., a privately held company. Mr. Harder earned an M.B.A. from the Wharton School of the University of Pennsylvania, and a B.A. with honors from Cornell University. Mr. Harder's term as a Director expires in 2005.

Richard F. Latour has served as President, Chief Executive Officer, Chief Financial Officer, Treasurer, Clerk and Secretary of the Company since October 2002 and as President, Chief Operating Officer, Chief Financial Officer, Treasurer, Clerk and Secretary, as well as a director of the Corporation, since February 2002. From 1995 to January 2002, he served as Executive Vice President, Chief Operating Officer, Chief Financial Officer, Treasurer, Clerk and Secretary. From 1986 to 1995 Mr. Latour served as Vice President of Finance and Chief Financial Officer. Prior to joining the Company, Mr. Latour was Vice President of Finance for eleven years with Trak Incorporated, an international manufacturer and distributor of consumer goods, where he was responsible for all financial and operational functions. Mr. Latour earned a B.S. in accounting from Bentley College in Waltham, Massachusetts. Mr. Latour's term as a Director expires in 2004.

Alan J. Zakon has served as a Director of the Corporation since 1988 and has served as Chairman of the Audit Committee since 1997. Since 1995, he has been the Vice Chairman and a Director, and since November 1997, Chairman of the Executive Committee, of Scientific Games Corporation, a New York-based global gaming and simulcasting company. Dr. Zakon served as Managing Director of Bankers Trust Corporation from 1989 to 1995 where he was Chairman of the Strategic Policy Committee. Dr. Zakon is a Director of Arkansas-Best Freight Corporation, a nationwide commercial transportation and trucking company and a Director of InfraRedx, a privately held medical research and development company. Dr. Zakon holds a B.A. from Harvard University, an M.S. in Industrial Management from the Sloan School at the Massachusetts Institute of Technology and a Ph.D. in Economics and Finance from the University of California at Los Angeles. Mr. Zakon's term as a Director expires in 2003.

James R. Jackson Jr. has served as Vice President and Chief Financial Officer of the Company since April 2002. Prior to joining the Company, from 1999 to 2001, Mr. Jackson was Vice President of Finance for Deutsche Financial Services Technology Leasing Group. From 1992 to 1999, Mr. Jackson held positions as Manager of Pricing and Structured Finance and Manager of Business Planning with AT&T Capital Corporation.

John Plumlee has served as Vice President, MIS of the Company since 1990. Prior to joining the Company, Mr. Plumlee was Vice President of M.M.C., Inc., a firm focusing on the delivery of software services to local governments.

Carol A. Salvo has served as Vice President, Legal of the Company since 1996. From 1995 to 1996, Ms. Salvo served as Director of Legal Collection Services of the Company. From 1992 to 1995, Ms. Salvo served as Litigation Supervisor of the Company. Prior to joining the Company, Ms. Salvo was a junior accountant with InfoPlus Inc.

Mark S. Belinsky has served as Vice President, Sales and Marketing of the Company since June 2001. Prior to joining the Company, from June 1999 to April 2001 Mr. Belinsky was the Vice President of Marketing and Business Development for Iwant.com, an Internet-based Application Service Provider, which owns a patent for Online advertising technology, used by the Internet's top websites. Prior to that, he served as President, Club Development for TransNational Group, an affinity marketing company.

COMPLIANCE WITH SECTION 16(A) OF THE EXCHANGE ACT

Section 16(a) of the Securities Exchange Act of 1934 (as amended, the "Exchange Act") requires the Corporation's directors, officers and persons who beneficially own more than ten percent (10%) of the Common Shares (each, a "Reporting Person") to file reports of ownership and changes of ownership with the Securities and Exchange Commission. Copies of all filed reports are required to be furnished to the Corporation pursuant to Section 16(a) of the Exchange Act. Based solely upon a review of Forms 3 and 4 and amendments thereto furnished to the Corporation pursuant to Rule 16a-3(e) of the Exchange Act during fiscal year ending December 31, 2002 and on written representations from Reporting Persons, the Corporation believes that each Reporting Person complied with all applicable filing requirements during its fiscal year ended December 31, 2002, with the exception of Dr. Boyle, who inadvertently failed to report the sales of 39,000 shares from June to September 2002. These transactions were subsequently reported by the Reporting Person.

ITEM 11. EXECUTIVE COMPENSATION

EXECUTIVE COMPENSATION

Edgar Filing: MICROFINANCIAL INC - Form 10-K

The following table sets forth the compensation of (i) Messrs. Bleyleben and Latour, both of whom served as the Chief Executive Officer of the Corporation during 2002, (ii) the four most highly compensated executive officers, other than Messrs. Bleyleben and Latour who were serving as executive officers of the Corporation as of December 31, 2002 (collectively, the "Named Executive Officers"), in each case for the years ended December 31, 2002, 2001 and 2000. Determination of the most highly compensated executive officers is based upon compensation for the Corporation's fiscal year ended December 31, 2002 and does not

22

necessarily reflect the most highly compensated executive officers for the Corporation's fiscal years ended December 31, 2001 and 2000.

SUMMARY COMPENSATION TABLE(1)

NAME AND PRINCIPAL POSITION	YEAR	ANNUAL COMPENSATION		
		SALARY	BONUS (2)	ALL OTHER COMPENSATION
PETER R. BLEYLEBEN..... Chairman and Director	2002	\$239,038	\$ 0	\$12,227 (3)
	2001	\$277,116	\$469,997	\$97,636
	2000	\$270,000	\$436,873	\$72,004
RICHARD F. LATOUR..... President, Chief Executive Officer, Treasurer, Clerk, Secretary and Director	2002	\$232,077	\$236,560	\$ 6,291 (4)
	2001	\$230,000	\$306,643	\$54,856
	2000	\$220,000	\$278,042	\$53,515
JAMES R. JACKSON, JR..... Vice President and Chief Financial Officer	2002	\$104,769	\$ 0	\$ 3,143 (5)
JOHN PLUMLEE..... Vice President, MIS	2002	\$169,029	\$ 70,351	\$ 5,229 (6)
	2001	\$165,000	\$ 73,753	\$19,456
	2000	\$155,769	\$ 63,819	\$20,888
CAROL SALVO..... Vice President, Legal	2002	\$138,183	\$ 73,698	\$ 4,359 (7)
	2001	\$135,000	\$ 73,753	\$ 4,098
	2000	\$115,269	\$ 63,819	\$ 4,701
MARK BELINSKY..... Vice President, Marketing and Sales	2002	\$175,000	\$ 10,040	\$ 6,317 (8)
	2001	\$ 88,173	\$ 30,000	\$ 0

(1) Columns required by the rules and regulations of the Securities and Exchange Commission that contain no entries have been omitted.

(2) Bonuses are paid over a three-year period, with one-third payable each year. The remaining two-thirds is subject to discretionary review by the Corporation and, therefore, does not vest to the employee. The bonus amount set forth for each fiscal year thus represents the amount actually paid for such fiscal year, plus amounts relating to the prior two fiscal years.

Edgar Filing: MICROFINANCIAL INC - Form 10-K

- (3) Amounts for Dr. Bleyleben include: (a) contributions by the Corporation under the Corporation's 401(k) retirement/profit sharing plan in 2002 (\$4,411), 2001 (\$3,200) and 2000 (\$3,199); (b) split dollar life insurance premiums paid by the Corporation in 2001 (\$90,382) and 2000 (\$65,259) (this policy was terminated in 2002 and the Corporation was repaid the cash value under the policy) and (c) executive disability insurance policy premiums paid by the Corporation in 2002 (\$7,816), 2001 (\$4,054) and 2000 (\$3,546).
- (4) Amounts for Mr. Latour include: (a) contributions by the Corporation under the Corporation's 401(k) retirement/profit sharing plan in 2002 (\$3,200), 2001 (\$3,200) and 2000 (\$3,323); (b) split dollar life insurance premiums paid by the Corporation in 2001 (\$50,782) and 2000 (\$49,318) (this policy was terminated in 2002 and the Corporation was repaid the cash value under the policy) and (c) executive disability insurance policy premiums paid by the Corporation in 2002 (\$3,091), 2001 (\$874) and 2000 (\$874).
- (5) Mr. Jackson joined the Company in 2002. Amounts for Mr. Jackson include contributions by the Corporation under the Corporation's 401(k) retirement/profit sharing plan in 2002 (\$3,143).
- (6) Amounts for Mr. Plumlee include: (a) contributions by the Corporation under the Corporation's 401(k) retirement/profit sharing plan in 2002 (\$4,213), 2001 (\$3,440), and 2000 (\$4,111); (b) split dollar life insurance premiums paid by the Corporation in 2001 (\$15,000), and 2000 (\$15,084) (this policy was

23

terminated in 2002 and the Corporation was repaid the cash value under the policy) and (c) executive disability insurance policy premiums paid by the Corporation in 2002 (\$1,016), 2001 (\$1,016) and 2000 (\$1,016).

- (7) Amounts for Ms. Salvo include: (a) contributions by the Corporation under the Corporation's 401(k) retirement/profit sharing plan in 2002 (\$3,673), 2001 (\$3,440) and 2000 (\$3,090); (b) executive disability insurance policy premiums paid by the Corporation in 2002 (\$686), 2001 (\$658) and 2000 (\$630); and (c) the benefit to the executive of interest-free loans from the Corporation based on the applicable federal rate in effect on the date of issuance of each such loan, in 2000 (\$981). This loan was repaid to the Corporation as of December 31, 2002.
- (8) Mr. Belinsky joined the Corporation in 2001. Amounts for Mr. Belinsky include: (a) contributions by the Corporation under the Corporation's 401(k) retirement/profit sharing plan in 2002 (\$5,072); and (b) executive disability insurance policy premiums paid by the Corporation in 2002 (\$1,255).

1998 EQUITY INCENTIVE PLAN

The following table indicates the aggregate options granted in 2002 to the Named Executive Officers:

OPTION/SAR GRANTS IN LAST FISCAL YEAR

INDIVIDUAL GRANTS

NUMBER OF SECURITIES	PERCENT OF TOTAL OPTIONS/SARS	POTENTIAL VALU RATES OF STOCK
-------------------------	-------------------------------------	----------------------------------

Edgar Filing: MICROFINANCIAL INC - Form 10-K

NAME	UNDERLYING OPTION/SARS GRANTED (#) (1)	GRANTED TO EMPLOYEES IN FISCAL YEAR (2)	EXERCISE OR BASE PRICE (\$/SH)	EXPIRATION DATE	FOR OPTION 5% (\$)
Peter R. Bleyleben...	50,000	5.15%	\$1.585	11/25/12	\$ 129,089
Richard F. Latour....	100,000	10.31%	\$ 6.70	02/28/12	\$1,091,360
	200,000	20.62%	\$1.585	11/25/12	\$ 516,360
James R. Jackson, Jr.....	150,000	15.46%	\$1.585	11/25/12	\$ 387,270
John Plumlee.....	40,000	4.12%	\$ 6.70	02/28/12	\$ 436,544
	50,000	5.15%	\$1.585	11/25/12	\$ 129,089
Carol Salvo.....	40,000	4.12%	\$ 6.70	02/28/12	\$ 436,544
	50,000	5.15%	\$1.585	11/25/12	\$ 129,089
Mark Belinsky.....	40,000	4.12%	\$ 6.70	02/28/12	\$ 436,544

(1) Stock options were granted under the Plan. No stock appreciation rights were awarded with these grants. All options granted other than those that expire on November 25, 2012 first become exercisable, in five equal annual installments, beginning one year from the grant date, and have a ten-year term. The options that expire on November 25, 2012 vested 20% on the date of grant and 5% every three months in arrears, and have a ten-year term. If a change of control of MicroFinancial were to occur, the options would become immediately exercisable in full.

All options outstanding to Messrs. Jackson, Plumlee and Belinsky and Ms. Salvo were cancelled in February 2003, and replaced by a smaller number of shares of restricted stock which vested 20% upon grant, and vests 5% on the first day of each quarter after the grant date, with accelerated vesting if the price of the Corporation's common stock exceeds certain thresholds during the vesting period. The number of shares of restricted stock for each Names Executive Officer is included in "Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters."

(2) The percentages in the table for the stock options granted in 2002 are based on a total of 970,000 stock options granted in 2002 to MicroFinancial employees, all of which were granted on the same material terms described in footnote (1) above.

24

(3) The dollar amounts under these columns represent the potential realizable value of each grant assuming that the market value of the Common Stock appreciates from the date of grant to the expiration of the option at annualized rates of 5% and 10%. These assumed rates of appreciation have been specified by the SEC for illustrative purposes only and are not intended to forecast future financial performance or possible future appreciation in the price of the Common Stock. The actual amount the executive officer may realize will depend on the extent to which the stock price exceeds the exercise price of the options on the date the option is exercised.

The following table indicates the fiscal year-end option values for options held by the Named Executive Officers at December 31, 2002. No options were exercised in 2002.

FISCAL YEAR-END OPTION VALUES

Edgar Filing: MICROFINANCIAL INC - Form 10-K

NAME	NUMBER OF SECURITIES UNDERLYING UNEXERCISED OPTIONS/SAR'S AT FISCAL YEAR-END (#)		VALUE OF UNEXERCISED IN-THE-MONEY OPTIONS AT FISCAL YEAR-END (\$)	
	EXERCISABLE	UNEXERCISABLE	EXERCISABLE	UNEXERCISABLE
Peter R. Bleyleben.....	110,000	140,000	\$0	
Richard F. Latour.....	188,000	452,000	\$0	
James R. Jackson, Jr.....	30,000	120,000	\$0	
John Plumlee.....	74,000	186,000	\$0	
Carol Salvo.....	74,000	186,000	\$0	
Mark Belinsky.....	6,000	64,000	\$0	

- (1) The exercise price of all unexercised options exceeded the fair market value of the Common Stock on December 31, 2002.
- (2) The value of unexercised in-the-money stock options at December 31, 2002 is presented to comply with regulations of the Securities and Exchange Commission. The actual amount realized upon exercise of stock options (if any) will depend upon the excess of the fair market value of the Common Stock over the exercise price at the time the stock option is exercised. There is no assurance that the values of unexercised stock options reflected in this table will be realized.

PROFIT SHARING PLAN AND DISCRETIONARY BOARD OF DIRECTOR BONUS PROGRAMS

The Corporation pays annual bonuses and makes profit sharing payments as determined by the Compensation Committee of the MicroFinancial Board. Each year the Compensation Committee indicates to the executive officers the percentage of the following year's pre-tax profits on which profit sharing plan payments will be based. Upon the conclusion of the audit of the prior year's financial results, the Compensation Committee determines the total percentage of pre-tax profits eligible for profit-sharing plan payments, and awards payments to all Named Executive Officers, as well as ten other employees. To enhance long-term retention of these executives, only one-third of the amount awarded is paid at that point in time. The remaining two-thirds may be paid out over the next two years in the discretion of the Compensation Committee and are subject to separate annual approvals of the Compensation Committee. In March 2003, the Board of Directors voted to issue promissory notes to these executives to cover the deferred portion of the profit-sharing plan payments.

EMPLOYMENT AGREEMENTS

The Corporation has entered into Employment Agreements with Dr. Bleyleben and Mr. Latour for a three-year period commencing June 12, 1998, subject to automatic successive one-year renewals unless terminated pursuant to the terms thereof. In the event of a termination of the Employment Agreements by the Corporation without cause, or by Dr. Bleyleben or Mr. Latour for specified good reason, the Employment Agreements provide for three years of severance payments to Dr. Bleyleben and Mr. Latour, respectively, on

the basis of their highest base salary during the employment period. In

Edgar Filing: MICROFINANCIAL INC - Form 10-K

addition, Dr. Bleyleben and Mr. Latour would also be entitled to a prorated payment of base salary and bonus to the date of termination, and the acceleration of deferred compensation and accrued but unpaid amounts under the Corporation's bonus and/or profit sharing plans. Dr. Bleyleben's and Mr. Latour's current base salaries, respectively, are \$130,000 and \$250,000. The bonus for the current fiscal year will be determined by the MicroFinancial Board. If, in connection with a payment under their Employment Agreement, either Dr. Bleyleben or Mr. Latour shall incur any excise tax liability on the receipt of "excess parachute payments" as defined in Section 280G of the Internal Revenue Code of 1986, as amended, the Employment Agreements provide for gross-up payments to return them to the after-tax position they would have been in if no excise tax had been imposed. As used in each Employment Agreement, "for good reason" means the assignment to the executive of duties inconsistent with the executive's position, authority, duties or responsibilities; the failure by the Corporation to pay the agreed base salary and provide the executive with benefits; moving the executive to a location outside of the metropolitan Boston, Massachusetts area; and the failure by the Corporation to require a successor to assume all obligations under the Employment Agreement.

The Corporation has also entered into separate employment agreements with Messrs. Jackson and Plumlee and Ms. Salvo, as well as six other employees, which are designed to provide an incentive to each executive to remain with the Corporation pending and following a Change in Control (as defined below). Each employment agreement has an initial term of one year following a Change in Control, with automatic extensions upon the expiration of the initial one-year term for successive one-month periods (such date and each annual anniversary thereof, the "Renewal Date"). Pursuant to each employment agreement, the executive will be entitled to receive an annual base salary of not less than twelve times the highest monthly base salary paid or payable to the executive within the twelve months preceding the Change in Control. If the employment agreement is terminated by the MicroFinancial Board other than for cause, death or disability, or is terminated by the executive for specified good reason, the Corporation shall pay to the executive, the aggregate of the following amounts: (i) one times annual base salary in the case of Mr. Jackson and one and one-half times the annual base salary in the case of Mr. Plumlee and Ms. Salvo; (ii) any other compensation or bonus previously deferred by the executive, together with any accrued interest or earnings thereon; and (iii) any accrued vacation pay. Pursuant to each employment agreement, if the Executive's employment is terminated during the Change of Control employment period, the Company shall pay the amounts referenced above to the Executive in a lump sum in cash within 30 days after the date of termination. If the Executive's employment is terminated prior to the first day of the Change of Control employment period, the Company is obligated to pay the amounts referenced above, however, payments of the Executive's annual base salary would be payable over twelve months, in the case of Mr. Jackson and eighteen months in the case of Mr. Plumlee and Ms. Salvo with payment to be made at the same time that the Company pays other peer executives of the Company.

"Change in Control" means (i) the acquisition by any individual, entity or group (within the meaning of Section 13(d)(3) or 14(d)(2) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")) of beneficial ownership (within the meaning of Rule 13d-3 promulgated under the Exchange Act) of 50% or more of either the then outstanding shares of Common Stock or the combined voting power of the then outstanding voting securities of the Corporation entitled to vote generally in the election of directors; (ii) individuals who, as of the date of the original employment agreements constitute the MicroFinancial Board, cease for any reason to constitute at least a majority of the MicroFinancial Board or are divested of possession by appointment of a trustee pursuant to Chapter 7 or 11 of the United States Bankruptcy Code, except with respect to any director who was approved by a vote of at least a majority of the directors then comprising the MicroFinancial Board; (iii) approval by the shareholders of the Corporation or, in the instance of proceedings for the

Edgar Filing: MICROFINANCIAL INC - Form 10-K

Corporation pursuant to Chapter 7 or Chapter 11 of the United States Bankruptcy Code, approval by the bankruptcy judge, of a reorganization, merger or consolidation, in each case, unless, following such reorganization, merger or consolidation, more than 60% of, respectively, the then outstanding shares of Common Stock of the corporation resulting from such reorganization, merger or consolidation and the combined voting power of the then outstanding voting securities of such corporation entitled to vote generally in the election of directors continues to be owned by the shareholders who were the beneficial holders of such stock prior to such transaction; or (iv) approval by the shareholders or, in the instance of

26

proceedings for the Company pursuant to Chapter 7 or Chapter 11 of the United States Bankruptcy Code, approval by the bankruptcy judge, of the Corporation of a complete liquidation or dissolution of the Corporation or the sale or other disposition of all or substantially all of the assets of the Corporation.

DIRECTOR COMPENSATION

The MicroFinancial Board is comprised of five Directors, two of whom, Peter Bleyleben and Richard F. Latour, are salaried employees of the Corporation who receive no additional compensation for services rendered as Directors. The members of the MicroFinancial Board who were not employees of the Corporation ("Non-Employee Directors") received stock options to purchase 50,000 shares of Common Stock in 1999 and stock options to purchase 50,000 shares of Common Stock in 2000 for their service on the MicroFinancial Board. In 2001, the Non-Employee Directors each received stock options to purchase 25,000 shares of Common Stock. In February 2002, the options granted in 2001 were voluntarily cancelled, and each of the Directors received new options to purchase 45,000 shares of Common Stock. In November 2002, the Non-Employee Directors each received stock options to purchase 50,000 shares of Common Stock. Directors also are reimbursed for out-of-state travel expenses incurred in connection with attendance at meetings of the MicroFinancial Board and committees thereof. In addition, the Corporation pays for health care insurance for each Non-Employee Director.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

SECURITIES AUTHORIZED FOR ISSUANCE UNDER EQUITY COMPENSATION PLANS AS OF DECEMBER 31, 2002

PLAN CATEGORY	NUMBER OF SECURITIES TO BE ISSUED UPON EXERCISE OF OUTSTANDING OPTIONS WARRANTS AND RIGHTS	WEIGHTED-AVERAGE EXERCISE PRICE OF OUTSTANDING OPTIONS, WARRANTS AND RIGHTS	NUMBER OF AVAILABLE EQUITY COMPENSATION SECURITIES
Equity compensation plans approved by security holders.....	2,995,000	\$7.849	
Equity compensation plans not approved by security holders.....	0	\$ 0	

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth information as of February 28, 2003 with respect to the beneficial ownership of Common Stock of each person known by the

Edgar Filing: MICROFINANCIAL INC - Form 10-K

Corporation to be the beneficial owner of more than 5% of the 13,141,800 shares of Common Stock outstanding as of such date (not including treasury stock), each director and executive officer of the Corporation and all directors and executive officers of the Corporation as a group. Each person named has sole voting and investment power with respect to the shares indicated, except as otherwise stated in the notes to the table.

NAME AND ADDRESS OF BENEFICIAL OWNER -----	NUMBER OF SHARES BENEFICIALLY OWNED (1) -----	PERCENTAGE OUTSTANDING OF COMMON STOCK -----
Peter R. Bleyleben(2)..... 66 Norfolk Road Chestnut Hill, Massachusetts 02464	1,532,910	11.5%
Torrence C. Harder(4)..... 675 Sudbury Road Concord, Massachusetts 01742	1,683,229	12.7%
Brian E. Boyle(3)..... 11 Whispering Lane Weston, Massachusetts 02493	1,446,900	10.9%

27

NAME AND ADDRESS OF BENEFICIAL OWNER -----	NUMBER OF SHARES BENEFICIALLY OWNED (1) -----	PERCENTAGE OUTSTANDING OF COMMON STOCK -----
Wasatch Advisors, Inc..... 150 Social Hall Avenue Salt Lake City, Utah 84111	1,543,355	11.7%
Key Colony Fund, L.P.(5)..... 10825 Financial Centre Parkway Suite 100 Little Rock, Arkansas 72211	689,300	5.2%
Royce & Associates, LLC..... 1414 Avenue of the Americas New York, New York 10019	701,700	5.3%
Alan J. Zakon(6)..... 32 Cardinal Lane Ocean Reef Club Key Largo, Florida 33037	131,500	*
Richard F. Latour(7)..... 11 Stillbrook Lane Mansfield, Massachusetts 02048	601,550	4.7%
James R. Jackson, Jr.(8)..... 6 Hickory Ridge Road Plaistow, New Hampshire 03865	85,558	*
John Plumlee(9)..... 243 Pearl Street Manchester, New Hampshire 03104	49,916	*
Carol Salvo(10)..... 3 Woodridge Road Medfield, Massachusetts 02052	64,916	*
Mark Belinsky(11)..... 237 Strasser Avenue Westwood, Massachusetts 02090	12,721	*

Edgar Filing: MICROFINANCIAL INC - Form 10-K

All directors and executive officers as a group (11 persons).....	5,659,200	43.1%
--	-----------	-------

* Less than 1%

- (1) Unless otherwise indicated in the footnotes, each of the stockholders named in this table has sole voting and investment power with respect to the shares of Common Stock shown as beneficially owned by such stockholder, except to the extent that authority is shared by spouses under applicable law.
- (2) Includes 152,500 shares of Common Stock issuable upon the exercise of options issued to Dr. Bleyleben which vest on or before May 1, 2003.
- (3) Includes 91,500 shares of Common Stock issuable upon the exercise of options issued to Dr. Boyle which vest on or before May 1, 2003 and 10,700 shares of Common Stock held in the Brian E. Boyle Charitable Foundation, for which Dr. Boyle disclaims beneficial ownership.
- (4) Includes 91,500 shares of Common Stock issuable upon the exercise of options issued to Mr. Harder which vest on or before May 1, 2003; 92,200 shares of Common Stock held in trust for Mr. Harder's daughter, Lauren E. Harder, over which Mr. Harder retains sole voting and investment power as the sole trustee and for which Mr. Harder disclaims beneficial ownership; 92,200 shares of Common Stock held in trust for Mr. Harder's daughter, Ashley J. Harder, over which Mr. Harder maintains voting and investment power as the sole trustee and for which Mr. Harder disclaims beneficial ownership; and 276,045 shares of Common Stock owned by Entrepreneurial Ventures, Inc. over which Mr. Harder retains shared voting and investment power through his ownership in, and positions as President and Director of, Entrepreneurial Ventures, Inc.

28

- (5) Alex R. Lieblong, Key Colony Fund, L.P., Key Colony Management LLC, Alex R. Lieblong IRA and Paul Spann filed a Schedule 13G with the Securities and Exchange Commission reporting that they held as a group 689,300 shares of Common Stock. In the Schedule 13G, Alex R. Lieblong reported that he had sole and shared voting and investment power over an aggregate of 689,300 shares held directly by him as well as the shares held by the Fund and the IRA; Key Colony Fund, L.P. reported that it had sole and shared voting and investment power over 668,900 shares held directly by it; Key Colony Management LLC reported that it had sole voting and investment power over the shares held by the Fund; Alex R. Lieblong IRA reported that it had sole voting and investment power over 4,100 shares held directly by it; and Paul Spann reported that he had sole voting and investment power over 16,900 shares held directly by him. All members of the group reported a business address as set forth in the table above.
- (6) Includes 91,500 shares of Common Stock issuable upon the exercise of options granted to Mr. Zakon which vest on or before May 1, 2003.
- (7) Includes 336,000 shares of Common Stock issuable upon the exercise of options granted to Mr. Latour which vest on or before May 1, 2003.
- (8) Consists of 85,558 shares of restricted stock over which Mr. Jackson has sole voting power. The stock may not be transferred by the executive until the shares are vested, and are forfeited if the executive leaves the employ

Edgar Filing: MICROFINANCIAL INC - Form 10-K

of the Corporation other than for reason of death or disability. The restricted stock vested 20% upon grant, and vests 5% on the first day of each quarter after the grant date, with accelerated vesting if the price of the Corporation's Common Stock exceeds certain thresholds during the vesting period.

- (9) Consists of 49,916 shares of restricted stock over which Mr. Plumlee has sole voting power. The stock may not be transferred by the executive until the shares are vested, and are forfeited if the executive leaves the employ of the Corporation other than for reason of death or disability. The restricted stock vested 20% upon grant, and vests 5% on the first day of each quarter after the grant date, with accelerated vesting if the price of the Corporation's Common Stock exceeds certain thresholds during the vesting period.
- (10) Includes 49,916 shares of restricted stock over which Ms. Salvo has sole voting power. The stock may not be transferred by the executive until the shares are vested, and are forfeited if the executive leaves the employ of the Corporation other than for reason of death or disability. The restricted stock vested 20% upon grant, and vests 5% on the first day of each quarter after the grant date, with accelerated vesting if the price of the Corporation's Common Stock exceeds certain thresholds during the vesting period. Also includes 15,000 shares of Common Stock held jointly by Ms. Salvo and her husband over which Ms. Salvo shares voting and investment power with her husband.
- (11) Consists of 12,721 shares of restricted stock over which Mr. Belinsky has sole voting power. The stock may not be transferred by the executive until the shares are vested, and are forfeited if the executive leaves the employ of the Corporation other than for reason of death or disability. The restricted stock vested 20% upon grant, and vests 5% on the first day of each quarter after the grant date, with accelerated vesting if the price of the Corporation's Common Stock exceeds certain thresholds during the vesting period.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Dr. Bleyleben, the Chairman and a Director of the Corporation, loaned the Corporation \$100,000 in the form of a term note on November 6, 2002, which matures on November 6, 2004 and bears interest at a rate of 7.5% per annum. Additionally, per the terms of the note, in the event of a payment default on the note, the interest rate will increase by 2 percentage points, for as long as the default goes uncured. On May 1, 2001 he also loaned \$200,000 in the form of a subordinated note. This note matures on May 1, 2006 (with a one-year optional extension by the Corporation) and bears interest at a rate of 12% per annum.

Mr. Boyle, a Director of the Corporation, loaned the Corporation \$100,000 in the form of a term note on November 26, 2002, which matures on November 26, 2004 and bears interest at a rate of 7.5% per annum.

29

Additionally, per the terms of the note, in the event of a payment default on the note, the interest rate will increase by 2 percentage points, for as long as the default goes uncured. On May 1, 2001 he also loaned \$200,000 in the form of a subordinated note. This note matures on May 1, 2006 (with a one-year optional extension by the Corporation) and bears interest at a rate of 12% per annum.

Mr. Harder, a Director of the Corporation, loaned the Corporation \$50,000 in the form of a term note on November 13, 2002 which matures on November 13, 2004 and bears interest at a rate of 7.5% per annum. Additionally, per the terms

Edgar Filing: MICROFINANCIAL INC - Form 10-K

of the note, in the event of a payment default on the note, the interest rate will increase by 2 percentage points, for as long as the default goes uncured. On May 1, 2001 he also loaned \$100,000 in the form of a subordinated note. This note matures on May 1, 2006 (with a one-year optional extension by the Corporation) and bears interest at a rate of 12% per annum.

Mr. Latour President, Chief Executive Officer, Treasurer, Clerk, Secretary and Director of the Corporation loaned the Corporation \$75,000 in the form of a subordinated note on May 1, 2001. The note matures on May 1, 2003 and bears interest at prime plus 3% per annum.

On March 29, 1999, Ms. Ingrid Bleyleben, Dr. Bleyleben's mother, loaned the Corporation \$200,000 in the form of a demand note at an interest rate per annum equal to a bank prime rate minus 1%. This note was repaid in full on May 16, 2002.

On March 30, 1999, Fritz Froelich, Dr. Bleyleben's father-in-law, loaned the Corporation \$85,000 in the form of a demand note at an interest rate per annum equal to a bank prime rate minus 1%. This note was repaid in full on February 20, 2002. On December 1, 1998, Mr. Froelich also loaned the Corporation \$35,000 in the form of a subordinated note. This note matures on December 1, 2003 and bears interest at 8% per annum.

All of the foregoing transactions are on terms at least as favorable as those that would have been obtained through arms-length negotiations.

ITEM 14. CONTROLS AND PROCEDURES

DISCLOSURE CONTROLS AND PROCEDURES

Within 90 days before filing this report, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures. Our disclosure controls and procedures are the controls and other procedures that we designed to ensure that we record, process, summarize and report in a timely manner the information we must disclose in reports that we file with or submit to the SEC. Richard F. Latour, our President and Chief Executive Officer, and James R. Jackson, our Vice President and Chief Financial Officer, reviewed and participated in this evaluation. Based on this evaluation, Messrs. Richard F. Latour and James R. Jackson concluded that, as of the date of their evaluation, our disclosure controls were effective.

INTERNAL CONTROLS

During the fourth quarter, a system access control deficiency was identified. It was determined that this deficiency potentially provided the opportunity for certain employees to gain direct access to certain data tables stored in the Company's database. Management took immediate steps to eliminate this issue and utilized non-system controls, which have long been in place, to test that the information contained in the database had not been corrupted. No discrepancies were encountered.

30

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

(a) (1) Financial Statements MicroFinancial Incorporated's Financial Statements, together with the related Independent Auditors' Report, appear at pages F-1 through F-31 of this Form 10-K

Edgar Filing: MICROFINANCIAL INC - Form 10-K

(2) None

(3) Exhibits Index

EXHIBIT NUMBER -----	DESCRIPTION -----
3.1	Restated Articles of Organization, as amended(1)
3.2	Bylaws(1)
10.1	Standard Terms and Condition of Indenture, dated as of March 21, 2000 governing the MFI Finance Corp. I 7.375% Lease-Backed Notes, Series 2000-1 (the "2000-1 Notes") and the MFI Finance Corp. I 6.939% Lease-Backed Notes, Series 2000-2 (the "2000-2 Notes")(6)
10.2	Supplement to Indenture, dated March 21, 2000, governing the 2000-1 Notes(6)
10.3	Specimen 2000-1 Note(6)
10.4	Standard Terms and Conditions of Servicing governing the 2000-1 Notes(6)
10.5	Office Lease Agreement by and between WXI/AJP Real Estate Limited Partnership and Leasecomm Corporation dated, May 3, 2000, for facilities in Newark, California(7)
10.6	Fourth Amended and Restated Revolving Credit Agreement, dated August 22, 2000, among Leasecomm Corporation, the lenders parties thereto, and Fleet National Bank as agent(8)
10.8	Office Lease Agreement by and between MicroFinancial Incorporated and Desmond Taljaard and Howard Friedman, Trustees of London and Leeds Bay Colony I Realty Trust, dated April 14, 1994, for facilities in Waltham, Massachusetts(1)
10.9**	1987 Stock Option Plan(1)
10.10**	Forms of Grant under 1987 Stock Option Plan(1)
10.12**	1998 Equity Incentive Plan(3)
10.13*+	Employment Agreement between the Company and Peter R. Bleyleben
10.14*+	Employment Agreement between the Company and Richard F. Latour
10.15	Amended and Restated Standard Terms and Condition of Indenture dated as of September 2001 governing the MFI Finance Corp. I, 5.5800% Lease-Backed Notes, Series 2000-3 (the "2001-3 Notes")(9)
10.16	Supplement to Indenture dated September 2001 governing the 2001-3 Notes(9)
10.17	Specimen 2001-3 Note(9)
10.18	Standard Terms and Conditions of Servicing governing the 2001-3 Notes(9)
10.19	Standard Terms and Condition of Indenture dated as of September 2001 governing the MFI Finance Corp. II, LLC, 8.0000% Lease-Backed Notes, Series 2001-1 (the "2001-1 Notes")(9)
10.20	Supplement to Indenture dated September 2001 governing the 2001-1 Notes(9)
10.21	Specimen 2001-1 Note(9)
10.22	Standard Terms and Conditions of Servicing governing the 2001-1 Notes(9)
10.25	Commercial Lease, dated November 3, 1998, between Cummings Properties Management, Inc. and MicroFinancial Incorporated(3)
10.26	Amendment to Lease #1, dated November 3, 1998, between

Edgar Filing: MICROFINANCIAL INC - Form 10-K

Cummings Properties Management, Inc. and MicroFinancial Incorporated(3)

10.30 Supplement to Indenture, dated December 1, 2000, governing the 2000-2 Notes(9)

10.31 Specimen, 2000-2 Notes(9)

31

EXHIBIT NUMBER -----	DESCRIPTION -----
10.33	Third Amended and Restated Revolving Credit Agreement, dated December 21, 1999, among Leasecomm Corporation, the lenders parties thereto, and BankBoston, N.A. as agent(5)
10.34	Fifth Amendment to Office Lease Agreement by and between MicroFinancial Incorporated and Leasecomm Corporation and Bay Colony Corporate Center LLC, dated June 29, 1999, for facilities in Waltham, Massachusetts(5)
10.40*+	Employment Agreement between the Company and John Plumlee
10.41*+	Employment Agreement between the Company and Carol Salvo
10.42*+	Employment Agreement between the Company and James R. Jackson, Jr.
10.43*+	Employment Agreement between the Company and Stephen Constantino
10.44*	Employment Agreement between the Company and Steven LaCreta
21.1	Subsidiaries of Registrant
23.1*	Consent of Deloitte & Touche LLP
99.1*	Certification of Chief Executive Officer Regarding Annual Report on Form 10-K for the Year Ended December 31, 2002
99.2*	Certification of Chief Financial Officer Regarding Annual Report on Form 10-K for the Year Ended December 31, 2002

* Filed herewith.

+ Management contract or compensatory plan or arrangement required to be filed as an exhibit pursuant to Item 14(c) of this Report.

- (1) Incorporated by reference to the Exhibit with the same exhibit number in the Registrant's Registration Statement on Form S-1 (Registration Statement No. 333-56639) filed with the Securities and Exchange Commission on June 9, 1998.
- (2) Incorporated by reference to the Exhibit with the same exhibit number in the Registrant's Amendment No. 1 to Registration Statement on Form S-1 (Registration Statement No. 333-56639) filed with the Securities and Exchange Commission on August 3, 1998.
- (3) Incorporated by reference to the Exhibit with the same exhibit number in the Registrant's Amendment No. 2 to Registration Statement on Form S-1 (Registration Statement No. 333-56639) filed with the Securities and Exchange Commission on January 11, 1999.
- (4) Incorporated by reference to the Exhibit with the same exhibit number in the Registrant's Amendment No. 3 to Registration Statement on Form S-1

Edgar Filing: MICROFINANCIAL INC - Form 10-K

(Registration Statement No. 333-56639) filed with the Securities and Exchange Commission on February 4, 1999.

- (5) Incorporated by reference to the Exhibit with the same exhibit number in the Registrant's Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 30, 2000.
- (6) Incorporated by reference to the Exhibit with the same exhibit number in the Registrant's Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on May 22, 2000.
- (7) Incorporated by reference to the Exhibit with the same exhibit number in the Registrant's Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on August 14, 2000.
- (8) Incorporated by reference to the Exhibit with the same exhibit number in the Registrant's Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on November 14, 2000.
- (9) Incorporated by reference to the Exhibit with the same exhibit number in the Registrant's Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on November 14, 2001.

(b) One report on Form 8-K was filed on October 11, 2002 disclosing other events, a second report on Form 8-K was filed on October 31, 2002 to discuss the third quarter results and a third report on

32

Form 8-K was filed on March 11, 2003, to announce the results for the year ended December 31, 2003. A fourth report on Form 8-K was filed on March 19, 2003 disclosing other events.

(c) See (a) (3) above.

(d) None.

33

SIGNATURES

Pursuant to the requirements of Section 13 of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

MICROFINANCIAL INCORPORATED

By: /s/ RICHARD F. LATOUR

President and Chief Executive
Officer

By: /s/ JAMES R. JACKSON JR.

Vice President and Chief Financial
Officer

Date: April 15, 2003

Pursuant to the requirements of the Securities Exchange Act of 1934, this

Edgar Filing: MICROFINANCIAL INC - Form 10-K

report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

SIGNATURE -----	TITLE -----	DA ---
/s/ PETER R. BLEYLEBEN ----- Peter R. Bleyleben	Chairman of the Board of Directors	April 1
/s/ RICHARD F. LATOUR ----- Richard F. Latour	President, Chief Executive Officer, Treasurer, Clerk, Secretary and Director	April 1
/s/ JAMES R. JACKSON JR. ----- James R. Jackson Jr.	Vice President and Chief Financial Officer	April 1
/s/ BRIAN E. BOYLE ----- Brian E. Boyle	Director	April 1
/s/ TORRENCE C. HARDER ----- Torrence C. Harder	Director	April 1
/s/ ALAN J. ZAKON ----- Alan J. Zakon	Director	April 1

34

CERTIFICATION

I, Richard F. Latour, certify that:

1. I have reviewed this annual report on Form 10-K of MicroFinancial Incorporated;

2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

Edgar Filing: MICROFINANCIAL INC - Form 10-K

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and

c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officer and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

/s/ RICHARD F. LATOUR

Richard F. Latour
President and Chief Executive Officer

Date: April 15, 2003

35

CERTIFICATION

I, James R. Jackson Jr., certify that:

1. I have reviewed this annual report on Form 10-K of MicroFinancial Incorporated;

2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;

Edgar Filing: MICROFINANCIAL INC - Form 10-K

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and

c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officer and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

/s/ JAMES R. JACKSON JR.

James R. Jackson Jr.
Vice President and Chief Financial
Officer

Date: April 15, 2003

36

MICROFINANCIAL INCORPORATED

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

Independent Auditors' Report.....	F-2
Financial Statements:	
Consolidated Balance Sheets as of December 31, 2001 and 2002.....	F-3

Edgar Filing: MICROFINANCIAL INC - Form 10-K

Consolidated Statements of Operations for the Years Ended
December 31, 2000, 2001, and 2002..... F-4
Consolidated Statements of Stockholders' Equity for the
Years Ended December 31, 2000, 2001, and 2002..... F-5
Consolidated Statements of Cash Flows for the Years Ended
December 31, 2000, 2001, and 2002..... F-6
Notes to Consolidated Financial Statements..... F-8

F-1

INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Stockholders of MicroFinancial Incorporated:

We have audited the accompanying consolidated balance sheets of MicroFinancial Incorporated and subsidiaries (the "Company") as of December 31, 2001 and 2002, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2002. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of MicroFinancial Incorporated and subsidiaries as of December 31, 2001 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2002, in conformity with accounting principles generally accepted in the United States of America.

DELOITTE & TOUCHE LLP

Boston, Massachusetts
April 15, 2003

F-2

MICROFINANCIAL INCORPORATED

CONSOLIDATED BALANCE SHEETS

DECEMBER 31,	
2001	2002
(IN THOUSANDS, EXCEPT SHARE DATA)	

Edgar Filing: MICROFINANCIAL INC - Form 10-K

ASSETS

Net investment in leases and loans:		
Receivables due in installments.....	\$ 399,361	\$334,623
Estimated residual value.....	37,114	30,754
Initial direct costs.....	7,090	4,891
Loans receivable.....	2,248	1,796
Less:		
Advance lease payments and deposits.....	(287)	(96)
Unearned income.....	(104,538)	(67,574)
Allowance for credit losses.....	(45,026)	(69,294)
	-----	-----
Net investment in leases and loans.....	\$ 295,962	\$235,100
Investment in service contracts.....	14,126	14,463
Cash and cash equivalents.....	146	5,494
Restricted cash.....	20,499	18,516
Property and equipment, net.....	16,034	9,026
Income taxes receivable.....	--	8,652
Other assets.....	14,961	3,834
	-----	-----
Total assets.....	\$ 361,728	\$295,085
	=====	=====

LIABILITIES AND STOCKHOLDERS' EQUITY

Notes payable.....	\$ 203,053	\$168,927
Subordinated notes payable.....	3,262	3,262
Capitalized lease obligations.....	833	471
Accounts payable.....	2,517	3,840
Dividends payable.....	642	--
Other liabilities.....	6,182	6,776
Income taxes payable.....	4,211	1,400
Deferred income taxes payable.....	30,472	23,806
	-----	-----
Total liabilities.....	251,172	208,482
	-----	-----
Commitments and contingencies (Note I).....	--	--
Stockholders' equity:		
Preferred stock, \$.01 par value; 5,000,000 shares authorized; none issued at 12/31/01 and 12/31/02.....	--	--
Common stock, \$.01 par value; 25,000,000 shares authorized; 13,410,646 shares issued at 12/31/01 and 12/31/02.....	134	134
Additional paid-in capital.....	47,723	47,723
Retained earnings.....	69,110	45,089
Treasury stock (588,700 shares of common stock at 12/31/01 and 12/31/02), at cost.....	(6,343)	(6,343)
Notes receivable from officers and employees.....	(68)	--
	-----	-----
Total stockholders' equity.....	110,556	86,603
	-----	-----
Total liabilities and stockholders' equity.....	\$ 361,728	\$295,085
	=====	=====

The accompanying notes are an integral part of the consolidated financial statements.

F-3

MICROFINANCIAL INCORPORATED

CONSOLIDATED STATEMENTS OF OPERATIONS

Edgar Filing: MICROFINANCIAL INC - Form 10-K

	FOR THE YEARS ENDED DECEMBER 31,		
	2000	2001	2002
	(IN THOUSANDS, EXCEPT PER-SHARE DATA)		
Revenues:			
Income on financing leases and loans.....	\$ 69,847	\$ 70,932	\$ 53,932
Income on service contracts.....	8,687	8,665	9,112
Rental income.....	27,638	37,664	37,664
Loss and damage waiver fees.....	6,034	6,344	6,344
Service fees and other.....	27,271	30,486	20,486
Total revenues.....	139,477	154,091	126,938
Expenses:			
Selling, general and administrative.....	38,371	44,899	45,899
Provision for credit losses.....	38,912	54,092	88,912
Depreciation and amortization.....	10,227	14,378	18,378
Interest.....	15,858	14,301	10,301
Total expenses.....	103,368	127,670	163,580
Income (loss) before provision for income taxes.....	36,109	26,421	(36,642)
Provision (benefit) for income taxes.....	15,249	10,104	(14,104)
Net income (loss).....	\$ 20,860	\$ 16,317	\$ (22,546)
Net income (loss) per common share -- basic.....	\$ 1.64	\$ 1.28	\$ (1.82)
Net income (loss) per common share -- diluted.....	\$ 1.63	\$ 1.26	\$ (1.82)
Dividends per common share.....	\$ 0.175	\$ 0.195	\$ 0.195

The accompanying notes are an integral part of the consolidated financial statements.

F-4

MICROFINANCIAL INCORPORATED

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2000, 2001 AND 2002

	COMMON STOCK		ADDITIONAL PAID-IN CAPITAL	RETAINED EARNINGS	TREASURY STOCK	
	SHARES	AMOUNT			SHARES	AMOUNT
	(IN THOUSANDS, EXCEPT SHARE DATA)					
Balance at December 31, 1999.....	13,347,726	\$133	\$47,920	\$ 36,656	667,790	\$(5,777)
Exercise of stock options.....	62,920	1	118			
Common stock dividends.....				(2,225)		
Treasury stock						

Edgar Filing: MICROFINANCIAL INC - Form 10-K

repurchased.....					164,100	(1,595)
Treasury stock retired.....		(138)			(162,190)	138
Notes receivable from officers and employees...						
Net income.....				20,860		
-----	-----	-----	-----	-----	-----	-----
Balance at December 31, 2000.....	13,410,646	\$134	\$47,900	\$ 55,291	669,700	\$(7,234)
Exercise of stock options, net of tax benefit.....			(177)		(96,000)	1,037
Common stock dividends.....				(2,498)		
Treasury stock repurchased.....					15,000	(146)
Net income.....				16,317		
-----	-----	-----	-----	-----	-----	-----
Balance at December 31, 2001.....	13,410,646	\$134	\$47,723	\$ 69,110	588,700	\$(6,343)
Common stock dividends.....				(1,923)		
Notes receivable from officers and employees...						
Net loss.....				(22,098)		
-----	-----	-----	-----	-----	-----	-----
Balance at December 31, 2002.....	13,410,646	\$134	\$47,723	\$ 45,089	588,700	\$(6,343)
=====	=====	=====	=====	=====	=====	=====

The accompanying notes are an integral part of the consolidated financial statements.

F-5

MICROFINANCIAL INCORPORATED

CONSOLIDATED STATEMENTS OF CASH FLOWS

	FOR THE YEAR ENDED DECEMBER 31,		
	2000	2001	2002
	-----	-----	-----
	(IN THOUSANDS)		
Cash flows from operating activities:			
Cash received from customers.....	\$ 174,501	\$ 185,939	\$ 175,859
Cash paid to suppliers and employees.....	(34,405)	(44,060)	(41,573)
Cash paid for income taxes.....	(9,726)	(6,767)	(3,829)
Interest paid.....	(15,649)	(14,186)	(10,222)
Interest received.....	1,639	1,354	393
	-----	-----	-----
Net cash provided by operating activities.....	116,360	122,280	120,628
	-----	-----	-----
Cash flows from investing activities:			
Investment in lease contracts.....	(141,076)	(92,118)	(66,042)
Investment in inventory.....	--	(4,198)	(2,989)
Investment in direct costs.....	(7,812)	(5,200)	(4,150)
Investment in service contracts.....	(4,138)	(6,658)	(6,773)
Investment in Resource Leasing Corporation.....	(2,800)	(6,900)	--
Investment in fixed assets.....	(2,354)	(1,722)	(255)
Repayment of notes from officers.....	25	--	68
Investment in notes receivable.....	(117)	(70)	--

Edgar Filing: MICROFINANCIAL INC - Form 10-K

Repayment of notes receivable.....	325	6	--
	-----	-----	-----
Net cash used in investing activities.....	(157,947)	(116,860)	(80,141)
	-----	-----	-----
Cash flows from financing activities:			
Proceeds from secured debt.....	195,917	84,750	33,521
Repayment of secured debt.....	(123,075)	(90,839)	(66,672)
Proceeds from refinancing of secured debt.....	473,118	515,897	490,000
Prepayment of secured debt.....	(488,118)	(509,555)	(490,100)
Proceeds from short-term demand notes payable.....	259	902	305
Repayment of short-term demand notes payable.....	(983)	(93)	(1,181)
Proceeds from issuance of subordinated debt.....	--	2,975	--
Repayment of subordinated debt.....	(4,500)	(4,500)	--
(Increase) decrease in restricted cash.....	(5,401)	(7,372)	1,983
Proceeds from exercise of common stock options.....	119	810	--
Repayment of capital leases.....	(494)	(505)	(430)
Purchase of treasury stock.....	(1,595)	(146)	--
Payment of dividends.....	(2,166)	(2,428)	(2,565)
	-----	-----	-----
Net cash provided by (used in) financing activities.....	43,081	(10,104)	(35,139)
	-----	-----	-----
Net increase in cash and cash equivalents.....	1,494	(4,684)	5,348
Cash and cash equivalents, beginning of period.....	3,336	4,830	146
	-----	-----	-----
Cash and cash equivalents, end of period.....	\$ 4,830	\$ 146	\$ 5,494
	=====	=====	=====

(Continued)

The accompanying notes are an integral part of the consolidated financial statements.

F-6

MICROFINANCIAL INCORPORATED
CONSOLIDATED STATEMENTS OF CASH FLOWS
(CONTINUED)

FOR THE YEAR ENDED DECEMBER 31,

2000 2001 2002

(IN THOUSANDS)

Reconciliation of net income to net cash provided by operating activities:			
Net income (loss).....	\$ 20,860	\$ 16,317	\$ (22,098)
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization.....	10,227	14,378	18,385
Provision for credit losses.....	38,912	54,092	88,948
Recovery of equipment cost and residual value, net of revenue recognized.....	40,288	34,685	49,046
Increase (decrease) in income taxes payable.....	(1,211)	1,878	(2,811)
Increase in income taxes receivable.....	--	--	(8,652)
Increase (decrease) in deferred income taxes.....	6,480	1,472	(6,666)
Changes in assets and liabilities:			
Decrease (increase) in other assets.....	(934)	(1,200)	3,124

Edgar Filing: MICROFINANCIAL INC - Form 10-K

Increase (decrease) in accounts payable.....	1,267	(129)	1,323
Increase in accrued liabilities.....	471	787	29
	-----	-----	-----
Net cash provided by operating activities.....	\$116,360	\$122,280	\$120,628
	=====	=====	=====
Supplemental disclosure of noncash activities:			
Property acquired under capital leases.....	\$ 109	\$ 479	\$ 68
	=====	=====	=====
Accrual of common stock dividends.....	\$ 573	\$ 642	\$ --
	=====	=====	=====

(Concluded)

The accompanying notes are an integral part of the consolidated financial statements.

F-7

MICROFINANCIAL INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (TABLES IN THOUSANDS, EXCEPT SHARE AND PER-SHARE DATA)

A. NATURE OF BUSINESS

MicroFinancial Incorporated (the "Company") which operates primarily through its wholly-owned subsidiary, Leasecomm Corporation, is a specialized commercial finance company that primarily leases and rents "microticket" equipment and provides other financing services in amounts generally ranging from \$400 to \$15,000 with an average amount financed of approximately \$1,500 and an average lease term of 44 months. The Company does not market its services directly to lessees but sources leasing transactions through a network of independent sales organizations and other dealer-based origination networks nationwide. The Company funded its operations primarily through borrowings under its credit facilities, issuances of subordinated debt and on balance sheet securitizations.

MicroFinancial incurred net losses of \$22.1 million for the year ended December 31, 2002. The net losses incurred by the Company during the third and fourth quarters caused the Company to be in default of certain debt covenants in its credit facility and securitization agreements. In addition, as of September 30, 2002, the Company's credit facility failed to renew and consequently, the Company was forced to suspend new origination activity as of October 11, 2002. On April 14, 2003, the Company entered into a long-term agreement with its lenders. This long-term agreement waives the defaults described above, and in consideration for this waiver, requires the outstanding balance of the loan to be repaid over a term of 22 months beginning in April 2003 at an interest rate of prime plus 2.0%. The Company received a waiver, which was set to expire on April 15, 2003, for the covenant violations in connection with the securitization agreement. Subsequently, the Company received a permanent waiver of the covenant defaults and the securitization agreement was amended so that going forward, the covenants are the same as those contained in the long-term agreement entered into on April 14, 2003, for the senior credit facility. To date, the Company has fulfilled all of its debt obligations, as agreed to by the bank group, in a timely manner.

In an effort to improve its financial position, MicroFinancial has taken certain steps including the engagement of a financial and strategic advisory firm, Triax Capital Advisors, LLC. Management and its advisors are actively considering various financing, restructuring and strategic alternatives as well as continuing to work closely with the Company's lenders to obtain long-term

Edgar Filing: MICROFINANCIAL INC - Form 10-K

agreements. In addition, Management has taken steps to reduce overhead, including a reduction in headcount from 380 to 203.

Leasecomm Corporation periodically finances its lease and service contracts, together with unguaranteed residuals, through securitizations using special purpose vehicles. MFI Finance Corporation I and MFI Finance Corporation II, LLC are special purpose companies. The assets of such special purpose vehicles and cash collateral or other accounts created in connection with the financings in which they participate are not available to pay creditors of Leasecomm Corporation, MicroFinancial Incorporated, or other affiliates. While Leasecomm Corporation generally does not sell its interests in leases, service contracts or loans to third parties after origination, the Company does, from time to time, contribute certain leases, service contracts, or loans to special-purpose entities for purposes of obtaining financing in connection with the related receivables. The contribution of such assets under the terms of such financings are intended to constitute "true sales" of such assets for bankruptcy purposes (meaning that such assets are legally isolated from Leasecomm Corporation). However, the special purpose entities to which such assets are contributed are not "qualifying special purpose entities" within the meaning Statement of Financial Accounting Standards ("SFAS") SFAS No. 140, and are required under generally accepted accounting principles to be consolidated in the financial statements of the Company. As a result, such assets and the related liability remain on the balance sheet and do not receive gain on sale treatment.

F-8

MICROFINANCIAL INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

B. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. Intercompany accounts and transactions have been eliminated in consolidation.

USE OF ESTIMATES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America, requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported period. A significant area requiring the use of management estimates is the Allowance for credit losses. Actual results could differ from those estimates.

CASH AND CASH EQUIVALENTS

The Company considers all highly liquid instruments purchased with initial maturities of less than three months to be cash equivalents. Cash equivalents consist principally of overnight investments.

RESTRICTED CASH

As part of its servicing obligation under the securitizations agreements, the Company collects cash receipts for financing contracts that have been pledged to special purpose entities, specifically MFI Finance Corporation I and MFI Finance Corporation II, LLC. These collections are segregated into separate

Edgar Filing: MICROFINANCIAL INC - Form 10-K

accounts for the benefit of the entities to which the related contracts were pledged or sold and are remitted to such entities on a weekly basis.

LEASES AND LOANS

The Company's lease contracts are accounted for as financing leases. At origination, the Company records the gross lease receivable, the estimated residual value of the leased equipment, initial direct costs incurred, and the unearned lease income. Unearned lease income is the amount by which the gross lease receivable plus the estimated residual value exceeds the cost of the equipment. Unearned lease income and initial direct costs incurred are amortized over the related lease term using the interest method, which results in a level rate of return on the net investment in leases. Unamortized unearned lease income and initial direct costs are written off if, in the opinion of management, the lease agreement is determined to be impaired. It is management's opinion, given the nature of its business and the large number of small balance lease receivables, that a lease is impaired when one of the following occurs: (i) the obligor files for bankruptcy; (ii) the obligor dies, and the equipment is returned; or (iii) an account has become 360 days past due without contact with the lessee. It is also management's policy to maintain an allowance for credit losses that will be sufficient to provide adequate protection against losses in its portfolio. Management regularly reviews the collectibility of its lease receivables based upon all of its communications with the individual lessees through its extensive collection efforts and through further review of the creditworthiness of the lessee.

In conjunction with the origination of leases, the Company may retain a residual interest in the underlying equipment upon termination of the lease. The value of such interest is estimated at inception of the lease and evaluated periodically for impairment. An impairment is recognized when expected cash flows to be realized subsequent to the end of the lease are expected to be less than the residual value recorded. Other revenues, such as loss and damage waiver and service fees relating to the leases, contracts, and loans and rental revenues are recognized as they are earned.

F-9

MICROFINANCIAL INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

Loans are reported at their outstanding principal balances. Interest income on loans is recognized as it is earned.

ALLOWANCE FOR CREDIT LOSSES

The Company maintains an allowance for credit losses on its investment in leases, service contracts and loans at an amount that it believes is sufficient to provide adequate protection against losses in its portfolio. The allowance is determined principally on the basis of the historical loss experience of the Company and the level of recourse provided by such lease, service contract or loan, if any, and reflects management's judgment of additional loss potential considering current economic conditions and the nature and characteristics of the underlying lease portfolio. The Company determines the necessary periodic provision for credit losses, taking into account actual and expected losses in the portfolio, as a whole, and the relationship of the allowance to the net investment in leases, service contracts and loans.

INVESTMENT IN SERVICE CONTRACTS

The Company's investments in cancelable service contracts are recorded at cost and amortized over the expected life of the service period, which is seven

Edgar Filing: MICROFINANCIAL INC - Form 10-K

years. Income on service contracts is recognized monthly as the related services are provided. The Company periodically evaluates whether events or circumstances have occurred that may affect the estimated useful life or recoverability of the investment in service contracts.

PROPERTY AND EQUIPMENT

At the end of the lease term, the lease typically converts into a month-to-month rental contract. Rental equipment is recorded at estimated residual value and depreciated using the straight-line method over a period of twelve months.

Office furniture, equipment and capital leases are recorded at cost and depreciated using the straight-line method over a period of three to five years. Leasehold improvements are amortized over the shorter of the life of the lease or the asset. Upon retirement or other disposition, the cost and related accumulated depreciation of the assets are removed from the accounts and the resulting gain or loss is reflected in income.

FAIR VALUE OF FINANCIAL INSTRUMENTS

For financial instruments including cash and cash equivalents, restricted cash, net investment in leases and loans, accounts payable, and other liabilities, it is assumed that the carrying amount approximates fair value.

DERIVATIVE FINANCIAL INSTRUMENTS

On January 1, 2001, the Company adopted SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" as amended by SFAS No. 138. SFAS No. 133, as amended, requires that all derivative instruments be measured at fair value and recognized in the consolidated balance sheet as either assets or liabilities. The Company has assessed the effects of SFAS No. 133 and has determined that the adoption of SFA No. 133 does not have a material impact on its results of operations or consolidated financial position. The Company did not hold any derivative instruments at either December 31, 2001 or 2002.

DEBT ISSUE COSTS

Debt issuance costs incurred in securing credit facility financing are capitalized and subsequently amortized over the term of the credit facility.

F-10

MICROFINANCIAL INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

INCOME TAXES

Deferred income taxes are determined under the liability method. Differences between the financial statement and tax bases of assets and liabilities are measured using the currently enacted tax rates expected to be in effect when these differences reverse. Deferred tax expense is the result of changes in the liability for deferred taxes. The principal differences between assets and liabilities for financial statement and tax return purposes are the treatment of leased assets, accumulated depreciation and provisions for doubtful accounts. The deferred tax liability is reduced by loss carryforwards and alternative minimum tax credits available to reduce future income taxes.

NEW ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board ("FASB") issued SFAS

Edgar Filing: MICROFINANCIAL INC - Form 10-K

No. 141, "Business Combinations." SFAS No. 141 addresses financial accounting and reporting for business combinations and amends or supersedes a number of interpretations concerning business combinations. SFAS No. 141 requires companies to use the purchase method of accounting for all business combinations, whereas previous interpretations provided for the use of another method (pooling-of-interests method) if certain criteria were met. This statement also amends the recognition policies of intangible assets and goodwill and provides for additional disclosure requirements for business combinations. The Company has determined that the adoption of this Statement does not have a material impact on its results of operations or consolidated financial position.

In June 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets". This statement supersedes APB Opinion No. 17, "Intangible Assets" ("APB No. 17") and addresses financial accounting and reporting for intangible assets, but not those acquired in a business combination at acquisition. SFAS No. 142 addresses financial accounting and reporting of goodwill and other intangible assets subsequent to their acquisition, assigning a definite or indefinite useful life to these assets. Goodwill and other intangible assets having an indefinite useful life will not be amortized, but rather tested at least annually for impairment. It also provides guidance on how to define, measure and record impairment losses on goodwill and other intangible assets and provides for additional disclosures regarding these assets in years subsequent to their acquisition. The Company has determined that the adoption of this Statement does not have a material impact on its results of operations or consolidated financial position.

In June 2001, the FASB issued SFAS No. 143 "Accounting for Asset Retirement Obligations." SFAS No. 143 provides new accounting standards for recording of liabilities related to legal obligations to retire tangible long-lived assets. The Statement requires an entity to recognize at fair value a liability associated with an asset retirement obligation in the period in which the liability is both incurred and in which the fair value is determinable. The provisions of this Statement are effective for the Company's fiscal year ended December 31, 2003, although earlier application is permitted. The Company has determined that the adoption of this Statement does not have a material impact on its results of operations or consolidated financial position.

In August 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 addresses financial accounting and reporting for the impairment or disposal of a long-lived asset or group of assets. This pronouncement, which supersedes and amends several earlier interpretations, establishes a single comprehensive statement to provide impairment accounting guidance for tangible long-lived assets to be either held and continued to be used by the entity or disposed of by sale or by some other means. The Company has determined that the adoption of this Statement does not have a material impact on its results of operations or consolidated financial position.

On January 1, 2002, the Company adopted the provisions of Statement of Position ("SOP") 01-6, Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others. The SOP was effective for financial statements issued for the fiscal year beginning after

F-11

MICROFINANCIAL INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

December 15, 2001. The Company has determined that the adoption of this SOP does not have a material impact on its results of operations or consolidated financial position.

Edgar Filing: MICROFINANCIAL INC - Form 10-K

In April 2002, the FASB issued SFAS No. 145, "Rescission of FASB Statements No. 4, 44 and 64 and Technical Corrections." This Statement which rescinds and amends several statements, improves financial reporting for extinguishment of debt, modifies the accounting for certain leasing transactions, and makes various technical corrections to existing pronouncements. The Statement requires the gains and losses from the extinguishment of debt to be classified as extraordinary items only if they meet the criteria in APB Opinion No. 30, "Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions." Also, the Statement requires that the accounting treatment of certain lease modifications that have economic effects similar to sale-leaseback transactions be accounted for in the same manner as sale-leaseback transactions. The Company has determined that the adoption of this Statement does not have a material impact on its results of operations or consolidated financial position.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." SFAS No. 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (EITF) Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." This statement requires an entity to recognize and measure initially at fair value a liability for a cost associated with an exit or disposal activity, when the liability is incurred. The provisions of this Statement are effective for exit or disposal activities that are initiated after December 31, 2002 although earlier adoption is permitted. The Company has determined that the adoption of this Statement does not have a material impact on its historical financial statements.

In October 2002, the FASB issued SFAS 147, "Acquisitions of Certain Financial Institutions." SFAS 147 addresses the financial accounting and reporting for the acquisition of all or part of a financial institution except for a transaction between two or more mutual enterprises. In addition, this statement removes acquisitions of financial institutions, other than transactions between two or more mutual enterprises, from the scope of FASB Statement No. 72, "Accounting for Certain Acquisitions of Banking or Thrift Institutions," and FASB Interpretation No. 9, "Applying APB Opinions No. 16 and 17 When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method." SFAS 147 clarifies that a branch acquisition that meets the definition of a business should be accounted for as a business combination, otherwise the transaction should be accounted for as an acquisition of net assets that does not result in the recognition of goodwill. The provisions of this Statement were effective on October 1, 2002. The Company has determined that the adoption of this Statement does not have a material impact on its results of operations or consolidated financial position.

In December 2002, the FASB issued SFAS 148, "Accounting for Stock-Based Compensation -- Transition and Disclosure, an amendment of FASB Statement No. 123." This statement amends FASB Statement No. 123, Accounting for Stock-Based Compensation, to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this Statement amends the disclosure requirements of Statement 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The Company has adopted the disclosure provisions under SFAS 148, but does not intend to adopt the fair value method.

In January 2003, the FASB issued FASB Interpretation No. 46 (FIN 46), "Consolidation of Variable Interest Entities an interpretation of ARB No. 51."

Edgar Filing: MICROFINANCIAL INC - Form 10-K

This interpretation clarifies the application of Accounting Research Bulletin No. 51, Consolidated Financial Statements to certain entities in which equity investors do not have the characteristic of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. The

F-12

MICROFINANCIAL INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

Company has determined that the adoption of the provisions under FIN 46 does not have a material impact on its results of operations or consolidated financial position.

RECLASSIFICATION OF PRIOR YEAR BALANCES

Certain reclassifications have been made to prior years' consolidated financial statements to conform to the current presentation.

NET INCOME (LOSS) PER COMMON SHARE

Basic net income per common share is computed based on the weighted-average number of common shares outstanding during the period. Dilutive net income per common share gives effect to all dilutive potential common shares outstanding during the period. The computation of diluted earnings per share does not assume the issuance of common shares that have an antidilutive effect on net income per common share. Options to purchase 830,000 and 440,609 shares of common stock were not included in the computation of diluted earnings per share for the years ended December 31, 2000 and 2001, respectively, because their effects were antidilutive. Stock options were excluded from the computation of dilutive earnings per share for the year ended December 31, 2002, because their inclusion would have had an antidilutive effect on earnings per share.

	FOR THE YEARS ENDED DECEMBER 31,		
	2000	2001	2002
Net income (loss).....	\$ 20,860	\$ 16,317	\$ (22,098)
Shares used in computation:			
Weighted-average common shares outstanding used in computation of net income per common share.....	12,728,441	12,789,605	12,821,946
Dilutive effect of common stock options.....	79,373	155,638	--
Shares used in computation of net income per common share -- assuming dilution.....	12,807,814	12,945,243	12,821,946
Net income (loss) per common share -- basic...	\$ 1.64	\$ 1.28	\$ (1.72)
Net income (loss) per common share -- diluted.....	\$ 1.63	\$ 1.26	\$ (1.72)

STOCK-BASED EMPLOYEE COMPENSATION

Edgar Filing: MICROFINANCIAL INC - Form 10-K

All stock options issued to employees have an exercise price not less than the fair market value of the Company's common stock on the date of grant. In accordance with accounting for such options utilizing the intrinsic-value method, there is no related compensation expense recorded in the Company's financial statements. The Company follows the disclosure requirements of SFAS No. 123, Accounting for Stock-Based Compensation. SFAS No. 123 requires that compensation under a fair value method be determined using the Black-Scholes option-pricing model and disclosed in a pro forma effect on earnings and earnings per share. The Company accounts for stock-based employee compensation plans under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. No stock-based employee compensation cost is reflected in net income, as either all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant or options granted that result in a variable compensation costs had an exercise price greater than the fair market value of the underlying common stock on December 31, 2002. The methodology used to calculate the fair value of stock-based employee compensation is described more fully in Note G. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value

F-13

MICROFINANCIAL INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation, to stock-based employee compensation.

	YEAR ENDED DECEMBER 31		
	2000	2001	2002
Net income (loss), as reported.....	\$20,860	\$16,317	\$(22,098)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects.....	(932)	(1,305)	(1,475)
Pro forma net income (loss).....	19,928	15,012	(23,573)
Earnings (loss) per share:			
Basic -- as reported.....	\$ 1.64	\$ 1.28	\$ (1.72)
Basic -- pro forma.....	\$ 1.57	\$ 1.17	\$ (1.84)
Diluted -- as reported.....	\$ 1.63	\$ 1.26	\$ (1.72)
Diluted -- pro forma.....	\$ 1.56	\$ 1.16	\$ (1.84)

The fair value of option grants is estimated on the date of grant utilizing the Black-Scholes option-pricing model with the following weighted-average assumptions.

2000	2001	2002
------	------	------

Edgar Filing: MICROFINANCIAL INC - Form 10-K

	-----	-----	-----
Risk-free interest rate.....	6.50%	5.03%	3.63%
Expected dividend yield.....	1.37%	2.50%	0.80%
Expected life.....	7 years	7 years	7 years
Volatility.....	55.00%	51.00%	68.00%

The weighted-average fair value at the date of grant for options granted during 2000, 2001, and 2002 approximated \$5.45, \$5.34, \$2.03 per option, respectively.

C. NET INVESTMENT IN LEASES AND LOANS

At December 31, 2002, future minimum payments on the Company's lease receivables are as follows:

FOR THE YEAR ENDED
DECEMBER 31,

2003.....	\$233,820
2004.....	60,645
2005.....	32,258
2006.....	7,426
2007.....	474

Total.....	\$334,623
	=====

At December 31, 2002, the weighted-average remaining life of leases in the Company's lease portfolio is approximately 26 months and the implicit rate of interest is approximately 34.4%.

The Company's business is characterized by a high incidence of delinquencies that in turn may lead to significant levels of defaults. The Company evaluates the collectibility of leases originated and loans based on the level of recourse provided, if any, delinquency statistics, historical loss experience, current economic

F-14

MICROFINANCIAL INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

conditions and other relevant factors. The Company provides an allowance for credit losses for leases which are considered impaired.

The Company takes charge-offs against its receivables when such receivables are 360 days past due and no contact has been made with the lessee for 12 months. Cumulative net charge-offs after recoveries from the Company's inception to December 31, 2002 have totaled 12.60% of total cumulative receivables plus total billed fees over such period.

The following table sets forth the Company's allowance for credit losses as of December 31, 2000, 2001, and 2002 and the related provisions, charge-offs and recoveries for the years ended December 31, 2000, 2001, and 2002.

Edgar Filing: MICROFINANCIAL INC - Form 10-K

Balance at December 31, 1999.....		\$41,719
Provision for leases and loans credit losses.....	36,029	
Provision for other asset credit losses.....	2,883	
Total provisions for credit losses.....		38,912
Charge-offs (including \$1,064 in other asset charge-offs)...	57,145	
Recoveries.....	19,257	

Charge-offs, net of recoveries.....		37,888

Balance of allowance for credit losses at December 31, 2000.....		\$40,924

Balance of other asset reserve at December 31, 2000.....		\$ 1,819

Provision for leases and loans credit losses.....	54,092	
Total provisions for credit losses.....		54,092
Charge-offs (including \$1,418 in other asset charge-offs)...	68,882	
Recoveries.....	17,474	

Charge-offs, net of recoveries.....		51,408

Balance of allowance for credit losses at December 31, 2001.....		\$45,026

Balance of other asset reserve at December 31, 2001.....		\$ 401

Provision for leases and loans credit losses.....	88,948	
Total provisions for credit losses.....		88,948
Charge-offs (including \$401 in other asset charge-offs).....	76,844	
Recoveries.....	11,763	

Charge-offs, net of recoveries.....		65,081

Balance of allowance for credit losses at December 31, 2002.....		\$69,294
		=====
Balance of other asset reserve at December 31, 2002.....		\$ --
		=====

In conjunction with the origination of leases, the Company may retain a residual interest in the underlying equipment upon termination of the lease. The value of such interests is estimated at inception of the lease and evaluated periodically for impairment. The following table sets forth the Company's estimated residual value as of December 31, 2000, 2001, and 2002 and changes in the Company's estimated residual

F-15

MICROFINANCIAL INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

value as a result of new originations, and lease terminations for the years ended December 31, 2000, 2001, and 2002.

Balance of Estimated Residual Value at December 31, 2000....	\$ 35,368
New Originations.....	15,052

Edgar Filing: MICROFINANCIAL INC - Form 10-K

Lease Terminations.....	(13,306)
Balance of Estimated Residual Value at December 31, 2001....	\$ 37,114
New Originations.....	10,254
Lease Terminations.....	(16,614)
Balance of Estimated Residual Value at December 31, 2002....	\$ 30,754

New originations represent the residual value added to the Company's estimated residual value upon origination of new leases. Lease terminations represent the residual value deducted from the company's estimated residual value upon the termination of a lease (i) that is bought out during or at the end of the lease term; (ii) upon expiration of the original lease term when the lease converts to an extended rental contract or (iii) that has been charged off by the Company.

D. PROPERTY AND EQUIPMENT

At December 31, 2001 and 2002, property and equipment consisted of the following:

	DECEMBER 31,	
	2001	2002
Rental Equipment and Inventory.....	\$19,196	\$15,751
Computer Equipment.....	7,251	7,072
Office Equipment.....	1,525	1,278
Leasehold improvements.....	381	154
	-----	-----
	28,353	24,255
Less accumulated depreciation and amortization.....	12,319	15,229
	-----	-----
Total.....	\$16,034	\$ 9,026
	=====	=====

Depreciation and amortization expense totaled \$10,227,000, \$14,378,000, and \$18,385,000 for the years ended December 31, 2000, 2001, and 2002, respectively.

At December 31, 2001 and 2002, computer equipment includes \$1,793,000 and \$1,650,000 respectively, under capital leases. Accumulated amortization related to capital leases amounted to \$988,000 and \$1,186,000 in 2001 and 2002, respectively.

E. NOTES PAYABLE AND SUBORDINATED DEBT

NOTES PAYABLE

On December 21, 1999, the Company entered into a revolving line of credit and term loan facility with a group of financial institutions whereby it may borrow a maximum of \$150,000,000 based upon qualified lease receivables. Outstanding borrowings with respect to the revolving line of credit bear interest based either at Prime for Prime Rate loans or the prevailing rate per annum as offered in the interbank Eurodollar market (Eurodollar) plus 1.75% for Eurodollar Loans. If the Eurodollar loans are not renewed upon their maturity they automatically convert into prime rate loans. On August 22, 2000, the revolving line of credit and term loan facility was amended and restated whereby the Company may now borrow a maximum of \$192,000,000 based upon qualified lease receivables, loans, rentals and service contracts. Outstanding borrowings with

Edgar Filing: MICROFINANCIAL INC - Form 10-K

F-16

MICROFINANCIAL INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

respect to the revolving line of credit bear interest based either at Prime minus 0.25% for Prime Rate Loans or the prevailing rate per annum as offered in the London Interbank Offered Rate (LIBOR) plus 1.75% for LIBOR Loans or the seven-day Money Market rate plus 2.00% for Swing Line Advances. If the LIBOR loans are not renewed upon their maturity they automatically convert into prime rate loans. The Swing Line Advances have a seven-day maturity, and upon their maturity they automatically convert into prime rate loans. In addition, the Company's aggregate outstanding principal amount of Swing Line Advances shall not exceed \$10 million. The prime rates at December 31, 2000, 2001, and 2002 were 9.50%, 4.75%, and 4.25% respectively. The 90-day LIBOR rates at December 31, 2001 and 2002 were 1.938% and 1.40% respectively. The 7-day Money Market Rates at December 31, 2001 was 1.88%.

At December 31, 2001 and 2002, the Company had borrowings outstanding under this agreement with the following terms:

TYPE	2001		2002	
	RATE	AMOUNT	RATE	AMOUNT
Prime.....	4.5000%	\$ 4,640	4.7500%	\$ 31,556
LIBOR.....	3.8750%	100,000	4.1875%	50,000
LIBOR.....			4.1875%	45,000
Total Outstanding.....		\$104,640		\$126,556

Outstanding borrowings are collateralized by leases, loans, rentals, and service contracts pledged specifically to the financial institutions. As of September 30, 2002 the revolving credit line failed to renew and the Company has been paying down the balance on the basis of a 36 month amortization plus interest. Based on the terms of the agreement, interest rates increased from Prime minus 0.25% to Prime plus 0.50% for prime based loans and from LIBOR plus 1.75% to LIBOR plus 2.50% for LIBOR based loans. In addition, based on the covenant defaults described below, the outstanding borrowings on all loans bear an additional 2.00% default interest. On January 3, 2003, the Company entered into a Forbearance and Modification Agreement for the senior credit facility which expired on February 7, 2003. Based on the terms of the Forbearance and Modification Agreement, interest rates increased again on the prime based loans to prime plus 1.00%.

At December 31, 2002, the Company was in default of certain of its debt covenants in its senior credit facility. The covenants that were in default with respect to the senior credit facility require that the Company maintain a fixed charge ratio in an amount not less than 130% of consolidated earnings, a consolidated tangible net worth minimum of \$77.5 million plus 50% of net income quarterly beginning with September 30, 2000 and compliance with the borrowing base. On April 14, 2003, the Company entered into a long-term agreement with its lenders. This long-term agreement waives the defaults described above, and in consideration for this waiver, requires the outstanding balance of the loan to be repaid over a term of 22 months beginning in April 2003 at an interest rate

Edgar Filing: MICROFINANCIAL INC - Form 10-K

of prime plus 2.0%. Based on the amortization schedule in the new agreement, the Company is obligated to repay a minimum of \$54 million, plus applicable interest, over the next twelve months.

BLT III had three series of notes, the 1996-A Notes, the 1997-A Notes and the 1998-A Notes. In May 1996, BLT III issued the 1996-A Notes in aggregate principal amount of \$23,406,563. In August 1997, BLT III issued the 1997-A Notes in aggregate principal amount of \$44,763,000 and in November 1998, BLT III issued the 1998-A Notes in aggregate principal amount of \$40,769,000. All outstanding amounts under the 1996-A Notes were repaid in October 1999. All outstanding amounts under the 1997-A Notes were repaid in September 2000. All outstanding amounts under the 1998-A notes were repaid in September 2001. MFI I has three series of notes, the 2000-1 Notes, the 2000-2 Notes, and the 2001-3 Notes. In March 2000, MFI I issued the 2000-1 Notes in aggregate principal amount of \$50,056,686. In December 2000, MFI I issued the 2000-2 Notes in aggregate principal amount of \$50,561,633. In September 2001, MFI I issued the 2001-3

F-17

MICROFINANCIAL INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

Notes in aggregate principal amount of \$39,397,354. Outstanding borrowings are collateralized by a specific pool of lease receivables. In September 2001, MFI II, LLC was formed and issued one series of notes, the 2001-1 Notes in aggregate principal amount of \$10,000,000. Outstanding borrowings are collateralized by a specific pool of lease receivables as well as the excess cash flow from the MFI I collateral. These notes are subordinated to the three series of notes issued by MFI I.

At December 31, 2002, the Company was in default on two of its debt covenants in its securitization agreements. The covenants that were in default with respect to the securitization agreements require that the Company maintain a fixed charge ratio in an amount not less than 125% of consolidated earnings and a consolidated tangible net worth greater than \$90 million plus 50% of net income for each fiscal quarter after June 30, 2001. Additionally per the terms of the securitization agreement, any default with respect to the senior credit facility is considered a default under the terms of the agreement. The Company received a waiver, which was set to expire on April 15, 2003, for the covenant violations in connection with the securitization agreement. Subsequently, the Company received a permanent waiver of the covenant defaults and the securitization agreement was amended so that going forward, the covenants are the same as those contained in the long-term agreement entered into on April 14, 2003, for the senior credit facility.

At December 31, 2002, MFI I and MFI II, LLC had borrowings outstanding under the series of notes with the following terms:

NOTE SERIES	EXPIRATION	RATE	AMOUNT
-----	-----	----	-----
MFI I			
2000-1 Notes.....	9/16/2005	7.38%	\$ 3,464
2000-2 Notes.....	6/16/2006	6.94%	17,983
2001-3 Notes.....	2/18/2008	5.58%	17,019
MFI II LLC			
2001-1 Notes.....	2/18/2008	8.00%	3,625

Edgar Filing: MICROFINANCIAL INC - Form 10-K

Total Outstanding.....	----- \$42,091 =====
------------------------	----------------------------

At December 31, 2001, MFI I and MFI II, LLC had borrowings outstanding under the series of notes with the following terms:

NOTE SERIES -----	EXPIRATION -----	RATE ----	AMOUNT -----
MFI I			
2000-1 Notes.....	9/16/2005	7.38%	\$19,855
2000-2 Notes.....	6/16/2006	6.94%	34,518
2001-3 Notes.....	2/18/2008	5.58%	34,160
MFI II LLC			
2001-1 Notes.....	2/18/2008	8.00%	8,725
Total Outstanding.....			----- \$97,258 =====

At December 31, 2001 and 2002, the Company also had other notes payable which totaled \$1,155,000 and \$280,000 respectively. Of these notes, at December 2001 and 2002, \$339,000 and \$30,000 respectively, are notes that are due on demand and bear interest at a rate of prime less 1.00%. As of December 31, 2002, \$250,000 are two-year term notes that carry an interest of 7.5%. As of December 31, 2001, the Company had \$816,000 of notes which were borrowed against the cash surrender value of the life insurance policies held on key officers. These notes were all repaid as of December 31, 2002. Other notes payable included amounts due

F-18

MICROFINANCIAL INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

to stockholders and directors of the Company at December 31, 2001 and 2002 of \$309,000 and \$250,000. Interest paid to stockholders under such notes was not material for the years ended December 31, 2001 and 2002.

SUBORDINATED NOTES PAYABLE

At December 31, 2001 and 2002, the Company also had subordinated debt outstanding amounting to \$3,262,000. This debt is subordinated in the rights to the Company's assets to notes payable to the primary lenders as described above. Outstanding borrowings bear interest ranging from 8% to 12.5% for fixed rate financing and prime plus 3% to 4% for variable rate financing. These notes have maturity dates ranging from May 2003 to November 2007. The Company had three senior subordinated notes. The first was issued in August 1994 at 12% to a financial institution with an aggregate principal amount of \$7,500,000. Cash proceeds from this note were \$6,743,108, net of a discount of \$756,892 which was amortized over the life of the note. This senior note required annual payments of \$1,500,000 commencing on July 15, 1997 until the note matured in July 2001. The second senior subordinated note was issued in October 1996 at 12.25% to a financial institution with an aggregate principal amount of \$5,000,000. This senior note required monthly payments of (i) \$125,000 for the period November 1, 1998 through October 1, 2000 and (ii) \$166,667 for the period November 1, 2000

Edgar Filing: MICROFINANCIAL INC - Form 10-K

until the note matured in October 1, 2001. In April 1999, this note was amended to require monthly payments of \$250,000 for the period May 1, 1999 until the note matured on September 1, 2000. The third senior subordinated note was issued in October 1996 at 12.60% to a financial institution with an aggregate principal amount of \$5,000,000. This senior note requires quarterly payments of \$250,000 commencing on March 15, 1999 until the note matures in October 2003. The most restrictive covenants of the senior subordinated note agreements have minimum net worth and interest coverage ratio requirements and restrictions on payment of dividends.

At December 31, 2000, the Company was in default on one of its debt covenants in its senior subordinated notes. The covenant that was in default requires that the Company maintain an allowance for credit losses in an amount not less than 100% of the Delinquent Billed Lease Receivables. The covenant default was waived as of December 31, 2000. In consideration of the waiver, the Company repaid one of the notes in full on March 2, 2001.

At December 31, 2001 and 2002, subordinated notes payable included \$727,000 due to stockholders, officers and directors. Interest paid to stockholders, officers and directors under such notes, at rates ranging between 8% and 12%, amounted to \$8,500, \$53,700, and \$84,000 for the years ended December 31, 2000, 2001, and 2002, respectively.

REPAYMENT SCHEDULE

At December 31, 2002, the repayment schedule for outstanding notes and subordinated notes is as follows:

FOR THE YEAR ENDED DECEMBER 31, -----	
2003.....	\$ 83,677
2004.....	51,397
2005.....	34,515
2006.....	2,600
Thereafter.....	--

Total.....	\$172,189 =====

F-19

MICROFINANCIAL INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

It is estimated that the carrying amounts of the Company's borrowings under its variable rate revolving credit agreements approximate their fair value. The fair value of the Company's short-term and long-term fixed rate borrowings is estimated using discounted cash flow analysis, based on the Company's current incremental borrowing rates for similar types of borrowing arrangements. At December 31, 2001 and 2002, the aggregate carrying value of the Company's fixed rate borrowings was approximately \$101,336,000, and \$45,603,000 respectively, with an estimated fair value of approximately \$102,049,000, and \$45,562,000 respectively.

F. REDEEMABLE PREFERRED STOCK:

Edgar Filing: MICROFINANCIAL INC - Form 10-K

At December 2001 and 2002, the Company had authorized 5,000,000 shares of preferred stock ("preferred stock") with a par value of \$0.01 of which zero shares were issued and outstanding.

G. STOCKHOLDERS' EQUITY:

COMMON STOCK

The Company had 25,000,000 authorized shares of common stock with a par value of \$.01 per share of which 13,410,646 shares were issued and outstanding at December 31, 2001 and 2002.

TREASURY STOCK

The Company had 588,700 shares of common stock in treasury at December 31, 2001 and 2002.

STOCK OPTIONS

In 1987, the Company adopted its 1987 Stock Option Plan (the "Plan") which provided for the issuance of qualified or nonqualified options to purchase shares of the Company's common stock. In 1997, the Company's Board of Directors approved an amendment to the plan, as a result of the June 16, 1997 stock split. Pursuant to this amendment, the aggregate number of shares issued could not exceed 1,220,000 and the exercise price of any outstanding options issued pursuant to the Plan would be reduced by a factor of ten and the number of outstanding options issued pursuant to the Plan would be increased by a factor of ten. The Company adopted the 1998 Equity Incentive Plan (the "1998 Plan") on July 9, 1998. The 1998 Plan permits the Compensation Committee of the Company's Board of Directors to make various long-term incentive awards, generally equity-based, to eligible persons. The Company reserved 4,120,380 shares of its common stock for issuance pursuant to the 1998 Plan. Qualified stock options, which are intended to qualify as "incentive stock options" under the Internal Revenue Code, may be issued to employees at an exercise price per share not less than the fair value of the common stock at the date granted as determined by the Board of Directors. Nonqualified stock options may be issued to officers, employees and directors of the Company as well as consultants and agents of the Company at an exercise price per share not less than fifty percent of the fair value of the common stock at the date of grant as determined by the Board. The vesting periods and expiration dates of the grants are determined by the Board of Directors. The option period may not exceed ten years.

F-20

MICROFINANCIAL INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

The following summarizes the stock option activity:

	SHARES	PRICE PER SHARE	WEIGHTED- AVERAGE EXERCISE PRI
	-----	-----	-----
Outstanding at December 31, 1999.....	936,920	\$0.6375 to \$13.544	\$11.357
Exercised.....	(62,920)	\$0.6375 to \$1.95	\$ 1.889
Canceled.....	(10,000)	\$12.313	\$12.313
Granted.....	730,000	\$9.781	\$ 9.781

Edgar Filing: MICROFINANCIAL INC - Form 10-K

Outstanding at December 31, 2000.....	1,594,000	\$1.95 to \$13.544	\$11.003
Exercised.....	(96,000)	\$1.95 to \$13.125	\$ 8.439
Canceled.....	(112,000)	\$9.78125 to \$13.125	\$11.214
Granted.....	650,000	\$9.48 to \$13.10	\$11.708

Outstanding at December 31, 2001.....	2,036,000	\$9.48 to \$13.544	\$11.337

Canceled.....	(391,000)	\$6.70 to \$13.544	\$11.184
Granted.....	1,350,000	\$1.585 to \$6.70	\$ 3.555

Outstanding at December 31, 2002.....	2,995,000	\$1.585 to \$13.544	\$ 7.849
	=====		

The options vest over five years and are exercisable only after they become vested. At December 31, 2000, 2001 and 2002, 200,000, 414,000 and 876,000, respectively, of the outstanding options were fully vested.

At December 31, 2001 and 2002, 2,036,000 and 2,995,000 shares, respectively, of common stock were reserved for common stock option exercises.

Information relating to stock options at December 31, 2002, summarized by exercise price, is as follows:

OUTSTANDING			EXERCISABLE	
EXERCISE PRICE	SHARES	WEIGHTED-AVERAGE LIFE (YEARS)	EXERCISE PRICE	SHARES
\$ 12.3125	581,391	6.15	\$12.3125	345,635
\$ 13.5440	40,609	6.15	\$13.5440	24,365
\$ 12.0625	10,000	6.58	\$12.0625	6,000
\$ 9.7813	608,000	7.15	\$ 9.7813	242,000
\$ 13.1000	260,000	8.14	\$13.1000	52,000
\$ 9.4800	200,000	8.87	\$ 9.4800	40,000
\$ 6.7000	465,000	9.17	\$ 6.7000	--
\$ 1.5850	830,000	9.91	\$ 1.5850	166,000
	-----			-----
\$1.585 to \$13.544	2,995,000	8.22	\$ 9.5303	876,000
	=====			=====

F-21

MICROFINANCIAL INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

H. INCOME TAXES:

The provision (benefit) for income taxes consists of the following:

FOR THE YEARS ENDED DECEMBER 31,		
2000	2001	2002
-----	-----	-----

Edgar Filing: MICROFINANCIAL INC - Form 10-K

Current:			
Federal.....	\$ 7,109	\$ 7,633	\$ (7,198)
State.....	1,659	1,000	(872)
	-----	-----	-----
	8,768	8,633	(8,070)
	-----	-----	-----
Deferred:			
Federal.....	5,532	1,256	(4,685)
State.....	949	215	(1,980)
	-----	-----	-----
	6,481	1,471	(6,665)
	-----	-----	-----
Total.....	\$15,249	\$10,104	\$ (14,735)
	=====	=====	=====

At December 31, 2001 and 2002, the components of the net deferred tax liability were as follows:

	2001	2002
	-----	-----
Deferred tax assets:		
Allowance for credit losses.....	\$ 19,181	\$ 17,353
Lease receivable and unearned income.....	7,159	59,582
State NOL and other state attributes.....	0	1,249
	-----	-----
Total deferred tax asset.....	\$ 26,340	\$ 78,184
	=====	=====
Deferred tax liabilities:		
Residual value.....	\$ (8,677)	\$ (8,428)
Initial direct cost.....	(4,470)	(4,013)
State refunds.....	0	(432)
Depreciation and amortization.....	(43,665)	(89,117)
	-----	-----
Total deferred tax liability.....	\$ (56,812)	\$ (101,990)
	=====	=====
Net deferred tax liability.....	\$ (30,472)	\$ (23,806)
	=====	=====

A valuation allowance against the deferred tax assets is not considered necessary, because it is more likely than not that the deferred tax assets will be fully realized.

At December 31, 2002, the Company had state loss carryforwards of \$8,800,000 which may be used to offset future income. These loss carryforwards are available for use against future state income until they expire between the years 2007 and 2022.

F-22

MICROFINANCIAL INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

The following is a reconciliation between the effective income tax rate and the applicable statutory federal income tax rate:

Edgar Filing: MICROFINANCIAL INC - Form 10-K

	FOR THE YEARS ENDED DECEMBER 31,		
	2000	2001	2002
Federal statutory rate.....	35.00%	35.00%	(35.00)%
State income taxes, net of federal benefit.....	5.60%	4.60%	(5.38)%
Nondeductible expenses and other.....	1.60%	(1.40)%	0.38%
Effective income tax rate.....	42.20%	38.20%	(40.00)%

I. COMMITMENTS AND CONTINGENCIES:

OPERATING AND CAPITAL LEASES

The Company's lease for its facility in Waltham, Massachusetts, expires in 2004. This lease contains one five-year renewal option with escalation clauses for increases in the lessor's operating costs. The Company's lease for its facilities in Newark, California expires in 2005. The Company's lease for its facilities in Woburn, Massachusetts, expires in 2003. The Company has vacated the facilities in Newark, California and Herndon, Virginia and is in the process of negotiating early termination of the outstanding leases.

The Company also has entered into various operating lease agreements ranging from three to four years for additional office equipment. At December 31, 2002, the future minimum lease payments under noncancelable operating leases with remaining terms in excess of one year are as follows:

FOR THE YEARS ENDED DECEMBER 31,	

2003.....	\$1,776
2004.....	867
2005.....	227
2006.....	--
Total.....	\$2,870

Rental expense under operating leases totaled \$1,557,000, \$1,998,000, and \$2,321,000 for the years ended December 31, 2000, 2001, and 2002, respectively. Rental expense for the year ended 2002 includes \$316,000 for the net present value for the remaining lease payments on office space that is currently not being utilized.

F-23

MICROFINANCIAL INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

The Company has entered into various capital lease agreements ranging from three to four years for office equipment, computer equipment and

Edgar Filing: MICROFINANCIAL INC - Form 10-K

telecommunication systems. At December 31, 2002, future minimum lease payments under capital leases were as follows:

FOR THE YEARS ENDED
DECEMBER 31,

2003.....	\$272
2004.....	180
2005.....	55
2006.....	--

Total minimum lease payments.....	507
Less amounts representing interest.....	(36)

Total.....	\$471
	====

LEGAL MATTERS

Management believes, after consultation with counsel, that the allegations against the Company included in the lawsuits described below are subject to substantial legal defenses, and the Company is vigorously defending each of the allegations. The Company also is subject to claims and suits arising in the ordinary course of business. At this time, it is not possible to estimate the ultimate loss or gain, if any, related to these lawsuits, nor if any such loss will have a material adverse effect on the Company's results of operations or financial position.

A. The Company filed an action in the United States District Court for the District of Massachusetts against Sentinel Insurance Company, Ltd., ("Sentinel"), Premier Holidays International, Inc., ("Premier") and Daniel DelPiano ("DelPiano") arising from Premier's October, 1999, default on its repayment obligations to the Company under a Twelve Million Dollar (\$12,000,000) loan. Judgment has been entered in this case against Sentinel, which had issued a business performance insurance policy guaranteeing repayment of the loan, in the amount of Fourteen Million Dollars (\$14,000,000). This judgment has not been satisfied. Sentinel is currently undergoing liquidation proceedings, and a claim in this amount has been filed with the bankruptcy court. Premier has asserted a counterclaim against the Company for Seven Hundred Sixty Nine Million Three Hundred Fifty Thousand dollars (\$769,350,000) in actual and consequential damages, and for Five Hundred Million Dollars (\$500,000,000) in punitive damages, plus interest, cost and attorney's fees. The counterclaim is based upon an alleged representation by the Company that it would lend Premier an additional Forty-Five Million Dollars (\$45,000,000), when all documents evidencing the Premier loan refer only to the Twelve Million (\$12,000,000) amount actually loaned and not repaid. The Company denies any liability on the counterclaim, which the Company is vigorously contesting. The Company's motion for summary judgment seeking dismissal of the counterclaim and the award of full damages on the Company's claims was denied by Court Order, without a written decision. The Company's motion for the appointment of a special master was also denied without a written decision. Because of the uncertainties inherent in litigation, we cannot predict whether the outcome will have a material adverse effect.

B. On January 29, 2002, Leasecomm was served with an Amended Complaint ("Complaint") in an action entitled People v. Roma Computer Solutions, Inc., et al., Ventura County Superior Court Case No. CIV207490. The Complaint asserts two claims, one for violation of the California Business Professions Code Section

Edgar Filing: MICROFINANCIAL INC - Form 10-K

17500 (false advertising), and the other for violation of the California Business and Professions Code Section 17200 (unfair or unlawful acts or practices). The claims arise from the marketing and selling activities of other defendants, including Roma Computer Solutions, Inc., and/or Maro Securities, Inc. The Complaint seeks to have Leasecomm held liable for the acts of other defendants, alleging that Leasecomm

F-24

MICROFINANCIAL INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

directly participated in those acts and received proceeds and the assignment of lease contracts as a result of those acts. The Complaint requests injunctive relief, rescission, restitution, and a civil penalty. The Company has filed an Answer denying the claims. Because of the uncertainties inherent in litigation, we cannot predict whether the outcome will have a material adverse affect.

C. On May 8, 2000, Plaintiff Efraim Bason brought an action in the Supreme Court of the State of New York, County of Nassau, seeking compensatory damages in the amount of \$450,000 and punitive damages under various legal theories for Leasecomm's refusal to promptly release him from an equipment lease to which he claims his name was forged (the "Bason Complaint"). The Bason Complaint alleged that Leasecomm's failure to promptly release him from the lease, and subsequent negative reports to credit agencies, ruined his credit and prevented him from securing certain financing that he allegedly needed to purchase merchandise which he claims he could have then re-sold at a \$450,000 profit. Leasecomm has subsequently settled this matter with Court approval.

D. On January 29, 2002, Leasecomm was served with an Amended Complaint ("Complaint") in an action entitled Rae Lynn Copitka v. Leasecomm Corp., et al., Travis County (Texas) District Court Case No. GN-102292. The Complaint asserts that the original action, filed mid-2001 by a single plaintiff should proceed as a class action. In the original action, Ms. Copitka sought to rescind her finance lease with Leasecomm and to recover economic damages arising from prior payments under the lease. Ms. Copitka alleges that her proposed class includes all persons in Texas who have executed Leasecomm finance leases for "virtual terminal" type credit card software during the years 1998, 1999, 2000, and 2001. On November 25, 2002 Leasecomm and E-Commerce Exchange agreed to settle the case with Ms. Copitka and a class of residents of Texas who leased Quickcommerce or QuickcommercePro software licenses from Leasecomm. The Travis County District Court entered its order approving the class settlement and entered its final judgement in the case on January 24, 2003. Leasecomm has satisfied its obligations under the Settlement, and the time to appeal has expired.

E. On April 3, 2000, a purported class action suit was filed in Superior Court of the State of California, County of San Mateo against Leasecomm and MicroFinancial as well as a number of other defendants with whom Leasecomm and MicroFinancial are alleged to have done business, directly or indirectly. The complaint seeks certification of a subclass of those class members who entered into any lease agreement contracts with Leasecomm for the purposes of financing the goods or services allegedly purchased from other defendant entities. The class action complaint alleges multiple causes of action, including: fraud and deceit; negligent misrepresentation; unfair competition; false advertising; unjust enrichment; fraud in the inducement and the inception of contract; lack of consideration for contact; and breach of the contractual covenant of good faith and fair dealing.

The Court granted final approval of the class action Settlement on December 2, 2002. Leasecomm has satisfied its obligations under the Settlement, and the time to appeal has expired. The Court retains jurisdiction to oversee any issues

Edgar Filing: MICROFINANCIAL INC - Form 10-K

that may arise regarding administration of the settlement.

F. In October, 2002, the Company was served with a Complaint in an action in the United States District Court for the Southern District of New York filed by approximately 170 present and former lessees asserting individual claims. The Complaint contains claims for violation of RICO (18 U.S.C. sec. 1964), fraud, unfair and deceptive acts and practices, unlawful franchise offerings, and intentional infliction of mental anguish. The claims purportedly arise from Leasecomm's dealer relationships with Themeware, E-Commerce Exchange, Cardservice International, Inc., and Online Exchange for the leasing of websites and virtual terminals. The Complaint asserts that the Company is responsible for the conduct of its dealers in trade shows, infomercials and web page advertisements, seminars, direct mail, telemarketing, all which are alleged to constitute unfair and deceptive acts and practices. Further, the Complaint asserts that Leasecomm's lease contracts as well as its collection practices and late fees are unconscionable. The Complaint seeks restitution, compensatory and treble damages, and injunctive relief. The Company filed a Motion to Dismiss the

F-25

MICROFINANCIAL INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

Complaint on January 31, 2003, and expects that the Motion will be argued sometime after May 6, 2003. Because of the uncertainties inherent in litigation, we cannot predict whether the outcome will have a material adverse effect.

G. On March 31, 2002, plaintiffs Robert Hayden and Renono Wesley filed a Complaint against Leasecomm Corporation alleging a violation of California Business & Professions Code Section 17200. The Complaint was filed on behalf of Hayden and Wesley individually, on behalf of a class of people similarly situated, and on behalf of the general public. The case is venued in San Francisco Superior Court. Specifically, plaintiffs allege that Leasecomm's practice of filing suits against lessees in Massachusetts courts constitutes an unfair business practice under California law. On March 12, 2003, the San Francisco County Superior Court granted Leasecomm's Motion to dismiss this action.

H. On August 22, 2002 plaintiff Aaron Cobb filed a Complaint against Leasecomm Corporation and MicroFinancial, Inc. and another Entity known as Galaxy Mall, Inc. alleging breach of contract; Fraud, Suppression and Deceit; Unjust Enrichment; Conspiracy; Conversion; Theft by Deception; and violation of Alabama Usury Laws. The Complaint was filed on behalf of Aaron Cobb individually, and on behalf of a class of persons and entities similarly situated in the State of Alabama. More specifically, the Plaintiff purports to represent a class of persons and small business in the State of Alabama who allegedly were induced to purchase services and/or goods from any of the Defendants named in the Complaint. The case is venued in Bullock County, Alabama. On March 31, 2003 the trial court entered an Order denying the Company's Motion to Dismiss. This Order is currently being reviewed and in all likelihood will be appealed to the Alabama Supreme Court. The appeal must be filed within 45 days of the entry of the Order. Should the appeal not be filed or should the Company otherwise be unsuccessful with its appeal the discovery in this case would commence with the first efforts being directed toward the Class Certification issues. The Company continues to deny any wrongdoing and plans to vigorously defend this claim. Because of the uncertainties inherent in litigation, the company cannot predict whether the outcome will have a material adverse affect.

I. In March, 2003, an action was filed by a shareholder against the Company in United States District Court asserting a single count of common law fraud and constructive fraud. The complaint alleges that the shareholder was

Edgar Filing: MICROFINANCIAL INC - Form 10-K

defrauded by untrue statements made to him by management, upon which he relied in the purchase of Company stock for himself and for others. The complaint seeks damages in an unspecified amount. Because of the uncertainties inherent in litigation, we cannot predict whether the outcome will have a material adverse effect.

J. In March, 2003, a purported class action was filed in Superior Court in Massachusetts against Leasecomm and one of its dealers. The class sought to be certified is a nationwide class (excluding certain residents of the State of Texas) who signed identical or substantially similar lease agreements with Leasecomm covering the same product. The complaint asserts claims for declaratory relief, rescission, civil conspiracy, usury, breach of fiduciary duty, and violation of Massachusetts General Laws Chapter 93A, Section 11 ("Chapter 93A"). The claims concern the validity, enforceability, and alleged unconscionability of agreements provided through the dealer, including a Leasecomm lease, to acquire on line credit card processing services. The complaint seeks rescission of the lease agreements with Leasecomm, restitution, multiple damages and attorneys fees under Chapter 93A, and injunctive relief. Because of the uncertainties inherent in litigation we cannot predict whether the outcome will have a material adverse effect.

Leasecomm has been served with Civil Investigative Demands by the Offices of the Attorney General for the states of Kansas, Illinois, Florida, and Texas, and for the Commonwealth of Massachusetts. Those Offices of the Attorney General, in conjunction with the Northwest Region Office of the Federal Trade Commission, the Offices of the Attorney General for North Carolina and North Dakota, and the Ventura County, California, District Attorney's Office, have informed Leasecomm that they are seeking to coordinate their investigations (collectively, the "Government Investigators"). At this time, the principal focus of the investigations appears to be software license leases (principally virtual terminals) and leases from certain

F-26

MICROFINANCIAL INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

vendor/dealers whose activities included business opportunity seminars. Leasecomm has further been informed that the investigations cover certain lease provisions, including the forum selection clause and language concerning the non-cancellability of the lease. In addition, the investigations include, among other things, whether Leasecomm's lease termination, or rollover, provisions, are legally sufficient; whether a Leasecomm lease is an enforceable lease; whether there were potential problems with its leases of which Leasecomm had knowledge; whether the leases are enforceable in accordance with their terms; whether three day right of rescission notices were required and, if required, whether proper notices were given; whether any lease prices were unconscionable; whether the lease of a software license is the lease of a service, not a good; whether any lease of satellites or computers are leases to consumers which must comply with certain consumer statutes; whether electronic fund transfer payments pursuant to a lease violate Reg. E; whether any Leasecomm billing and collection practices or charges are unreasonable, or constitute unfair or deceptive trade practices; whether Leasecomm's course of dealings with its vendors/dealers makes Leasecomm liable for any of the activities of its vendors/dealers. In April, 2002, Leasecomm and the Government Investigators entered into provisional relief and tolling agreements which provide for Leasecomm to take certain interim actions, temporarily stop the running of the statute of limitations as of January 29, 2002, and require advance notice by Leasecomm of its withdrawal from the provisional relief agreement and advance notice by each of the Government Investigators of its intention to commence legal action. The tolling agreement has been extended several times and is set to expire in May, 2003.

Edgar Filing: MICROFINANCIAL INC - Form 10-K

In February, 2003, Leasecomm received a Civil Investigative Demand from the Office of the Attorney General, State of Washington, to which a response is currently due in April, 2003. The Civil Investigative Demand concerns an investigation of monitoring agreements between Priority One, Inc. and various State of Washington consumers, as to which Leasecomm appears to be the assignee of the right to receive monthly payments.

Since the investigations are in process, and no legal action has been commenced against Leasecomm, there can be no assurance as to the eventual outcome.

INDEMNITIES

In the normal course of its business, the Company has entered into agreements that include indemnities in favor of third parties, such as engagement letters with advisors and consultants, outsourcing agreements, underwriting and agency agreements, information technology agreements, distribution agreements and service agreements. The foregoing agreements generally do not contain any limits on the Company's liability and therefore, it is not possible to estimate the Company's potential liability under these indemnities.

The Company has entered into agreements relating to the acquisition of assets, each of which contains indemnities in favor of third parties that are customary to such commercial transactions. It is not possible to estimate the Company's potential liability for these indemnities due to the nature of these indemnities.

In certain cases, the Company has recourse against third parties with respect to the foresaid indemnities and the Company also maintains insurance policies that may provide coverage against certain of these claims.

J. EMPLOYEE BENEFIT PLAN:

The Company has a defined contribution plan under Section 401 (k) of the Internal Revenue Code to provide retirement and profit sharing benefits covering substantially all full-time employees. Employees are eligible to contribute up to 15% of their gross salary. The Company will contribute \$.50 for every \$1.00 contributed by an employee up to 3% of the employee's salary. Vesting in the Company contributions is over a five-year period based upon 20% per year. The Company's contributions to the defined contribution plan were \$142,700, \$89,100, and \$135,300 for the years ended December 31, 2000, 2001, and 2002, respectively. A Director of the Company is an Officer of the company that is the Plan custodian and record keeper.

F-27

MICROFINANCIAL INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

K. CONCENTRATION OF CREDIT RISK:

The Company's financial instruments that are exposed to concentrations of credit risk consist primarily of lease and loan receivables and cash and cash equivalent balances. To reduce the risk to the Company, credit policies are in place for approving leases and loans, and lease pools are monitored by management. In addition, the cash and cash equivalents are maintained with several high-quality financial institutions.

One dealer accounted for approximately 10.6%, 4.5%, and .22% of all originations during the years ended December 31, 2000, 2001, and 2002,

Edgar Filing: MICROFINANCIAL INC - Form 10-K

respectively. Another dealer accounted for approximately 4.89%, 7.38%, and 10.98% of all originations during the years ended December 31, 2000, 2001, and 2002, respectively. No other dealer accounted for more than 10% of the Company's origination volume during the years ended December 31, 2000, 2001, or 2002.

The Company originates and services leases, contracts and loans in all 50 states of the United States and its territories. As of December 31, 2001 and 2002, leases in California, Florida, Texas, Massachusetts and New York accounted for approximately 42% of the Company's portfolio. Only California accounted for more than 10% of the total portfolio as of December 31, 2001 and 2002 at approximately 14%. None of the remaining states accounted for more than 4% of such total.

L. RELATED-PARTY TRANSACTIONS:

The Company had notes receivable from officers and employees of \$68,000 at December 31, 2001. During 1997 and 1998, the Company issued notes to certain officers and employees in connection with the exercise of common stock options amounting to \$150,000 and \$144,000 respectively, in exchange for recourse loans with fixed maturity dates prior to the expiration date of the original grant. These notes are non-interest bearing unless the principal amount thereof is not paid in full when due, at which time interest will accrue at a rate per annum equal to the prime rate plus 4.0%. All principal amounts outstanding under these notes is due in full on the earlier of the end of employment or the expiration date. As of December 31, 2002, the notes were paid in full. No new notes were issued during 2001 or 2002.

Other notes payable includes amounts due to stockholders of the Company at December 31, 2001 and 2002 of \$309,000 and \$250,000. Interest paid to stockholders under such notes was not material for the years ended December 31, 2001 and 2002.

At December 31, 2001 and 2002, subordinated notes payable included \$727,000 due to stockholders, officers and directors. Interest paid to stockholders, officers and directors under such notes, at rates ranging between 8% and 12%, amounted to \$8,500, \$53,700, and \$84,000 for the years ended December 31, 2000, 2001, and 2002, respectively.

F-28

MICROFINANCIAL INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

M. SELECTED QUARTERLY DATA (UNAUDITED):

The following is a summary of the unaudited quarterly results of operations of the Company for 2001 and 2002.

	2001				2002		
	FIRST QUARTER	SECOND QUARTER	THIRD QUARTER	FOURTH QUARTER	FIRST QUARTER	SECOND QUARTER	THIRD QUARTER
Revenues:							
Income on leases and loans.....	\$18,731	\$18,060	\$18,105	\$16,036	\$15,235	\$13,791	\$ 12,000
Income on service contracts rental and fees.....	20,611	20,491	21,204	20,853	20,050	19,170	17,000

Edgar Filing: MICROFINANCIAL INC - Form 10-K

Total revenues.....	39,342	38,551	39,309	36,889	35,285	32,961	30
Expenses:							
Selling general and administrative.....	11,903	10,658	10,900	11,438	12,574	11,409	10
Provision for credit losses.....	10,266	11,819	15,064	16,943	10,964	10,824	44
Depreciation and amortization.....	3,442	3,640	3,618	3,678	3,639	4,851	5
Interest.....	4,370	3,493	3,444	2,994	2,747	2,618	2
Total expenses.....	29,981	29,610	33,026	35,053	29,924	29,702	63
Income (loss) before provision for income taxes.....	9,361	8,941	6,283	1,836	5,361	3,259	(32)
Net Income (loss).....	\$ 5,419	\$ 5,179	\$ 3,639	\$ 2,080	\$ 3,216	\$ 1,955	(\$ 19)
Net Income (loss) per common share -- basic.....	0.43	0.41	0.28	0.16	0.25	0.15	(
Net Income (loss) per common share -- diluted.....	0.42	0.40	0.28	0.16	0.25	0.15	(
Dividends per common share.....	0.045	0.050	0.050	0.050	0.050	0.050	0

F-29

MICROFINANCIAL INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

N. CONSOLIDATING BALANCE SHEET (UNAUDITED):

The following outlines the leases and other assets that have been transferred to special purpose entities, MFI Finance Corp I and MFI Finance Corp II, LLC.

	LEASECOMM	MFI FC I	MFI FCII	ELIMINATING ENTRIES	CONSOLIDATED LEASECOMM	MFI
	-----	-----	-----	-----	-----	-----
ASSETS:						
Net investment in leases and loans:						
Receivables due in installments.....	291,684	42,362	577		334,623	
Estimated residual value.....	30,754				30,754	
Initial direct costs.....	4,081	810			4,891	
Loans receivable.....	1,501				1,501	1,02
Less:						
Advance lease payments and deposits.....	(53)	(42)	(1)		(96)	
Unearned income:....	(57,363)	(10,210)	(1)		(67,574)	
Allowance for credit						

Edgar Filing: MICROFINANCIAL INC - Form 10-K

losses.....	(62,751)	(6,323)	(220)		(69,294)	
Net investment in leases and loans:.....	207,853	26,597	355	--	234,805	1,02
Investment in service contracts, net.....	14,463				14,463	
Cash and cash equivalents.....	5,515				5,515	(2
Restricted cash.....		17,697	819		18,516	
Property and equipment, net.....	5,426	1,139	59		6,624	2,40
Investment in subsidiary.....	43,974			(43,974)	--	65,11
Other assets.....	2,652	871	5		3,528	43,01
Income taxes receivable.....	--				--	8,65
Total assets:.....	279,883	46,304	1,238	(43,974)	283,451	120,18
LIABILITIES:						
Notes payable.....	126,621	38,466	3,625		168,712	28
Subordinated notes payable.....					--	3,26
Notes payable to parent.....	733				733	
Capitalized lease obligations.....					--	47
Accounts Payable.....	84,565	(33,690)	(4,875)		46,000	54
Other liabilities.....	6,565	10	32		6,607	16
Income taxes payable....	(2,877)				(2,877)	4,27
Deferred tax liability.....					--	23,80
Total Liabilities:.....	215,607	4,786	(1,218)	--	219,175	32,80
Stockholders' Equity:						
Common Stock:.....	1				1	13
Additional Paid-In-Capital.....	207				207	47,72
Retained Earnings.....	64,068	41,517	2,457	(43,974)	64,068	45,86
Treasury Stock.....					--	(6,34
Total Stockholders' Equity:.....	64,276	41,517	2,457	(43,974)	64,276	87,37
Total Equity and Liabilities:.....	279,883	46,303	1,239	(43,974)	283,451	120,18

Leasecomm Corporation periodically finances its lease and service contracts, together with unguaranteed residuals, through securitizations using special purpose vehicles. MFI Finance Corporation I and MFI Finance Corporation II, LLC are special purpose companies. The assets of such special purpose vehicles and cash collateral or other accounts created in connection with the financings in which they participate are not available to pay creditors of Leasecomm Corporation, MicroFinancial Incorporated, or other affiliates. While Leasecomm Corporation generally does not sell its interests in leases, service contracts or loans to third parties after origination, the Company does, from

Edgar Filing: MICROFINANCIAL INC - Form 10-K

time to time, contribute certain leases, service contracts, or loans to special-purpose entities for purposes of obtaining financing in connection with the related receivables.

F-30

MICROFINANCIAL INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

The contribution of such assets under the terms of such financings are intended to constitute "true sales" of such assets for bankruptcy purposes (meaning that such assets are legally isolated from Leasecomm Corporation). However, the special purpose entities to which such assets are contributed are not "qualifying special purpose entities" within the meaning SFAS No. 140, and are required under generally accepted accounting principles to be consolidated in the financial statements of the Company. As a result, such assets and the related liability remain on the balance sheet and do not receive gain on sale treatment.

O. SUBSEQUENT EVENTS

On January 3, 2003 the Company entered into a Forbearance and Modification agreement with its lenders with respect to the credit facility. This agreement expired on February 7, 2003. The Company entered into a long-term agreement with its lenders on April 14, 2003. This long-term agreement waives the covenant defaults described more fully in Note E, and in consideration for this waiver, requires the outstanding balance of the loan to be repaid over a term of 22 months beginning in April 2003 at an interest rate of prime plus 2.0%. Based on the amortization schedule in the new agreement, the Company is obligated to repay a minimum of \$54 million, plus applicable interest, over the next twelve months.

On February 7, 2003, the Company offered non-director employees and executives who had been granted stock options in the past the opportunity to cancel any of the original option agreements in exchange for a grant of shares of restricted stock. All option awards subject to the offer were converted to restricted stock. In connection with this offer, on February 12, 2003, 1,325,000 options converted to 319,854 shares of common stock. As of March 31, 2003, 63,971 of these shares were fully vested.

On February 18, 2003, the Company repaid \$2.4 million in principal plus accrued interest for the MFI Finance I series 2000-1 notes utilizing the clean up call provision under its securitizations. The re-payment was made using cash previously classified as restricted.

The Company is in the process of moving its headquarters from Waltham, Massachusetts to its facility in Woburn, Massachusetts.

F-31