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LEASE FINANCING IN INDIA: RETROSPECT AND PROSPECTS

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Abstract

World over leasing has emerged as an innovative technique of financing industrial equipment. In India leasing has been developed as an important supplementary source of finance and is gaining increased acceptance from the industries. A number of non-bank financial companies have shot up and many leading banks started wholly owned subsidiaries to transact leasing business. Leading financial institutions have also entered into the business of equipment leasing and financing. The present paper aims at presenting an overview of lease financing in India covering the major aspects of lease financing such as meaning of lease and lease financing, types of lease financing, its benefits and reasons for its growing popularity in our country.

Key Words: *Financial Statements, Hire Purchase, Lease Financing, Sales and Leaseback, Tax Shielding.*

LEASE FINANCING - AN INNOVATIVE TECHNIQUE OF FINANCING

In Simple words, a lease is a sort of contract. A lease contract can be defined as a contract whereby the owner of an asset (called lessor) grants to another party (Called lessee) the exclusive right to use the asset usually for an agreed period of time in return for the payment of rent **(Ghosh and Gupta, 1985)**. In other words, lease is a contract under which one party, the lessor of an asset agrees to grant the use of that asset to another, the lessee, in exchange for periodic rental payments. Lease financing denotes procurement of assets through lease. Today most of us are familiar with leases of houses, apartments, offices etc.

World over leasing has emerged as an innovative technique of financing industrial equipment. In India leasing has been developed as an important supplementary sources of finance and is gaining increased acceptance from the industries. A number of non-bank financial companies have shot up and many leading banks started wholly-owned subsidiaries to transact leasing business. Leading financial institutions have also entered into the business of equipment leasing and financing. The importance of leasing can hardly be over emphasised. The technique of leasing gives the facility to posses and operate the asset without owning the asset. It is a method of financing where huge capital outlay are substituted by periodical rental payments. Under a typical leasing transaction, a lessor acquires the title to the equipment to be leased by paying 100 percent value for the asset identified by the lesses and then leases it out to the lessee under a lease agreement for a period normally less than the depreciable life of the asset.

The Accounting Standard 17 issued by **The Institute of Chartered Accountants of India** defines a lease as "an agreement whereby a lessor conveys to the lessee, in return for rent, the right to use an asset for an agreed period of time."

Lease finance can be said to be a Contract between lessor and lessee whereby the former acquires the equipment/goods/plants as required and specified by the lessee and passes on the goods to the lessee for use for a specific place and in consideration promises to pay the lessor a specified sum in a specified mode at specific interval and at a specified place.

Under the lease financing, an asset can be acquired without incurring the initial purchase cost by just making payment of lease rentals over a specified period of the lease contract. It is more or less an off balance sheet financing, where neither by acquisition of asset nor the loan is to be shown in the financial position statement. The periodical lease rentals paid will be shown in the financial position statement as business expenditure. It is basically a contract whereby the owner of the asset (the lessor) grants to another party (the lessee) to exclusive right to use the asset for an agreed period of time, for an agreed amount payable on periodical basis (lease rentals) over the specified lease period. The lease transaction may be broadly equated to an instalment credit being extended to the person using the asset by the owner of the asset, but, without transferring the title of ownership.

The important features of lease contract are as follows:

- The lease finance is a contract.
- The parties to contract are lessor and lessee.
- Equipment are bought by lessor at the request of lessee.
- The lease contract specifies the period of contract.
- The lessee uses these equipments.
- The lessee in consideration pays the lease rentals to the Lessor.
- The lessor is the owner of the assets and is entitled to the benefit of depreciation and other allied benefits e.g., under sections 32A and 32B of the Income-tax Act.
- The lessee claims the rentals as expenses chargeable to his income.

DISTINCT FROM HIRE-PURCHASE

Leasing is an alternative to loan financing and somewhat akin to the hire purchase contract. The major line of distinction between hire-purchase and lease financing is that in case of former, the contract provides for the transfer of ownership of an asset at the end of the stipulated period. Whereas in the case of lease financing, the ownership rests with the lessor only. Say, the ownership of asset does not transfer from the lessor to the lessee even after the expiry of lease agreement period. Lease financing is based on the observation made by **Donald B. Grant (1911)**: "Why own a cow when the milk is so cheap? All you really need is milk and not the cow". In fact, this separation of 'ownership' from 'use' of an asset led to a dramatic development of lease financing. Lease of house apartment, offices, mines, etc. are the common examples of leases.

TYPES OF LEASE AGREEMENTS

Virtually all lease agreements fall into one of five types of lease financing viz.

(i) Financial lease,

(ii) Operating lease,

(iii) Sale and lease back,

(iv) Leveraged leasing and

(v) Sales aid leasing.

Financial lease is a non-cancellable contractual commitment on the part of the lessee (the user) to make a sense of payments to the lessor for the use of an asset. In this type of leases, lessee will use and have control over the asset without holding the title to it. The lessee is expected to pay for upkeep and maintenance of the asset. This is also known by the name capital lease. The essential point of this type of lease agreement is that it contains a condition whereby the lessor agrees to transfer the title for the asset at the end of the lease period at a nominal cost. At lease it must give on option to the lessee to purchase the asset he has used at the expiry of the lease. Under this lease usually 90 percent of the fair value of the asset is recovered by the lessor as lease rentals and the lease period is 75 percent of the economic life of the asset. The lease agreement is irrevocable. Practically all the risks incidental to the asset ownership and all the benefits arising there from is transferred to the lessee who bears the cost of maintenance, insurance and repairs. Only the title deeds remain with the lessor.

The **operating lease** is generally for a short term, where the lessor is usually the manufacturer of the asset who want to increase his sales by allowing the customers to pay in instalments for a short-term and ultimately the title to the asset will be transferred to the lessee on making full payment. In the operating lease, it is the responsibility of the lessee to maintain and upkeep the asset properly when the asset is under his control. The main characteristics of operating lease include.

- The lease can be cancelled by the lessee prior to its expiration at a short notice.
- The lessor is responsible for upkeep and maintenance of the asset.
- The lessee is not given any uplift to purchase the asset at the end of the lease period.
- The lease is for a smaller period.
- The sum of all the lease payments by the lessee does not necessarily fully provide for the recovery of cost of the asset.
- The lessor has the option to lease out the asset again to another party.

This is the popular type of lease in most of the advanced countries, under this it is easy to lease an asset on an experimental basis to know its exact profitability. The lessee is protected against the risk of technical obsolescence. For the use of costly equipment, for a limited period, it is the best method. This lease is preferred in the following situations:

(a) When the long-term stability of asset is uncertain.

(b) When the asset is subject to rapid obsolescence.

(c) When the asset is required for immediate use to tie over a temporary problem.

Under **Sale and lease back** the lessee first purchases the equipment of his choice and then sells it to the lessor firm. The lessor in turn leases out the asset to the same lessee. The advantage of this method is that the lessee can satisfy himself completely regarding the quality of the asset and after possession of the asset convert the sale into a lease arrangement. This option he can exercise even in the case of an old asset used by him for sometimes to get the release of a lump sum cash which he can put into alternative use. The lessor gets the tax credit for depreciation. This method of financing an asset is also popular when the lessee is in liquidity problems, he can sell the asset to a leasing company and takes it back on lease. This will improve the liquidity position of the lessee and will continue to use the asset without parting with it.

In Leveraged lease form of lease agreement, the lessor undertake to finance only a part of the money required to purchase the asset. The major party of the finance is arranged with a financier to whom the title deeds for the as well the lease retails are assigned. There are usually three parties involved, the lessor, the lessee and the financier. The lease agreement is between lessee and lessor as in any other case. But it is supplemented by another separate agreement between the lessor and the financier who agrees to provide a major part (say 75% of the money required. This is a type of lease agreement which will enable the lessor to undertake an expand volume of lease business with a limited amount of capital and hence it is named leverage leasing.

In **Sales Aid Leasing** a leasing company will enter into an agreement with the seller, usually manufacturer of the equipment, to market the latter's product through its leasing operations. The leasing company will also get commission for such sales, which add up to its profits.

ADVANTAGES AND DISADVANTAGES OF LEASING

The advantage arising from the leasing of assets are as follows:

From the view point of Lessee

- It is an easy method of financing capital asset having a heavy cost involved.
- It permits the lessee for alternative use of funds without incurring huge capital investment on an asset.
- There is margin money or down payment required for acquiring the asset on lease.
- It spreads the capital cost over a period of the lease, so that sufficient flexibility is available by just making payment of periodical lease rentals.
- The lease rentals can be structured according to the needs of the lessee.
- It is comparatively a cheaper sources of finance with less hassles particularly due to tax effect.
- It helps to conserve the funds which can be used to improve the liquidity and can be used for some other urgent purposes.
- The lessee can avoid the risk of obsolescence by taking the asset on lease basis.
- Leasing is free from restrictive covenants such as debt equity ratio, dividend declaration etc.
- The lessee can get lease finance upto 100 percent of the cost of asset.

- Small entrepreneurs and technocrats who have got uncertain income can able to get the necessary equipment on lease basis.
- The procedure is simple and documentation is minimum.
- Lease rentals are deductible expense for gaining tax shield.
- It is an 'off-balance sheet' financing and help to keep the debt equity ratio will not get effected.
- More beneficial to manufacturers to get plant and equipment on lease rather than purchasing it due to withdrawal of investment allowance.

From the view point of Lessor

- It is an asset based financing for a productive purpose and it is safer than normal course of financing business.
- The lessor can claim depreciation and will also enjoy the tax benefit.
- Lease rentals provide regular income and maintaining liquidity of the concern.
- The leasing suffers from the following disadvantages:
- The main criticism of lease method of financing is that the accounting procedure adopted for recording lease methods of financing is highly unsatisfactory. Professional institution after serious deliberations recommended a set of procedure for recording the transaction. But most of the organisations seldom follow the recommended practice.
- Lease financing, compared to other methods, is costly for the lessee.
- The financial lease has all the rigidities of other methods of financing.
- As the lessee is not the owner of the asset technically, he cannot enforce the warrantees or guarantees enforceable against the vendor.

Leasing is a special type of a transaction for asset acquisition and use. While the lessor is the owner of the asset, the possession and use of the asset remains with lessee. Therefore, the question of disclosure of the asset in the books of account, showing the depreciation and claiming tax benefits have become subject matter of controversy and debate.

EFFECTS ON FINANCIAL STATEMENTS

Effects on Profit and Loss Account - Accounting profit has tended to be higher under lease financing rather loan financing, only the lease payments were charged in the profit and loss account, whereas when a company borrows and buys both the interest payments and depreciation charges on the asset acquired are charged as an expense. Particularly in the early years of loan, accounting profit tended to be higher under the lease agreement.

Effects on Balance Sheet- The level of total assets appearing in the balance sheet has generally been lower under a lease arrangement than a loan arrangement. All loans appear in the balance sheet as sources of finance and all purchased assets appear as part of the total assets employed. However, with leased assets no lease obligation usually appeared in the balance sheet.

GROWING POPULARITY OF LEASE FINANCING IN INDIA

Before we discuss the growing popularity of lease financing in India, let us start with the emergence in the international area. The evolution of lease financing is traced way back to the early 1950s when the United States started equipment leasing. It spread to the European countries in the early 1960s and to the rest of the world during the 1970s. Since then, there has been no looking back in its expansion. Land leasing has been quite prevalent in India from old times. However, leasing of Capital equipments is of a recent origin in India. As per available records, lease financing started taking its roots in the Indian Soil since early 1970s. The pioneer in this field was "First Leasing Company of India Ltd. (FLC)" based in Madras. The Company started its business in 1973. Since then, a number of other leasing companies have come into existence. To name a few important ones are

- Mazda Leasing,
- Twentieth Century Leasing Company.
- Ross Morarka Leasing Company,
- Pioneer leasing and
- Express Leasing Company.

However, even after almost five decades lease financing in India still remains in the stage of experimentation mainly due to the non-availability of an appropriate analytical framework, policies and procedures to be adopted. To quote, the number of leasing institutions increased to over 700 by recently. With the amendment in the **Banking Regulation Act, 1994** a large number of nationalized banks are also participating directly in the leasing business in the present era. In India, the leasing industry continues to be vibrant and is in a position to contribute to business finance in a significant manner.

Ever since the FLC in 1973 lease financing has increased with a compound rate of 24 percent over the period **(Sharmita, 2009)**. The major reasons for the growing popularity of lease financing in India include but are not confined to the following only:

- Easy entry,
- Growing capital expenditure by companies,
- Ever growing car market,
- Tax shielding,
- Optimistic Capital markets,
- Easy access to Public Deposits and
- A conducive business environment.

FUTURE PROSPECTS OF LEASING

Lease Financing in India has come a long way, but the journey is for from over. No doubt, leasing was grown by leaps and bounds in the eighties but it is estimated that hardly one percent of the industrial investment in India is covered by the lease finance, as against 40 percent is USA, 30 percent in UK and 10 percent in Japan. The prospects of leasing in India are good due to growing investment needs and scarity of funds with public financial institutions **(Lakshmi and Rao, 2007)**. In view of its growing popularity, there is no denying the fact that leasing business has good prospects in India. At the same time, there are certain difficulties or challenges before the leasing industry to overcome. At present, the leasing industry is growing in almost regulatory vacuum. But the regulation of these companies is necessary not only to protect the funds of the public and the banks, but also to protect and place the leasing industry on a sound footing. These are found urgently wanting.

CONCLUSION

The present era is known as the "Survival of the fittest'. So is leasing industry also. With the accent of specialization as the key to success, it is high time for leasing industry also to reorient itself to the very needs of the market and lay its sole emphasis on market responsiveness. Professional outlook is required. The past success does not guarantee the future prosperity. Growth and success in leasing business require well planned marketing efforts in identifying a suitable and realistic lease proposal and properly educating the clients on the pros and cons modalities of a lease agreement. Finally, like in product marketing, it is here also the total consumer (clientele) satisfaction which should become the core focus of concern and attention for the leasing industry to grow in future.

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