CHAPTER I

INTRODUCTION

Leasing, as a booming business, is expanding at a much rapid pace both in developed as well as developing countries. Within a short span of five decades, it has witnessed phenomenal growth by spreading its wings to over 80 countries of the globe, including India. Initially evolved from being a manufacturer's selling technique, it has emerged as a specialised financial service. The contours of the leasing industry extend from the United States to Europe, Latin America to Africa and Asia. According to a World Bank report (1996), in 1994 over $350 billion worth of new vehicles, machinery and equipment was financed through leasing, accounting for about an eighth of the world's private investment. In Organisation for Economic Cooperation and Development (OECD) countries leasing is a stable source of private investment.

Concept of Leasing

Viewed in a broad perspective, a lease is construed as a contract or transaction between two parties in which a party owning the asset, called the 'lessor' or landlord' or 'owner', provides the asset for use over a certain period of time to the other party, called the 'lessee' or the 'tenant', for consideration in the form of periodic payments (called 'rent') with or without a further down payment. The international Accounting Standard No. 17 defines leasing as "an agreement whereby the lessor conveys to the lessee in return for rent the right to use an asset for an agreed period of time".¹ According to J.

McMenamin, "A leasing is a contract between two parties- the lessor who owns the asset and the lessee who operates or uses the asset- which grants the lessee the right to operate or use an asset for an agreed period of time. Under the leasing contract the lessee agrees to make regular payments to the lessor in return for the term of the lease."²

According to a World Bank study, "Leasing is a contractual arrangement between two parties, which allows one party (the lessee) to use an asset owned by the other (the lessor) in exchange for specified periodic payments."³ Leasing has continued to grow in popularity as a form of medium- to long-term asset financing – for all types of business, large and small.⁴ Long-term leases can be arranged to finance long-term assets such as property, and medium-term assets such as plant, machinery and equipment. Construction companies, for example, will arrange short-term leases for plant and equipment which they intend for specific use on specific construction projects.

Leasing is anchored on the business philosophy that profits are earned through the use- rather than ownership- of equipment and assets. A basic principle in medium and long term lending is that cash generated by the investment that has been partly financed should be the primary source of repayment. The collateral that is provided as security for the loan serves as a secondary source of repayment, in the event that the borrower is unable to repay the loan from cash generated by business operations. For short terms loans, the asset conversion cycle, rather than long-term profitability of the

business and cash generation, is more critical to an assessment of the probability of loan repayment. Conventional asset-based loans offered by banks focus on both a primary source (cash flow generation or asset conversion cycle) and a secondary source (credit enhancements and collateral) of loan repayment by the borrower.

In contrast, leasing is more intensely focused on the lessee’s ability to generate cash flow from business operations to service lease payments, because the lessor-financier retains ownership of the asset during the term of the lease. This could make leasing well suited to business activities which seldom have historical credit information or formal financial statements. The prime impact of leasing is to increase a business entity’s total availability of capital from an external source, leaving its own sources of capital available for other productive uses. The additional revenue generated by the use of the leased asset should be sufficient to meet the monthly lease rental payments to the lessor.

Conventional asset-based financing from a bank generally requires a borrower to provide up to 40 per cent of the cost of the asset required, since a loan cover only 60 per cent of the asset value. In some cases, the bank providing loan may require the borrower to put up as security another asset in addition to the one being acquired (e.g., real estate in the urban centre). Or additional security enhancements (e.g., assignment of bank deposits, marketable securities, trade receivables for third party guarantees) may be required by the bank providing the loan. The collateral provided as direct or additional security very frequently will have a discounted value for loan purposes, in accordance with prevailing banking regulations.5

5 Balkenhol, Bernard and Haje Schutte, Collateral Law and Collateral Substitute (International Labour Office, Geneva, 1996)
Comparative advantage of lease financing over conventional bank financing is shown in table 1.1 below:

**Table 1.1**

**Advantage of Lease Financing over Conventional Bank Financing**

<table>
<thead>
<tr>
<th>Period</th>
<th>Cash Flow</th>
<th>Discount Factor</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Lease Finance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>0</td>
<td>10% Security deposit</td>
<td>20,000</td>
<td>1,0000</td>
</tr>
<tr>
<td>0</td>
<td>1% Front-end fee</td>
<td>2,000</td>
<td>1,0000</td>
</tr>
<tr>
<td>Year 1</td>
<td>Tax shield on front-end fee</td>
<td>(700)</td>
<td>0.8475</td>
</tr>
<tr>
<td></td>
<td>Monthly lease rentals</td>
<td>5,364.72</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total lease rentals</td>
<td>252,137.14</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Tax shield on rentals</td>
<td>(88,247)</td>
<td></td>
</tr>
<tr>
<td>Month 48</td>
<td>Refund of security deposit</td>
<td>(20,000)</td>
<td>0.4894</td>
</tr>
<tr>
<td>Month 48</td>
<td>Payment of residual value</td>
<td>20,000</td>
<td>0.4894</td>
</tr>
<tr>
<td></td>
<td>Total, with tax shields</td>
<td>127,023</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total, without tax shields</td>
<td>187,851</td>
<td></td>
</tr>
<tr>
<td>Period</td>
<td>Cash Flow</td>
<td>Discount Factor</td>
<td>Present value</td>
</tr>
<tr>
<td></td>
<td>Financed Purchase</td>
<td></td>
<td></td>
</tr>
<tr>
<td>0</td>
<td>Acquisition cost</td>
<td>200,000</td>
<td>1,0000</td>
</tr>
<tr>
<td>0</td>
<td>Equity down-payment</td>
<td>80,000</td>
<td>1,0000</td>
</tr>
<tr>
<td></td>
<td>Monthly amortizations</td>
<td>3,047,21</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total amortization payments</td>
<td>182,832</td>
<td></td>
</tr>
<tr>
<td>Years 1-4</td>
<td>Annual depreciation (5 years)</td>
<td>40,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Tax shield (depreciation)</td>
<td>(56,000)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total, with tax shields</td>
<td>154,043</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total, without tax shields</td>
<td>191,703</td>
<td></td>
</tr>
<tr>
<td></td>
<td>With tax shields: Leasing advantage in $ as%</td>
<td>27,020</td>
<td>17.5 %</td>
</tr>
<tr>
<td></td>
<td>No tax shields: Leasing advantage in $ as%</td>
<td>3,952</td>
<td>2.1%</td>
</tr>
</tbody>
</table>

Note: The value in the original table is given in the Philippine's currency which has been substituted in US dollars for the purpose of clarity.

Table 1.1 provides, in summary form, the comparative advantage of lease financing, using a lease discount factor of 18 per cent at an annual percentage rate of 18 per cent, for acquiring an amount of $200,000 worth asset. The present value analysis as shown in table 1.1 shows lease financing with a 17.5 per cent advantage over outright purchase of the asset through bank loan financing, when the impact of the tax shield is prime consideration. When the tax shield is not an important consideration or is irrelevant for the lessee, the discounted present-value advantage of leasing over conventional bank financing is much smaller at $3952 or a difference of only 2.1 per cent over the relevant time period.

The probability is high that the tax shield factor might be irrelevant for formally organized business entity which can easily escape the jurisdiction of tax regulators and collectors. The tax shield factor is irrelevant to the borrower when that borrower is able to avoid taxation of income. However, it is revealed from table 1.1 that leasing would still present an advantage because the upfront down payment or security deposit in a lease contract is 10 per cent or $20,000 versus $80,000 or 40 per cent equity stake under bank financing. With leasing the borrower has $60,000 more available for operating capital. Besides, the discounted present value of lease rental payments is $187,851 compared to the discounted present value of loan amortization payments totaling $191,703 when the impact of tax shield is ignored or removed in both leasing and bank financing techniques.
TYPES OF LEASES

There are two main types of lease, a Financial Lease and an Operational Lease and the key distinction between them is the degree to which 'the risks and rewards associated with ownership of an asset, other than the legal title' are transferred to the lessee.

Financial Lease

A financial lease is defined in Statement of Standard Accounting Practice (SSAP) 21: Accounting for leases and hire-purchase contracts as one in which: "The lessee has substantially all the risks and rewards associated with ownership of an asset other than the legal title." Such a substantial transfer of ownership risks and rewards is deemed to occur if, at the beginning of the lease, the present value of all the lease payments amounts to 90 per cent or more of the fair value of the asset- which is normally its cash purchase price. The present value of the future lease payments is calculated using the interest rate implied in the lease.

Lease financing involves the acquisition of the economic use of an asset through a contractual commitment to make periodic lease payments to a lessor who owns the asset. Due to this contractual obligation, leasing is regarded as a method of financing similar to borrowing. The title of an asset remains with the lessor and the asset is returned at the end of lease period unless provided for otherwise. For many companies the leasing of assets represents an important source of financing. The lessee capitalizes a financial lease; in other words, the asset is treated as if owned by the lessee and appears under assets in the lessee's balance sheet. The obligation for the future rental payments also appears as a corresponding liability in the
balance sheet. The value which should be recorded for both the asset and corresponding liability is the present value of lease payments. The asset then will be depreciated over the shorter of the lease term and its useful economic life. Rentals paid should be apportioned between a finance charge and a capital repayment. For all practical purposes, a finance lease is effectively a term loan in which the capital is repaid by instalments. It is analogous to debt financing.

As a contractual arrangement between two parties, financial leasing allows one party-the lessee-to use an asset owned by the other-the lessor—in exchange for designated periodic payments. The lessee uses the asset and pays rentals to the lessor, who legally owns it. The legal owner relies on the ability of the user to generate sufficient cash flows to make lease payments, rather than relying on its assets, capital base or credit history. Knowledge about results of business operations generates indicators of the adequacy of prospective cash flows. This Knowledge provides some form of substitute information for credit history that would otherwise not be available if formal financial statements were insisted upon.

The asset provides security for the transaction itself. Thus leasing enables borrowers without well-developed balance sheets or credit histories especially new or small business entities to access the use of capital equipment in cases where they would not be able to avail of and qualify for traditional commercial bank lending. In spite of its long history as a financing technique, leasing has leapfrogged only in recent decades from being an equipment manufacturer's selling technique into a specialised service.6

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It is an alternative to bank loan financing for equipment purchase. The lessor buys the equipment chosen by the lessee, who then uses it for a significant period of useful life. Financial leases are called full-payout leases because payment during the lease term amortize the lessor's total purchase costs (residual value is typically between 0 per cent- 5 per cent of original acquisition price), cover his interest costs and provide him profit. The lessee carries the risk of obsolescence, and costs of maintaining the asset in good working condition and insuring it. The lessee typically has the right to purchase the asset at the end of the lease contract for a nominal fee.

Financial lease is of three types, (i) Direct Lease, (ii) Sale and Lease-back and (iii) Leveraged Leasing. All financial lease arrangements fall into one of these three categories.

(i) Direct Lease: Under direct leasing, a company acquires the use of an asset without owning it. There are a wide variety of direct leasing arrangements available to meet the various needs of the firm. The major types of lessors are manufacturers, finance companies, independent leasing companies and special purpose leasing companies. The vendor or equipment supplier sells an asset to the lessor and he, in return, leases it to the lessee. Often, economics of scale are possible in the purchase of capital assets by the lessor which may be passed on to the lessee in the form of lower rentals.

(ii) Sale and Lease-back: Under a sale and lease-back arrangement, a firm sells an asset it owns to another party, and this party leases it back to firm. The asset is usually sold at its market value and the firm receives the sale price in cash for meeting its working capital needs and the economic use of the asset/equipment during the basic lease period. The firm, in turn, contracts to make periodic lease payments and gives up title to the asset. The lessors
engaged in sale and lease-back arrangements include insurance companies, institutional investors, finance companies and independent leasing companies.⁷

According to one report, corporates in India decimate their liability through the route of sale and lease-back mechanism. A Syndication led by Apple Industries Power Investment Corp., and Securex Financial Services found a loop-hole in the laws governing sale-and-lease-back transaction to defer their multi-crore income tax liability. The lessors managed to claim tax relief available on normal 25 per cent depreciation assets. The deal was between the loss-making Rajasthan State Electricity Board (RSEB) which had sold its assets to a finance company who leased back the purchased assets to RSEB for use and, in return, got rentals. Since the assets were now owned by the finance companies, they could avail of depreciation coverage for income tax purposes. As RSEB was a loss-making company, it could not take advantage of any depreciation tax shield.⁸

(iii) Leveraged leasing: In the United States, a special form of leasing has developed in recent years in conjunction with the financing of assets requiring large capital outlays. It is known as leveraged leasing. In contrast to the parties involved in the form of leasing, there are three parties involved in leveraged leasing— the lessee, the lessor and the lender. From the point of view of the lessee there is no difference between a leveraged lease and any other type of lease. He enters into a contract to make periodic payments over the basic lease period and, in turn, is entitled to the use of the asset over that period. However, the role of the lessor is changed. He acquires the asset in keeping with the terms of lease arrangement. This acquisition is financed in

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part by an equity investment by the lessor, say, 25 per cent. A long-term lender or lenders provide the remaining 75 per cent.

The loan is usually secured by a mortgage on the asset as well as by the assignment of the lease and lease payments. Sometimes the lessee guarantees the debt. The lessor, it may be noted, is the borrower. As owner of the asset, the lessor is entitled to deduct all depreciation charges associated with the asset as well as utilize the entire investment tax credit (equivalent to investment allowance in Indian conditions). The leveraged leasing has increasingly been used in the financing of large capital assets.

Lease financing and debt financing are very similar from the point of view of analyzing the ability of the firm (the lessee) to service fixed obligations. The nature of obligation of the lessor and the lessee in lease financing is indicated in the lease contract. The contract shows: (a) the basic lease period; (b) the timing and amounts of period rental payments during the basic lease period; (c) any option to renew the lease or to purchase the asset at the end of the basic lease period; and (d) method for the payment of the cost of maintenance and repairs, taxes, insurance, and other expenses. These costs are usually met by the lessee unless there is a 'maintenance lease' where the lessor maintains the asset.

Therefore, lease is an arrangement between two parties- the leasing company (the lessor) and the lessee- whereby the former arranges to supply the equipment to the latter. The lessor steps in to provide a sort of financing. The consideration for the transaction is in the form of rentals paid by the lessee to the lessor who remains the owner of the equipment. The rentals are pre-determined and payable after fixed intervals of time according to the
convenience of both the parties. The entire deal is supported by a document called the Lease Agreement. Normally the lessor agrees to sell the lessee the leased asset at the end of a pre-determined period on payment of final sum. Thereupon the ownership of the asset gets transferred to the lessee. This transaction is supported by a separate Sale Agreement which is also executed at the outset. During the period of the Lease Agreement, the ownership of the asset vests in the lessor, who is eligible to claim depreciation and investment allowance. The lessee is eligible to claim deduction by way of lease rentals- comprising the instalment of principal and an interest component-, which are permitted to be set-off against revenue

**Operating Lease**

"An operating lease is any type of lease, that is to say, where the asset is not wholly amortized during the non-cancellable period, if any, of the lease and where the lessor does not rely for his profit on the rentals in the non-cancellable period." Clark, T.M. (1978), *Leasing* (McGraw hill Book Co., Berkshire, p. 57.) It is not a means to finance equipment purchase. The lessee contracts for short-term use of equipment the leasing company has on hand, e.g., car rentals. The lessor recovers the capital cost equipment from multiple, serial rentals and final sale of the asset. Maintenance costs and risks of obsolescence are borne by the leasing company.

As a direct arrangement, it is realistically a hiring or rental contract rather than a purchasing arrangement, and compared to a finance lease there is no long term fixed commitment. An operating lease is easily terminated without incurring the substantial financial penalties usually involved with the premature termination of a finance lease. This mainly explains its

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attractiveness to industries, such as construction and engineering, where equipment and machinery are used on specific short-term projects.

With an operating lease, the lessee pays a rental to the lessor for the hire of an asset over a period of time and simply charges the rentals paid to the profit and loss account as an operating expense. Thus for the user, the accounting or bookkeeping is much simpler than for a finance lease. As neither the asset nor the liability appear on a company’s balance sheet, an operating lease arrangement is often referred to as ‘Off Balance Sheet’ finance or ‘hidden gearing’ as it does not impact on company’s capital structure or gearing ratios.

As the leasing industry emerges, expands and becomes more complex, the difference between the finance and operational leases becomes narrow. Most of the leasing companies have begun to evaluate the feasibility of operating leases, which involves leasing an asset to more than one lessee. Operating leases are going to be the future. The profile of the manager for leasing has to expand to include asset skills. In a financial lease, nearly the full cost of an asset is recovered from a single lease period, usually five years. On the contrary, in an operating lease, the assets change hands: there is more than one lessee. A finance company needs to understand what kind of assets can be covered through operating lease.

**Cross-border Lease:** Leasing across national frontiers is called ‘cross-border leasing.’ Multiple factors, particularly exchange restrictions, have impeded the growth of this branch of leasing and kept it in a highly under-developed form. T.M. Clark is rather sanguine about the future of this type of leasing: “Cross-border leasing is likely to be one of the principal growth areas over the next
few years. Until now it has been a subject much discussed but little practiced because of the differing fiscal and legal systems.  

PROS AND CONS OF LEASING

Leasing can become an important financing technique for business entities because of the way the latter finance operations from the three main sources of capital: internally-generated cash, bank loans and capital markets. In most developing countries capital markets are relatively undeveloped and banks often prefer to lend to larger, well-established businesses that have a profitable track record and can offer stronger security. Also, banks are often unable or reluctant to undertake term lending. New or small business entities without strong collateral, or which operate in countries with weak or absent laws for enforcing rights to take possession of security, generally have limited access (if any) to traditional bank lending. Leasing or supplier's credits may be the only recourse to external financing, because the ownership of the asset financed does not transfer to the borrower until after the lease obligation has been fully discharged.

Leasing is a proposition that is a positive sum game whereby both the lessor and lessee stand to gain. The advantages accruing from leasing can be examined from the standpoint of three parties- the lessee, the lessor and the investor in the leasing companies.

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10 Clark, T.M. (1977), "There is no Accounting for Leasing", The Accountant, January 20, p.79.
Advantages for the Lessee

Although leasing is generally perceived as a high spread business it offers the lessee a number of advantages in comparison to conventional bank financing:

(a) Availability- In most developing countries leasing may be the only form of medium- to long-term financing available for purchase of equipment that can expand production levels or increase productivity of workers.

(b) Simpler security arrangements, in combination with less stringent requirements for historical balance sheets mean that new small enterprises can access lease finance more easily than bank loans.

(c) The up-front cash down payment or security deposit required in a lease contract is lower than the equity component or stake in conventional bank financing. Thus leasing can finance a higher percentage of the capital cost of equipment thereby allowing the business entity to preserve its cash resources or existing bank facilities to meet working capital needs. Leasing contracts can more easily be structured to match the cash flow generation of the lessee’s business. In some cases the down payment (security deposit) required may be less than the typical 10 per cent.

(d) Leasing can be arranged more quickly and easily than conventional bank loans because additional security often does not need to be established. The costs of assigning additional collateral, documentation and processing times for bank loans can be significant (since these are typically fixed and not related to the size of the loan), and usually offset the higher spreads in leasing.

(e) Satisfactory understanding of rights and obligations under a lease contract can serve to minimize or eliminate adverse decrease in service or resale value of leased equipment arising from deficient maintenance activities. To achieve this, a lease contract will have to incorporate periodic inspections of the leased equipment to confirm adherence to a maintenance programme and assessment of equipment value. This kind of procedure would be part of a lease portfolio administration programme and is analogous to the loan portfolio administration programme of a bank lender.

(f) Tax incentives are available through lease financing. Lessees can offset their full lease payments against income before tax, compared to the depreciation allowance or the interest charges on bank loans. This may not be a primary attraction for small business entities, whose cash flow-driven operations in informal markets are not conducive to record-keeping for income-tax purposes. However, lessors may be able to pass on to lessees some tax benefits related to the depreciation charges they can book as owners of the asset leased, by lowering their
financing costs or reducing their spread between funding costs vis-à-vis lease discount factor.

For the lessee the chief advantage that lease financing presents is a significantly lower discounted present value of cash disbursements over the term of the lease compared to the discounted present value of payments associated with bank-financed acquisition of an asset. The reason is that the aggregate periodic lease rental payments, which are a combination of interest-related financing costs and payments against principal, can be booked by the lessee as a business expense to shield against tax liability on income realized. The asset financed through a lease is depreciated over the life of the lease, a period shorter than its economic life.

On the other hand, the depreciation expense shield against tax liability is an asset acquisition financed by a conventional bank loan is for a longer period (the prescribed useful life of the assets) and a correspondingly smaller amount. If the asset to be acquired has a useful life of say, 5 years, a four-year lease financing arrangement effectively depreciates the asset over 4 years. In contrast, conventional bank loan financing for a similar four-year term will provide an 80 per cent tax shield (equaling to 4 years depreciation) during the term of the loan.

Limitations for the Lessee

Following are the limitations that can accrue to the lessee under lease financing:

(a) Area of operation for lease financing is almost restricted. Project financing can hardly be facilitated under lease owing to the fact that rentals become due for payment soon after entering into a lease contract while a new project cash generation takes place only after a long gestation period.
(b) In case of leased equipment, the lessee may not be entitled to certain tax benefits/incentives. For example, backward area incentives and Central subsidy in India are based on the amount of fixed capital employed. Assets taken on lease do not fall within its ambit.

(c) The lessee may not be in a position to terminate the lease contract except by paying heavy penalties even when he may wish to discontinue a particular line of business.

(d) As it is important for a lessor to evaluate the lessee, similarly there is need for the lessee to make a good appraisal of the capacity and competence of the lessor. He should make a comparative study of the lessors from whom he is going to take the equipment on lease. He should be aware of the technique for formulating a lease proposal to negotiate effectively the lease period, the total rentals to be paid and the structure of rentals to suit his cash flows.

(e) Utmost care has to be exercised in the selection of the lessor who should have adequate professional competence to suggest an effective lease package—keeping in mind the lessee’s cashflow position and tax liability.

(f) Leasing is a method of financing with a higher cost. The rental payments include a margin of profit for the lessor who often demands advance payments of rentals adding to the cost of leasing. Leasing may prove uneconomical when a company can readily borrow the full amount needed to buy the asset and pay it back over the expected life of the asset.11

Advantages for the Lessor

Leasing provides to lessors profitable new opportunities to reach borrowers and expand existing markets. The rapid growth of leasing in a broad cross-section of countries indicates that leasing as a financial product has addressed an important unsatisfied demand for financing and, at the same time, attracted borrowers away from the more traditional financial products such as bank loans. The following advantages accrue to the lessors from leasing:

(i) The lessor purchases the equipment directly from the supplier after the lessee has made his choice, which eliminates the opportunity for the lessee to utilize the borrowed funds for other purposes and, in some

cases, creates an opportunity for lower pricing of equipment based on fleet or volume sales.

(ii) Comparatively simpler documentation and supply processing can keep transaction costs down, permitting leasing companies to efficiently achieve high volumes and manage their costs. This is in some ways analogous to the general experience in microfinance in which simplification of transaction processes and reaching critical mass in business volumes make it possible to obtain a beneficial impact on administrative costs.

(iii) The lessor uses the expected investment yield in calculating periodic payments to be paid by the lessee under the lease contract and quantifies more easily the margins between funding and transaction costs on the lease contract. The expected investment yield will include the lessor's tax advantage from depreciation expense and, when conditions warrant, the lessor may be prepared to pass on to the lessee part of this advantage through a lower lease discount factor.

(iv) Leasing companies are not typically deposit-taking institutions and therefore may be subject to less stringent regulations than banks, permitting them higher leverage than other financial institutions and liberating them from directed lending mandates and quotas often imposed on banks by government policy. On the other hand, leasing companies have to source their funding from the more volatile and higher-costing money markets. Moreover, medium to long-term funds may also be in short supply in the domestic financial market.

(v) As legal owner of the asset financed the lessor has a stronger security position whereby enforcement of security rights from the non-payment is potentially simpler, less cumbersome and less costly since no court action is required. Moreover, a lively market might begin to develop for previously-owned equipment, including among leasing companies, particularly as the lease financing sector develops (Balkenhol and Schutte 1996: 14).

The tax advantage of lease financing compared to conventional financing is that the lessor, as legal owner of the asset financed, can take the benefit of depreciation expense as a shield against taxes on revenue realized from the lease. In conventional bank financing, the lender does not have that depreciation expense as a shield against taxes on interest revenue realized from the financing. This advantage to the lessor is becoming less clear, because tax authorities in a number of countries appear to be taking the viewpoint that depreciation should qualify as a tax-deductible expense only for
lease contracts, but not for financial leases. If this viewpoint spreads among tax authorities in a larger number of companies, an important financial benefit will be lost.\textsuperscript{12}

Leasing thus has the potential to facilitate investment in capital equipment and promote development of industry in general and the certain segments of small business in particular. Beyond improving access to sources of finance, leasing would broaden competition in financial services, and introduce business and financial institutions to innovations in financial instruments and techniques. In facilitating the financing of imported capital equipment, leasing can perform an important role in the transfer and application of new technology to domestic production processes.\textsuperscript{13}

**Limitations for the Lessor**

Following are the limitations for the lessor:

(a) The mushroom growth of leasing companies in India has created a glut with the result that they have to compete with one another for survival.

(b) Leasing companies in India will have to compete with large and well-placed foreign companies in case the latter are permitted to operate in India.

(c) Leasing entails a high risk of obsolescence for the lessor, who should have the requisite resources to absorb this risk. Due to competitive situation in the market he may not be able to get adequate compensation for this risk. Besides, technological improvement destroys the anticipated residual value in the leased equipment.\textsuperscript{14}

(d) Leasing costs are often subject to unexpected fluctuations throwing the lessor's entire profit picture out of focus unless an escalation clause is incorporated into the lease agreement.\textsuperscript{15}

(e) The success of the leasing business is dependent on the efficient management of cashflows so that the inflows are not allowed to remain


\textsuperscript{14} Gant, (1959), "Illusion in Lease Financing", op.cit., p.127.

\textsuperscript{15} Kothari, Vinod (1991), op. Cit., p.27.
idle by revolving them effectively. It requires the lessor to be alert and look for good investment opportunities.

(f) The leasing business may involve locking up of funds if due care has not been exercised in monitoring of cashflows. Consequently, heavy financial burden may be placed on the lessor who should have either the ability to borrow large funds or have funds of his own to pay for the cost of the leased equipment.

(g) Considerable period usually lapses before the accumulated profits from the business of leasing offset the capital tied up in leases. This means that the lessor has to adopt a conservative policy for the distribution of dividend and to rely heavily on the retained earnings for the growth of his business.

(h) Sales tax laws exclude the lessor from the concessional tax payable by the actual users of the equipment. This results in increasing the cost of equipment and hence the lease rentals.

(i) Heavy dependence on public deposits by the lessor may result in diversion of short-term funds for long-term use resulting in mismatch of funds and position of liquidity crisis.\(^{16}\)

**Current Scenario**

Leasing is fast emerging as a big business. The origins of leasing industry can be traced back to millennia, although the past five decades have seen phenomenal growth in the evolution of leasing industry. The industry evolved from being a manufacturer’s selling technique into a specialized financial service with the formation of the first independent leasing company in 1952 in the United States. The industry extended to Europe and Japan in the 1960s and has been spreading through developing countries since the mid-1970s. By 1994 leasing had been established in over 80 countries, including over 50 developing countries. In 1994 over $350 billion worth of new vehicles, machinery and equipment was financed through leasing, accounting for about an eighth of the world’s private investment. In OECD countries up to a third of private investment is financed through leasing.

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\(^{16}\) Vancil, R.F. and R.N. Anthony (1959), "The Financial Community Looks at Leasing", *Harvard Business Review*, 37, N0.6, November-December, p. 113-130
Developing countries are driving most of the leasing industry's growth today: between 1988 and 1994, new leases written increased from $15 billion to $44 billion. The most spectacular growth has been in South Korea. Started in 1975 and supported by International Finance Corporation (IFC) investments in the first leasing company, the South Korean leasing market was the fifth largest in the world by 1994. Furthermore, market penetration of leasing, leasing as a share of private investment, more than doubled in both middle and low-income countries between 1988 and 1994. By 1994 leasing accounted for an average of 11 percent of the financing of capital equipment in middle-income countries, up from just 4 per cent in 1988. Table 1.2 below shows the growth of leasing markets in the world during 1988-94:

Table 1.2
Top Leasing Markets, 1988-1994

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Leasing volume (US$ bn)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>High income countries [1]</td>
<td>259</td>
<td>310</td>
<td>292</td>
<td>313</td>
</tr>
<tr>
<td>Middle income countries</td>
<td>12</td>
<td>17</td>
<td>27</td>
<td>39</td>
</tr>
<tr>
<td>Low income countries</td>
<td>3</td>
<td>5</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td><strong>Total [2]</strong></td>
<td>274</td>
<td>332</td>
<td>323</td>
<td>357</td>
</tr>
<tr>
<td><strong>Market share (%) [3]</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>High income countries</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>Middle income countries</td>
<td>4</td>
<td>5</td>
<td>9</td>
<td>11</td>
</tr>
<tr>
<td>Low income countries</td>
<td>3</td>
<td>4</td>
<td>4</td>
<td>7</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td>9</td>
<td>10</td>
<td>11</td>
<td>13</td>
</tr>
</tbody>
</table>


[2] The 1994 survey is based on a sample of 24 high, 20 middle and 6 low income countries, as classified by the *World Leasing Yearbook*.  
[3] Unweighted averages, Leasing as % of private investment.
It is clear from table 1.2 that in 1988 leasing volume in the world was to the tune of $274 billion, of which $259 billion was in high income countries, $12 billion in Middle income and $3 billion in low-income countries. In 1990 leasing volume rose to $332 billion in which the bulk share was that of high income countries. In 1994 the leasing volume rose to $357 billion in which share of the high income group was $313 billion, middle income countries $39 billion and that of the low-income countries was $5 billion. On an average the market share of leasing in 1988 was 9 percent which averaged 10 per cent in 1990, 11 per cent in 1992 and 13 per cent in 1994. It is seen from table 1.2 that bulk of the leasing activity remained confined to high-income countries during the period.

Over the years, leasing has emerged as a mature industry particularly in high-income countries. The United States continues to be a leader both in terms of volume, with $140 billion worth leases written in 1994, and market penetration, with 30 per cent of plant and equipment purchases. Most of the developing economies have also witnessed fast rate of growth in the leasing industry. Between 1988 and 1994 new leases written in developing countries increased from $15 billion to $44 billion. By 1994, middle and low-income countries accounted for five out of the largest twenty leasing markets. Besides, market penetration, in terms of leasing as a share of private investment, more than doubled in both middle and low-income countries between 1988-1994. By 1994 leasing accounted for an average of 11 per cent financing of capital equipment in middle income countries, up from just 4 per cent in 1988. Table 1.3 shows region-wise private investment financed by leasing:
Table 1.3

Private Investment Financed by Leasing, 1988-1994

<table>
<thead>
<tr>
<th>Regional average</th>
<th>Year</th>
<th>1988 (%)</th>
<th>1990 (%)</th>
<th>1992 (%)</th>
<th>1994 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>North America</td>
<td></td>
<td>21.3</td>
<td>20.6</td>
<td>21.5</td>
<td>22.1</td>
</tr>
<tr>
<td>Asia</td>
<td></td>
<td>4.4</td>
<td>4.9</td>
<td>5.9</td>
<td>8.2</td>
</tr>
<tr>
<td>Europe</td>
<td></td>
<td>11.7</td>
<td>12.1</td>
<td>13.5</td>
<td>13.4</td>
</tr>
<tr>
<td>Latin America</td>
<td></td>
<td>3.5</td>
<td>5.4</td>
<td>8.8</td>
<td>13.4</td>
</tr>
<tr>
<td>All regions</td>
<td></td>
<td>9.0</td>
<td>9.6</td>
<td>10.9</td>
<td>12.5</td>
</tr>
</tbody>
</table>

Source: *World Leasing Yearbook*, IFC

Note: Unweighted averages, Market share for Africa and Australia/NZ not shown. Because of small sample sizes, these markets, however, are included in the 'All Regions' average, *World Leasing Yearbook*, 1995.

Regional trends in the distribution of leasing shows that United States still accounts for about 40 per cent of worldwide leasing despite the fact that the regional distribution of leasing has undergone considerable transformation, particularly during 1990s. In 1993 Asia overtook Europe for the first time, and in 1994 accounted for 28 per cent of the world market compared to Europe’s 25 per cent. It is revealed from table 1.3 that Latin America’s share increased by more than five times from 0.8 per cent in 1989 to 4.2 per cent. Africa’s share of the global total increased marginally from 1 per cent to 1.3 per cent, but the figures should be treated with caution as South Africa and Morocco have been the only two African countries in the top 50 leasing markets every year since 1989. It is also discernible from table 1.3 that leasing has matured in United States where it has stabilized above 21 per cent and in Europe at around 12 per cent. In Latin America, Leasing’s market share grew from an average of 3.5 per cent in 1988 to 13.4 per cent of capital investment in 1994. The increase in Asia was almost as dramatic, from 4.4 per cent to 7.8 per cent.
Review of Literature

Review of the related literature equips the researcher to ascertain as to what extent one's specified area of research has been subject to academic probity and what new avenues remain to be explored. Financial Management, Managerial Economics, Accounting and Lease Financing etc. are vast academic realms that have attracted considerable attention of the scholars, researchers, economists, management and accounting professionals and consultants in India as well as abroad. Keeping in view the plethora of literature that is available on these aspects, it is cumbersome to gain an insight into the whole available literature so as to examine as to what extent the topic under research has already been covered and where lies the potential for future research. In order to overcome this dilemma, it would be convenient to briefly review the representative works.

The existing literature on lease financing worldwide, including India, has focused mainly on three aspects: (a) Evaluation of Lease vs. Buy/Borrow Decision; (b) factors responsible for the Growth of Leasing; and (c) Accounting and Disclosure Practices. In order to have a fair idea about the academic and professional treatment of lease financing in the existing literature, a brief appraisal of the representative works is facilitated under these subheads.

(a) Evaluation of Lease vs. Buy/Borrow Decision

Some of the major studies in this area have been conducted by Bloomfield and Ronald (1974), Grinyer (1975), Middleton (1977), Burrows (1977), Bower, Herringer and Williamson (1966), Bower (1973), Johnson and Lewellen (1972), and Schall (1974). These studies suggest the use of net
present value technique for the purposes of evaluating the lease or 
buy/borrow decision. However, there appears to be substantial disagreement
as to the discount rate to be used for obtaining Net Present Value. Vancil
(1961), Bower, Herringer and Williamson (1966), Clark, Jantorni and Gann
(1973) have mooted the suggestion of making use of firm's overall cost of
capital as discount rates. Bloomfield and Ma (1974) are in favour of using the
required rate of return on equity for this purpose. On the other hand, Schall
(1974) has argued in favour of using the risk-adjusted discount rate. Bower
(1977) and Burrows (1977) espouse the use of borrowing rate. Middleton
(1977), Grinyer (1977), Bierman (1982), Johnson and Lewellen (1972) have
endeavoured to present a case for using the borrowing rate after tax, for the
purpose of discounting the future cash flows.

(b) Factors Responsible for Growth of Leasing

Some of the major studies falling within the ambit of this category inter
alia include Marrah (1968), Fawthrop and Terry (1974), Deutsche Leasing
(1976), Sykes (1976), Dietz (1977), Anderson and Martin (1977), M.C. Gugan
john Woodhouse (1985), and Foreman Tony(1985).

(c) Accounting and Disclosure Practices

The studies pertaining to this category have primarily dealt with the
impact of capitalization of asset obtained on lease by lessees. Besides, these
studies also endeavour to ascertain the impact of such capitalization on share
prices and on the performance indicators of lessee companies. Vacil and
(1980), Khalik (1978), Trevor Wilkins and Zimmer (1983), and Reilly Keith (1984) have shown that the capitalization of leased assets in the books of lessee would affect the share prices adversely. The pith and substance of these studies reveals that the lessees do not prefer to disclose their lease obligations in the financial statements as such a move would share prices and financial indicators. However, Trevor Wilkins (1983), Nelson (1963) and Herst (1987) in their studies have shown that the respondents preferred to disclose their lease obligations through a footnote or an annexure to the financial statements. The Australian scholars like Gardiner (1978), Bazley (1983), Reilly Keith (1984) and Woodhams (1985) in their studies have revealed that the lessee companies in Australia accepted the concept of capitalization for long-term benefit albeit hesitatingly.

In the Indian context, only a handful of studies have been conducted in the realm of lease financing. Most these studies have dealt with the problems pertaining to leasing industry in India without any empirical evidence. These studies have laid emphasis on the need of studying various aspects of leasing empirically. Prachure and Ashok Kumar (1985), Ghosh and Gupta (1985), Joshi (1982), Kothari (1991), Pandey (1986), Verma (1986) and Naresh Gupta (1993) have largely dwelt upon the concept of leasing. However, Karuppiah (1988) in his study has tried to examine forms of leasing companies operating in India, sources and uses of funds of leasing by these companies, the number of the leasing companies listed in the Indian Stock Exchanges, and analysis of profitability of these leasing companies etc. Though it is a useful study but it suffers from limitations like old data, limited treatment of the comprehensive subject and lack of empirical analysis.
Kolb (1983) provides a brief appraisal of accounting considerations of lease financing. It is a brief informative explanation gives a peripheral view of financial leasing. Similarly Cheng Lee et al. (1997) throw some light on types of leases and accounting treatment. It is too brief an account to comprehend the full gamut of the issues involved in financial leasing. McMenamin (1999) provides a very brief but succinct account of different kinds of leases. However, its utility from research point of view is almost negligible. Kuchhal (1996) has devoted reasonable space to bring home salient characteristics of financial lease. The noteworthy aspect of this analytical account is that it provides interpretation of the issues involved in leasing in the Indian context. It is partly useful.

World Bank's two mimeographs (1996 &1997) on leasing are quite useful. The first mimeograph entitled *Leasing in Emerging Markets* (1996) deals with recent trends in global leasing with particular emphasis on the growth of leasing industry in developing countries during mid-1970s to mid-1990s. It appraises the role of the International Finance Corporation (IFC) in extending loans to leasing companies in developing countries, particularly in South Korea, the Philippines, Bangladesh and Pakistan. It is partly useful in understanding the international dimensions of the lease financing vis-à-vis the role of the IFC. World Bank's second mimeograph entitled *Leasing to Support Small Business and Microenterprises* sheds light on advantages of leasing for the lessee and the lessor, the regulatory, macroeconomic and financial framework essential to introduce leasing into small business enterprises. It also provides a brief overview of World Bank's experience in this regard, based on the case studies of Bangladesh and Pakistan. It is also partly useful.
It is revealed from the foregoing brief analysis of the representative literature that there is a real dearth of a qualitative, in-depth and analytical research study that can provide fresh insights into the complex and subtle aspects of leasing in the Indian context. Thus many penetrating questions like pattern of growth of 'Lease Financing' in India since 1973 in general and 1987-1997 in particular, modus operandi of leasing companies in raising funds from market place for deploying in assets, policies and evaluation criteria followed by leasing companies in financing assets and accounting and disclosure policies being followed by these companies etc., have remained unanswered. These and other related aspects are neglected in the available literature and the present study has made a humble attempt to find answers to them.

Statement of the Problem

The statement of the problem is "LEASE FINANCING: AN EVALUATION."

Objectives of the Study

Following are the objectives of the study:

1. It attempts to examine the growth of leasing companies in public and private sectors during 1998-2001 period.

2. It seeks to analyze the organizational structure of leasing companies, their growth pattern, potential for mobilizing savings and borrow from banks and channelizing the funds for the creation of the assets for the development and growth of Indian industry.

3. It focuses on the method of evaluation of lease financing by the major lease financing companies, including structuring of lease transactions during the period under review.

4. An endeavour has been made to comprehend a comparative analysis of the accounting practices followed by the major leasing companies in India as against the companies in the United States and Europe.
5. It also takes into consideration the changing regulations of the Reserve Bank of India (RBI) and their impact on leasing companies

Hypotheses

The following hypothetical axioms were contemplated to be tested in the present research study:

1. The leasing companies in India have registered rapid strides in the financial markets.

2. The leasing companies have in-built potential to raise funds and channelize them for the development and growth of Indian industry.

3. The lease financing companies in India are following a satisfactory pattern of evaluation of lease financing, including structuring of lease transactions.

4. The accounting practices followed by the major leasing companies in India are different from their counterpart companies in the United States and Europe.

5. Regulations of the Reserve Bank of India (RBI) impact upon the investment pattern of the leasing companies.

Scope of the Study

The present research study is quite comprehensive in its scope. It provides an insight into the functioning of the financial companies floated in India and appraises their role in the financial markets. An attempt has been made in this study to bring out clearly the evaluation of the performance of the leasing companies during the period when the Reserve Bank of India (RBI) was not having much control as against the regulation notified later. The present assumes added significance in view of the fact that leasing companies are equal partners of the financial system to mobilize deposits, public savings and creation of credit. It is now an acknowledged fact that finance companies are the fast creators of credit as compared to banks. The present study dwells on the theme as to how far the lease financing of assets have fulfilled the objectives during the period from March 1998 to March 2001.
for which the lease finance companies had been created and how this instrument would fulfil this objective in future with the increase in number of players, competition, RBI regulations, new accounting practices and fresh taxation policies etc.

On the basis of the emerging trends from the present study, some suggestions have been mooted that can be useful for the policy-makers, financial analysts, stock brokers and prospective investors to inform them in order to reorient their approach. Concurrently, it is also useful for the scholars and academicians. This study paves way for further research in related areas having semblance or bearing on the financial market.

Limitations of the Study

The present research study entails following limitations:

1. It lays main emphasis on the analysis of the performance of lease finance companies during the 1998-2001 period.

2. References to the developments occurring prior to that period have been incorporated to have a historical assessment of the lease financing in India.

3. Major focus of appraisal has been on the Indian lease financing companies and allusion to similar companies in the United States and Europe are for the sake of comparison.

Methodology

The basic techniques of research-historical, comparative and analytical-have been used in this study. Historical method enables in discerning the genesis of a problem in its past context so as to discern its present relevance and comprehend the future potential. This method has been relied upon to analyze the genesis of evolution of lease financing in India. Reliance has also been placed on comparative method. The application of this method helps in comparing the ups and downs in financial market vis-
à-vis leasing companies. Performance of leasing finance companies in India has been analyzed comparatively with those companies in the United States and Europe in order to ascertain the differing scales of performance and priorities.

The analytical method is helpful in analyzing the contents with reference to their appropriate context to ascertain their logic and veracity. Besides, it also enables to discern the overt as well as covert aspects of financial policies, RBI guidelines and market trends. This method has been relied upon in the present study to have in-depth analysis of the performance of lease financing companies in India.

Both primary and secondary data have been relied upon. The primary data was generated with the help of a questionnaire that was administered to major finance companies. Besides, an opinion survey was also conducted to seek the opinion of corporates and individuals who had availed of ‘Lease Financing’ for financing their assets. Apart from these, a number of journals, books and other materials published in India and abroad have also been extensively utilised. The information supplied by the Association of Leasing and Hire-Purchase and other associations/companies has too been made use of. Elaborate use of tables has been made to compile and present the data in a clear and cohesive order at appropriate places in this study. Optimum care has been taken to present an objective and dispassionate analysis.

**Plan of Study**

With a view to critically appraise the evolution, growth, and contemporary operations as well as standing of leasing industry in India's capital market, the present study has been undertaken. The entire study has
been divided into six chapters, with four substantive chapters and an introduction in the beginning and a conclusion in the end. Leasing as a concept, types of leasing as a financial lease and an operational lease, sub-heads of a financial lease, pros and cons of leasing, advantages and limitations for the lessee, advantages and limitations for the lessor, and current scenario for the leasing industry etc., have been examined in the first chapter.

An analysis of growth of leasing industry in India is facilitated in the second chapter. After briefly analysing the growth of leasing industry in India until the close of the 1980s, a detailed analysis of a study published by the Reserve Bank of India in November 2002, which covered selected 1,024 financial and investment companies in the country is presented in second chapter. This study has identified 67 ‘actively operative’ leasing companies with a paid up capital of Rs 536 crore and their net assets worth Rs 2,223 crore during 2000-2001.

The third chapter presents a critical analysis of the methods, both conventional as well as non-conventional, applied by leasing companies in India to raise funds from the market. Equity capital, debenture, and bank loans etc., fall within the ambit of conventional sources of finance and public deposits, short-term inter-corporate deposits and some innovative schemes like bank-guaranteed deposits, asset-ownership instruments, securitized leases and deposit-linked leases etc., come under the purview of the non-conventional sources of finance.

The fourth chapter looks into the ways and means of ascertaining creditworthiness of a borrower or a lessee. Client, bank references, trade
references, credit rating agencies, company financial reports, media reports, stock market opinion etc., are the principal sources of creditworthiness of a borrower. Related aspects like the types of information sought from the antecedents of the company, analysis of the financial information, reading of notes to accounts and other information, fixing the credit terms, securing the lease, after-lease monitoring, collection and subsequent follow-up etc., are also significant factors that have been examined in the fourth chapter.

Accounting policies and practices followed by the leasing companies in India form the pith and substance of analysis of the fifth chapter. While dealing briefly with the finance method of lease accounting as per the provisions of the IAS-17, FAS-13 and SSAP-21 etc. it provides a detailed analysis of the Accounting Standard (AS) 19, as envisaged by the Institute of Chartered Accountants of India (ICAI), which has come into force in May 2003. The final chapter is in the form of conclusion which presents some suggestions based on the trends emerging from the present study.