CHAPTER 1
INTRODUCTION

1.1 Leasing is a simple but unique, innovative source of medium term/long term finance. It is a method of acquiring the use of an asset without buying it. Leasing provides cent percent finance to a business which requires new plant and machinery, other office equipments, miscellaneous industrial, construction and commercial equipments. Hence it is an alternative to borrowing funds for the purchase of fixed assets.

1.2 This method of acquiring fixed assets gained ground in western countries by the middle of this century. In India, it got momentum only in the eighties. The growth in the volume of leasing activity in the recent past shows that the business community in India has widely accepted this mode of financing. It is estimated that there are nearly 1400 leasing companies (including private limited companies) in India at present and many are in the offing. Banks both in the public as well as in the private sector have managed to enter this field by starting subsidiaries. Of late, almost all manufacturing groups have formed captive leasing units. Quite recently Reserve Bank of India has issued orders allowing commercial Banks to
indulge into the field of leasing directly.

1.3 Leasing refers to a contract between the lessor who owns the equipment and the lessee (user), for the lease of specifically approved items of equipment, on payment of a periodical amount (lease rental) for a definite period of lease. The lease rental paid by the lessee to the lessor incorporates the components of interest charges and the actual cost of an asset.

1.4 Leasing Transaction:
A lessee chooses an asset and locates the lessor who will acquire it for him. The period of lease may spread over the entire economic life of the asset. The ownership in legal terms will always be with the lessor. The lessor may or may not be the manufacturer of the equipment. If he is the manufacturer (which is not the case usually) he capitalises the cost of the equipment in his books, funding it as a capital asset, and then gives it out on lease to the lessee. If he is not a manufacturer, he will purchase the equipment from the manufacturer paying the cost (including duties and taxes). He becomes the owner and will capitalise it in his books and then lease it out. Basically there are two major forms of leases - Financial lease and operational lease.

1.5 Financial lease, also known as capital lease or full pay out lease, is generally a long term lease. Here the
lessee selects the equipment, settles the price and terms of sale and arranges with a lessor to buy it. He takes the asset on lease by entering into an irrevocable, noncancellable contractual agreement with the lessor for a fixed term period. The lessee uses the equipment exclusively, maintains it, insures it and avails of the after sales service and the warranty backing it. In other words, all the risks and rewards incident to ownership is availed by the lessee, while the lessor retains the legal ownership.

1.6 Financial lease period may be primary lease period and secondary lease period. Primary lease is usually for five years which is followed by a 'secondary lease' of another three or four years depending on the type of equipment. During the primary lease period, the rentals are generally higher, to cover the cost. Rent for the subsequent period is normally lower and during this period, the lessor is getting the maximum profit, as the cost of equipment might have been covered in the initial period.

In financial lease there can be various options the lessor and lessee may exercise during or at the end of the lease term.

a. Lease with purchase option - The lessee will have the
option to buy the equipment. Acquisition may be at a pre-determined price or at a price fixed at the time of transfer. (Interview with lessors shows that ownership is transferred to the nominee of the lessee. Otherwise leasing transaction may be interpreted as Hire Purchase)

b. Lease with lessee enjoying residual benefit. The lessee will have the right to share a portion of the terminal sale proceeds and/or to review the lease agreement at a bargain rental.

1.7 There are various types of financial leases like sale and lease back, leveraged lease, consortium lease etc.

Sale and Lease Back - This is an arrangement by which an entity that owns a given asset may sell it to a lessor and then lease it back. This enables the lessee to immediately defreeze the money that it has locked up in the said asset, and makes it available for utilising in more profitable ventures. According to Earnest W. Walker, the net effect of the sale and lease back transaction is for the firm to 'trade' a fixed asset for a current asset. Lalitha Narayanan opines that sale and lease back

Arrangement is very tricky both from the point of view of equipment finance and from the point of view of income tax. Some companies sell the assets and invest the sale proceeds in UTI Units to get income tax benefits\(^2\). Because of the unique advantage of this scheme many lease arrangements are under sale and lease back. Mangalore Chemicals and Fertilisers has entered into a Rs. 25 crores sale and lease back arrangement on its ageing Di-ammonium Phosphate (DAP) Plant\(^3\).

**Leverage Lease** — Leveraged lease involves the inclusion of a third party. The third party may be a financier for a particular asset to be leased or owner of the asset. The lessor manages to get loan from the third party at a rate lower than the return from leasing (rate agreed between lessor and lessee). The difference in the rates can be enjoyed by the lessor.

**Consortium Leasing** — Under this arrangement, two or more lessors may jointly acquire the asset and lease it out to the lessee. In the case of assets which require

---


huge funds, a single lessor may not be capable of acquiring it or may not be willing to shoulder the entire risk associated with it. In such cases two lessors jointly own the asset and share the rentals.

1.8 Operating Lease: This type of lease is also known as maintenance lease or service lease. Under this, the lessor has to maintain and service the leased equipment and the cost of maintenance is built into the lease payments. Because of the inclusion of service charges in the lease rentals, operating lease rentals will be comparatively higher than other leases. Operating lease may contain a cancellation clause which can be exercised either by the lessor or lessee. The lessor can take away the equipment on circumstances like misbehaviour of the lessee, non payment of the rental in time, misuse of the equipment for a use not shown in the contract etc. The lessee can return the equipment at any time, on any ground which may be technological developments which make the equipment obsolete, nonrequirement of the services, the unsatisfactory performance of the lessor etc. Operational leases are common in telephones, computers, aircrafts and so on.

1.9 Among the different forms of leases, Indian leasing companies offer financial leases. Most leases have a primary period of five years, followed by a secondary
period. Lease can be front loaded (more rentals charged in the earlier years) or back loaded (less rentals charged in the initial years). There is also equated lease which is equated in terms of payment over the period of lease. Lease rentals are paid on definite intervals of time as agreed upon. In short, the flexibility of dates, timing and arrangement of financial lease, depends upon both the lessor and lessee.

1.10 Lease Versus Hire Purchase and Instalment Selling:
A leasing transaction can be distinguished from a 'Hire purchase' transaction or that of payment by instalments. In the case of payment by instalments, the user actually becomes the owner on payment of first instalment. The balance is to be paid in periodic instalments. But in a hire purchase transaction, some down payment is made, the balance being payable over a specified period. Even though ownership is passed on only on the payment of last instalment, he is deemed to be the owner at the very beginning.

Thus in both these transactions, the user acquires the ownership during the validity of the agreement, while under lease transaction the user (lessee) gets only the custody/usage of the equipment. He will not get the ownership at any time during the period of the contract.
1.11 In accounting treatment also there is a substantial difference between the two. Under leasing the entire lease rentals represent a 'hire charge' for the lessee (user). They are treated as expenses and are deductible under tax laws. But under hire purchase, part of the instalment represents capital payment and is not an expense. Only that part of the instalment which is termed as interest on the loan is considered as a revenue expenditure and is tax deductible. Lease rentals represent income to the lessor and is credited to Profit & Loss Account.

1.12 In the case of leasing, the leased asset is not shown in the balance sheet of the lessee. But the lease rentals are debited to Profit and Loss Account. Further, as the lessee is not the owner, he cannot claim depreciation on the leased assets. As against this, the hire purchase capitalises the asset brought under hire purchase contract although ownership is not acquired by him until the end of the contract. He can claim depreciation as he is the deemed owner.

Thus, advocates of leasing vociferously claim that this is a convenient mode of financing assets due to the off balance sheet reporting and entitlement of 100 percent tax deduction in spite of losing depreciation benefits.
1.13 Significance of Leasing:

In India, leasing business was confined to just two companies till 1982 and the total assets leased out amounted to ₹. 50 crores. The various policy announcements like freeing of a number of items of import from the licensing list, measures to reduce bureaucratic delays in clearance of industrial projects, commendable changes in MRTP Act, etc. during the middle of 1980s ushered in a congenial climate for faster economic growth. Large number of manufacturing companies came into existence intensifying competition in the wake of technology upgradation and modernisation. The number of letters of intent issued during 1985 was 1456 - an all time record and was 37 percent more than those issued in 1984\(^4\). Enormous funds were required for financing the activities of these concerns. But conventional sources of financing like bank loans and financial institution loans failed to meet the potential requirements of the corporate sector.

1.14 During the middle of 1980s Government reduced the budgetary support to public sector companies and halted the liberal financial institution advances to these undertakings. Government made it known that as regards financial accommodation, both public sector and private sector will be treated at par. Public sector companies

\(^4\) Economic Diary, May 7-13, 1986.
too were allowed to tap the capital market for raising required funds. Consequently fund availability of private sector companies was expected to shrink. The seventh year plan (1985-90) envisaged an investment of ₹. 64,000 crores at the 1984-85 prices in the private sector. A growth of investment intentions is reflected in the spurt of consents granted by Controller of Capital Issues (CCI) aggregating to ₹. 5278 crores and ₹. 8029 crores during the years 1987-88 and 1988-89\(^5\). The actual investment by the Private corporate sector during the 7th plan period has been below the average annual investment of ₹. 12,800 crores postulated in the Plan\(^6\). The gap was inferred to be bridged by other sources. Financial Institutions cannot cater to the increased needs of the corporate sector due to the fund constraints faced by them. Accordingly, the Seventh Five Year Plan projected an investment saving gap of ₹. 12,000 crores to be met from alternative sources.

1.15 The traditional passion for ownership, among the Indian Industrialists, began to wear off due to the paucity of funds, increasing the scope for lease financing. The outstanding performance of the pioneer companies in the field, accelerated the pace of leasing activity. First Leasing Company of India Limited increased its profits from ₹. 2.35 lakhs as on 30th November

5. Kothari Industrial Directory of India, 1990
6. Ibid...
1.16 There was mushroom growth of leasing companies during 1985-86 period, the first year of the Seventh Five Year Plan. There was large scale acceptance from the investing public and the issues of leasing companies were heavily oversubscribed. Unlike manufacturing companies, leasing companies do not have gestation period and they distributed handsome dividends from the initial year itself. In the early 1980s the share prices of leasing companies were very buoyant. Share prices of some of the leasing companies appreciated even upto 570 percent. It can be seen that Government also was concerned about the healthy development of lease financing in India. The policy decision of the Government during the initial stages of the leasing boom period to enable the leasing companies to raise more funds equating it with the hire purchase companies is worth noting. Since August 22, 1984 leasing companies have been brought within the purview of

---

the Non Banking Financial Companies Directions 1977 and thereby leasing companies were permitted to raise deposits upto ten times their net owned funds. Till that date, leasing companies were governed by the Companies (Acceptance and deposit) Rules of 1976. This rule lays a ceiling of 25 per cent of paid up capital and free reserves for accepting deposits. Another positive sign of promoting this industry can be traced to the permission given to nationalised banks and financial institutions like IDBI, ICICI, IRCI, etc. to enter the field of leasing. Further the permission extended to International Finance Corporation (IFC), an affiliate of the World Bank, to enter the leasing arena of the country, also pronounce the fact that the Government is much eager to promote the leasing industry. The Dahotre Committee's report on norms of bank lending to leasing companies encouraged this line of activity. Thus, leasing which picked up momentum in our country in the beginning of 1980s, flourished to its peak level within the next three or four years.

1.18 But the subsequent happenings indicated that this was only a short lived phenomenon. Leasing experts view some governmental measures as anti leasing. For gathering more funds to the exchequer, Government took a decision to tax this fast developing line of activity. The 46th Amendment Act empowers the State Government to impose tax on the
right to use goods. Further the State Governments denied the privilege of using 'C' form by leasing companies. Otherwise the equipments could be purchased at a reduced cost. Introduction of Section 115 J which will lead to charging of minimum tax on book profits was seen as a blow to leasing companies. Accounting guidelines framed by Institute of Chartered Accountants of India for leasing transactions really scared the leasing companies.

1.19 Annual reports of leasing companies showed that they were not able to perform as expected. Leasing companies reduced or skipped the dividends in the wake of meagre bottomlines. Some leasing companies diversified into manufacturing activities, many added hire purchase as an activity, while several others became defunct. After 1986, the leasing scenario totally changed and in many cases the share prices nosedived to the brim point or even less. Most of the leasing company shares were striving hard to trade it at the par value. The leasing industry is apparently caught amidst a tangle of confused mix of policies and regulations, indicating that all is not well and growing in the industry. The reasons for this state of affairs has not so far been analysed systematically.

1.20 However some publications have already come out, but they are mostly in the nature of text books.
P.K. Ghosh and G.S. Gupta in their book *Fundamentals of Leasing and Lease Financing* explain the concept of leasing and evaluates the economic rationale of leasing. Various types of leases and the organisation and management of leasing companies are discussed in a general way.

Rajas Parchure and N. Ashok Kumar in their book, *Introduction to Lease Financing* elucidates the scientific evaluation of lease rent. It also exposes other aspects of financial leases like taxation, investment allowance, interest rate etc.

Dr. Prem Lal Joshi in his publication, *Leasing Comes of Age, Indian Scene* provides a comprehensive exposition of lease financing. History and development of leasing, accounting for leases, by V/S lease evaluation etc. are some of the points it projects.

J.C. Verma in his book *Lease Financing* — concept, Law and Procedure, elucidates, the prospects for lease

---


Vinod Kothari in his book Lease Financing & Hire Purchase including Consumer Credit\textsuperscript{13} gives an analysis of legal aspects, direct taxes and sales tax implications on leasing, besides familiarising businessmen with the concept of leasing. It also highlights accounting for leasing transactions.

1.21 Several related articles have appeared in journals and dailies, covering mainly the advantages and disadvantages of leasing. Some have focussed on the leasing scenario in India while others projected the prospects of leasing. However, there are some research articles worth mentioning. An exploratory study done by R. Narayana Swamy\textsuperscript{14} expresses the views of leasing


companies on lease accounting issues in India. It deals only with several aspects of accounting regulation, accounting standard setting, accounting proposals and implications and economic consequences of the proposals for leasing companies and for lessees and users of financial statements. Another article dealing with the growth and performance of leasing industry by Rita Vasan gives just a peripheral view of the performance of leasing companies. Hence an indepth study is attempted to analyse the leasing industry in India, in all its manifestations.

1.22 Objectives:

The study has the following objectives.

Primary Objective:

To examine the present state of leasing industry and to assess the prospects of leasing in India.

Secondary Objectives:

1) To evaluate the financial performance of leasing companies.

2) To examine the impact of Government regulations on leasing industry.

1.23 Data and Methodology:

The study is an exploratory one. The required information is obtained from both primary and secondary data. Primary data is collected from company annual reports, discussions with executives of lessor and lessee companies as well as experts in the leasing field and secondary data from the publications of the Reserve Bank of India, Stock Exchanges, various magazines and dailies.

For a detailed analysis, from a universe of 75 leasing companies who are members of Equipment Leasing Association (ELA) as in 1988, a sample of 15 companies has been drawn by random sampling. The study period covers 5 balance sheet periods from 1986 to 1990-91. In order to ensure uniformity in accounting periods, balance sheet periods are equated to 12 months wherever required.

Only simple statistical tools like compound growth rates, percentages, averages and trend analysis are used besides financial management techniques like ratios, cash flow statements and common size statements.

1.24 Limitations:

The financial data obtained for the study is based on annual reports prepared as on a particular date. In order to show a realistic picture of figures in annual reports, averaging is resorted to, if found necessary.
Certain companies are in the following stage and hence an abnormal growth is observed in some of these companies. It is noticed that there is no uniformity in reporting lease and hire purchase income. Certain companies are not segregating income into lease income and hire purchase income. In the absence of such details, income is apportioned to lease and hire purchase income in proportion to the funds blocked in these areas. Operation results may not be strictly comparable due to varied practices followed with regard to depreciation and income accounting.

1.25 Plan of Study:

The report proposes to have the following chapters - The introductory chapter familiarises the reader with the concept of leasing, parties involved in a lease, types of leasing found in India and the difference between leasing, hire purchase and instalment. Significance of the study, review of literature, objectives, hypothesis, data and methodology and limitations are also covered.

The second chapter, Leasing Industry in India, deals with the emergence of leasing, structure of leasing, growth and expansion of leasing, competition, diversification, other catalysts etc.
The economies of leasing are evaluated in the third chapter.

The fourth chapter deals with various regulations imposed by Government, RBI, ICAI etc. on leasing. The impact of these regulations on the industry is evaluated.

The fifth chapter fund management, elaborates the various sources and deployment pattern. Adequacy of funds for financing the main activity (leasing and hire purchase activity) is explored. In the sixth chapter profitability analysis, the effect of lease rentals, cost of borrowings and the volume of activity are examined. Possibilities of shifting to non fund activities are also looked into.

The prospects of leasing, considering the eighth five year plan capital expenditure projections, insufficiency of funds from capital market, financial institutions and banks are highlighted in the seventh chapter.

Findings, conclusions and suggestions are incorporated in the last chapter.