Chapter 1

Introduction

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Introduction

Finance is the backbone of all industrial activities. Finance is usually related to the procurement of funds. In a broader sense, finance includes financial instruments, institutions and practices through which funds are obtained.

In case of shortage of finances, the industry or business becomes sick. Therefore, whenever we think of any business or industry, we think of finance. For the business of leasing, finance is all the more important since the whole business of leasing and finance mainly depends upon the availability and disbursal of finance.

In the Indian context, any project whether a new proposal or a scheme for modernization, replacement, normal capital expenditure or diversification - is usually financed by a mix of funding sources which could be by way of cash accruals or fresh issue of share capital on the one hand and debt instruments on the other; such as:- long term loans, debentures, convertible debentures and deferred credit etc., bank borrowings and to a limited extent hire-purchase and leasing - are also used for such financing.

However, during the past two decades, leasing has become a popular method of financing equipments throughout the world, covering a wide spectrum of assets. Real estate leasing is a very old phenomenon in India which is also permitted under the Transfer of Property Act, 1882. But the importance of equipment leasing, as an additional source of finance for the industry, has lately
been recognized. In addition of debt and equity financing, firms have an option of getting long-term finance for all equipments and facilities of a project through leasing. It is becoming popular not only in the advanced countries like United States of America, United Kingdom, Canada, France, Japan, Australia, Germany etc. but also in most developing countries particularly in India. Rapid changes in technology, rising cost of machinery and the urgency of replacement of equipments had necessitated the adoption of this new source of finance.
Definitions of leasing

Various writers and financial experts have defined 'Lease' or 'Leasing' or 'Lease Financing' as follows:

According to John J. Hampton¹:

"Leasing is an agreement that provides a firm the use and control over assets without receiving the title to them. A lease is a written agreement allowing for the use of assets for a specified period of time. The lease is signed by both the owner of the assets, called the lessor, and the user called the lessee."

James C. Horne² has explained lease as follows:

"Lease is a contract whereby the owner of an asset (the lessor) grants to another party (the lessee), the exclusive rights to use the asset, usually for an agreed period of time in return for the payment of rent."

The equipment Leasing Association, U.K.³ has explained the lease as follows:

"A lease is a contract between a lessor and a lessee for the hire of a specific asset selected from a manufacturing concern or vendor of such assets by the lessee. The lessor, retains ownership of the assets. The lessee maintains possession and use of the asset on payment of specific rentals over a period."

In the words of Herbert B. Mayo¹:

"Leasing is a contract for the use of an asset such as plant or equipment. The firm that owns the asset (the lessor) permits the lessee to use the goods. In return, the lessee enters into a contract to make specified payments for the use of the asset. The lease is usually for a specified time period and may be renewable."

According to I.A.S.C. (International Accounting Standards Committee) -

"Lease is 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."

R.M. Srivastava opines that

"Leasing is an agreement under which a company acquires the right to make use of an asset without holding title to it. A lease, thus, is a written agreement for economic use of assets for a stated period of time."

According to Schultz, Raymond G. and Schultz, Robert E.:

"In lease financing the user (tenant or lessee) agrees to pay a rental charge and adhere to other conditions of a lease contract in return for the right to utilize property of the owner (lessor or landlord) in his operations for a specified period."

From the above definitions, we may conclude thus:

Lease is a contract between a lessor, the owner of the asset and a lessee, the user of the asset. Under the contract, the owner gives the right to use the asset to the user over an agreed period of time for a consideration called lease rental. The lessee pays the rental to the lessor as regular fixed payments over a period of time at the beginning or at the end of a month, quarter, half year or a year.

Technical Terms:

For the purpose of clarity, the researcher has tried to define all technical terms that are used in her study which are as follows:

Lessors:

Lessors are those individuals, partnerships, companies, corporations and/or financial institutions who lease assets and equipments etc. to another party under a contract of lease for a predetermined lease rental and for a specified period of time.

Lessees:

Lessees are those individuals, partnerships, companies, corporations and/or financial institutions which use assets and equipments owned by the owner (lesser) for a specified period on lease rental under a contract of lease.
**Lease Brokers:**

Lease brokers are those individuals, companies and/or institutions which help the lessees in all respects and also in providing a total service before and after lease contract rather than simply obtaining the lowest rate.

**Lease Rentals:**

Lease rental is a contract between a lessor, the owner of the asset, and a lessee, the user of the asset. Under the contract the owner gives the right to use the asset to the user over an agreed period of time for a consideration.

**Lease Agreement:**

A lease agreement is a statement indicating the intention of the parties concerned and a document providing the terms and conditions under which the performance of the intention of the lessor and the lessee is to be undertaken.

‘Lease’ distinguished with other modes of property acquisition:

There are several terms identical but distinct from lease. These distinctions need clarification here:

**Lease and Sale:**

The main distinctions between lease and sale are as follows:

In a sale, the relationship between the seller and the buyer comes to an end with the completion of the sale transaction, whereas in lease, the relationship between the parties concerned continues and each one of them bears outcome of
the incidents of ownership during the lease period. In a sale, ownership of the goods sold rests with the buyer, under written agreement, subject to full payment.

**Lease and Hire Purchase:**

1. A lease is distinguished from a hire purchase in a sense that the ultimate purpose of a hire purchase is to obtain ownership whereas a lessee aims at having only the use of the asset.

2. Lease contracts are of many types. The responsibility of maintenance will differ in each type of contract. In hire purchase, the maintenance is the duty of the hirer.

3. There are no finance charges under leasing agreement whereas in hire-purchase, finance charges will be calculated on the amount advanced by the companies.

4. In lease financing, depreciation will be written off by the lessor whereas in hire purchase, the depreciation will be claimed by the user of the equipment etc.

5. Investment allowance is not permissible either to lessor or lessee whereas in hire-purchase, it will be claimed by the hirer.

6. Leasing is considered to be 100% financing and it does not require any margin money whereas under hire-purchase margin, it is generally 25% to 30% of the asset.

**Lease and Buying:**

1. Lease minimizes the initial cost outlay whereas buying is cheaper in the long run.
2. In lease finance, the risk of obsolescence lies on the lessor whereas in buying the risk has to be borne by the buyer.

3. Under lease, neither lessee nor lessor is allowed to claim investment allowance whereas in buying the asset, the purchaser is allowed to claim investment allowance.

4. Appreciation in the value of real estates provides benefit to the owner and makes the buying decision more attractive rather than leasing.

**Type of Lease**

An equipment lease transaction can differ on the basis of:-

i.) the extent to which the risks and rewards of ownership are transferred,

ii.) number of parties to the transactions, and

iii.) domiciles of the equipment manufacturer, the lessor and the lessee and so on.

On the basis of these variations, leasing can be classified into the following types:

1) Finance lease and operating lease,
2) Sale and lease back, and Direct lease,
3) Single investor lease and leveraged lease, and
4) Domestic lease and International lease.

**Finance Lease**

According to International Accounting Standards (IAS - 17) in a finance lease, the lessor transfers to the lessee substantially all the risks and reward
incidentals to the ownership of the asset whether or not the title is eventually transferred. It involves payment of rentals over the obligatory non-cancelable lease period, sufficient in total to amortize the capital outlay of the lessor and leave some profit. In such leases, the lessor is only a financer and is usually not interested in the asset. It is for this reason that such leases are also called as full payout leases as they enable a lessor to recover his investment in the lease and earn a profit. Types of assets included under such a lease are ships, aircrafts, railway wagons, lands, buildings, heavy machinery, diesel generating sets and so on.

In India, however a lease is a finance lease, if one of the last two conditions is satisfied. A lease agreement with any of the first two conditions is treated as hire purchase agreement.

A finance lease is structured to include the following features:-

1. The lessee selects the equipment according to his requirements from its manufacturer or distributor.

2. The lessee negotiates and settles with the manufacturer or distributor, the price, the delivery schedule, installation, terms of warranties, maintenance and payment, so on.

3. The lessor purchases the equipment either directly from the manufacturer or distributor (under straightforward leasing) or from the lessee after the equipment is delivered (under sale and lease back).
4. The lessor then leases out the equipment to the lessee. The lessor retains the ownership while lessee is allowed to use the equipment.

5. A finance lease may provide a right or option, to the lessee, to purchase the equipment at a future date. However this purchase is rarely found in India.

6. The lease period spreads over the expected economic life of the asset. The lease is originally for a non-cancelable period called the primary lease period during which the lessor seeks to recover his investment along with some profit. During the period, cancellation of lease is possible only at a very heavy cost. Thereafter, the lease is subject to renewal for the secondary lease period, during which the rentals are substantially low.

7. The lessee is entitled to exclusive and peaceful use of the equipment during the entire lease period provided he pays the rentals and complies with the terms of the lease.

8. As the equipment is chosen by the lessee, the responsibility of its suitability, the risk of obsolescence and the liability for repair, maintenance and insurance of the equipment rests with the lessee.

**Operating Lease**

According to IAS - 17, an operating lease is one which is not a finance lease. An operating lease is an agreement in which the lessee acquires the use of an asset on a period to period basis. In other words a lease agreement gives the lessee the right to use the leased property for a limited period of time. The lessor may lease the asset to different lessees one after another. In an operating lease, the lessor does not transfer all the risks and rewards incident to the ownership of
the asset and the cost of the asset is not fully amortized during the primary lease period. The lessor provides services (other than the financing of the purchase price) attached to the leased asset, such as maintenance, repair and technical device. For this reason, operating lease is also called service lease.

The lease rentals in an operating lease include the cost for the 'services' provided, and the lessor does not depend on a single lessee for recovery of his cost. The lease rental payable by one lessee during his lease period is not fully sufficient to cover fully the cost of the asset plus a reasonable return on that. Operating lease is generally used for computers, office equipments, automobiles, trucks, telephones and so on.

An operating lease is generally preferred in the following circumstances:

a) Where there is possibility of rapid obsolescence of the asset.

b) Where the lessee is interested in tiding over a temporary problem.

An operating lease is structured with following features:

1) An operating lease is generally for a period significantly shorter than the economic life of the leased asset. In some cases it may be even on hourly, daily, weekly or monthly basis. The lease is cancelable by either party during the lease period.

2) Since the lease periods are shorter than the expected life of the asset, the lease rentals are not sufficient to totally amortize the cost of the asset.
3) The lessor does not rely on the single lessee for recovery of his investment. He has the ultimate interest in the residual value of the asset. The lessor bears the risk of obsolescence, since the lessee is free to cancel the lease at any time.

4) Operating leases normally include the maintenance clause requiring the lessor to maintain the leased asset and provide services such as insurance, support staff, fuel and so on.

Sale and Leaseback:

Under a sale and leaseback arrangement, a firm sells an asset to another party, and this party leases it back to the firm. Usually the asset is sold at approximately its market value. The firm receives the sale price in cash and gets the right to use the asset during the basic lease period. The firm makes periodic rental payments to the lessor. As a result, the lessor realizes any residual value the asset might have at the end of the lease period, whereas before, this value would have been realized by the firm.

From the leasing company's point of view, a sale and lease back arrangement poses certain issues. First, it is difficult to establish a fair market for the asset may not exist; even if it exists, it may lack breadth. Second, as per the Indian Income Tax Act, the depreciation that can be claimed by the leasing company for tax purposes cannot exceed the depreciation that would have been claimed by the vendor had he continued to own the asset. So the price paid by the lessor is irrelevant for the purpose of calculating tax relevant depreciation.
The sale and lease back arrangement are popular with the companies which are facing short-term liquidity crisis. Lessor engaged in a sale and lease back arrangement includes insurance companies, other institutional investors, finance companies and independent leasing companies.

The sale and lease back agreement is essentially to help the lessee to mobilize the funds to tide over the liquidity position. In practice, it is a common type of lease agreement. The tax provision relating to sale and lease back are:

a) The lease rental payable by the lessee is allowed as deductible expense.

b) The asset is to be sold initially by the lessee to the lessor at the book value of the asset and not at the revalued figure.

c) Depreciation on the asset is available to the lessor on the basis of the book value of the asset, and

d) The rental income will be taxable in the hands of the lessor.
Direct Leasing:

Under direct leasing, a company acquires the use of an asset it did not own previously. A firm may lease an asset from the manufacturer. In other words, in a direct lease, the lessee and the owner are two different entities. This is the most straightforward type of finance lease. The lessor itself purchases the asset and hands it over to the lessee. A manufacturer can also act as a lessor and can deliver the assets to the lessee under the lease agreement. In other words, the lessee will normally specify the manufacturer, the model number and other relevant characteristics of the asset it wishes to lease and the lessor will procure for the lessee. A direct lease can be of two types:

i.) Bipartite lease

ii.) Tripartite lease

i.) Bipartite lease:-

In a bipartite lease, there are the equipment supplier-cum-lessee and the lessee. Such a type of lease is typically structured as an operating lease with inbuilt facilities, like upgradation of the equipment (upgrade lease), addition to the original equipment configuration and so on. The lessor maintains the asset and if necessary, replaces it with a similar equipment in working conditions (swap lease).

ii.) Tripartite lease:-

A tripartite lease on the other hand is a transaction involving three different parties - the equipment supplier, the lessor and the lessee. An innovative
variant of tripartite lease is the sales-aid lease under which the equipment supplier arranges for lease finance in various forms by:

a) Providing reference about the customer to the leasing company.

b) Negotiating the terms of the lease with the customer and completing all the formalities on behalf of the leasing company.

c) Writing the lease on his own account and discounting the lease receivables with the designated leasing company.

The effect is that the leasing company owns the equipment and obtains an assignment of the lease rental. The sales-aid lease is usually with recourse to the supplier in the event of default by the lessee either in the form of offer from the supplier to buy back the equipment from the lessor or a guarantee on behalf of the lessee.

**Single Investor Lease and Leveraged Lease**

1) **Single Investor Lease:**

In a single investor lease transaction, the leasing company (lessee) funds the entire investment by raising an appropriate mix of debt and equity. The important point to be noted is that the debt funds raised by the leasing company are without recourse to the lessee, that is, in the case of default in servicing the debt by the leasing company, the lender is not entitled to payment from the lessee.

2) **Leveraged Lease:**

Under this form of leasing, the transaction is among three parties - the lender, the lessor and the lessee. A special form of leasing sometimes is used in
financing assets requiring large capital outlays. It is known as leveraged leasing. In a leveraged lease transaction, the leasing company and a lender (called the loan participant) jointly fund the investment in the asset to be leased to the lessee.

From the standpoint of the lessee, there is no difference between a leveraged lease and any other type of lease. The lessee contracts to make periodic payments over the basic lease period and in return is entitled to the use of the asset over that period of time. The role of the lessor, however is changed. The lessor acquires the asset in keeping with the terms of the lease agreement and finances the acquisition in part by an equity investment of, say, 20 percent. The remaining 80 percent is provided by a long term lender or lenders. The loan is usually secured by a mortgage on the asset, as well as by the assignment of the lease and lease payments. The lessor is the borrower.

**Domestic Lease and International Lease**

**Domestic Lease:**

A lease transaction is classified as domestic if all parties to the agreement, namely, equipment supplier, lessor and lessee are domiciled in the same country.

**International Lease:**

If the parties to the lease transaction are domiciled in different countries, it is known as international lease. This type of lease is further classified into:

a) Import lease

b) Cross border lease
Import Lease:

A large proportion of requirements of capital goods of the Indian Industry for upgradation, modernization, for expansion of existing facilities used to be imported against foreign currency loans from term lending institutions or purchased with foreign exchange through a permit from the Reserve Bank of India till 1985. The essence of such purchases was that the user was legal owner and was entitled to the capital allowance on the asset.

Since 1985, funding of imported equipment through leases is permitted. The import policy allows approved leasing companies to offer this facility. The Industrial Credit and Investment Corporation of India (ICICI) had offered this facility for the first time in India and now major leases for imported equipments are from Industrial Credit and Investment Corporation of India (ICICI). Import lease is now possible for items under Open General License (O.G.L.) and for items imported against free foreign exchange licenses or permissions from Reserve Bank of India.

Cross Border Lease:

In a cross border lease, the lessor and the lessee reside in different countries. A cross border lease normally comes into existence to take advantage of the tax allowances of a country lessee may like to take the advantage of the low cost funding available in the lessor's country. The interest rate differential can be quite large between two currencies to the benefit of the lessor and substantial cost savings in lease rentals for the lessee.
The major advantage of cross border leasing to India is the saving in the foreign currency outgo. Cross border lease are quite common in other countries and not in India. The Government of India has also made a beginning by approving cross border lease.

Concept of a Leasing Company

Leasing companies have emerged as a new class of financial intermediaries (professional lessors) between original owners of the property and prospective users of it. The major function of these leasing companies is to provide financial service by making assets or equipments or other facilities available for utilization in business to their prospective customers (lessees) for stated period without requiring them to make a capital investment in the assets or equipments to be leased, but for rental payments in return. Sometimes, these leasing companies provide from their own resources the total amount required to purchase an asset being leased, whereas in some other cases, they may approach another outside financing agency for assistance. In order to create their own resources, these leasing companies issue equity and preference shares, debentures (convertible / non-convertible) and bonds (secured / non-secured) to the public. These companies also invite fixed deposits from the public for varying periods upto the maximum rate of interest permitted by the Reserve Bank of India. Bank loans are also permitted to these companies for their business under the Reserve Bank of India guidelines. In turn, these companies utilize their resources in buying or acquiring assets from manufacturers of capital goods for the
prospective users / entrepreneurs so that they may further increase their production and thus finally, assist in the capital formation and economic development of the country.

**Significance of Leasing Companies.**

Leasing is now an important source of medium term finance in many countries. Different projects illustrate the role of leasing in promoting new capital investment whether it is to provide essential tools for small business.

Leasing is profitable for all parties of lease transaction. The leasing mechanism allows the lessee to allocate scarce financial resources to new capital investments, as the lessor is concerned with projected cash flow during the period of equipment lease to be able to receive lease payments rather than with the volume of assets or the lessee's capital. The leasing mechanism channels investment into the capital assets which allows the enterprise to start production and generate sufficient income to cover lease payments. From the suppliers point of view, leasing helps to sell his product. This varying nature of a lease transaction leads to the importance and significance of leasing companies which may be summed up as follows:-
1. **Leasing increases the volume of capital investments:**

   To a certain degree the growth of the leasing sector can be accounted for by the fact that leasing has gradually become a substitute for other types of financing. But mostly it can be explained by the fact that leasing is an additional form of long term financing.

2. **Leasing functions as a sales aid:**

   In addition to supporting the sales campaigns of equipment suppliers, leasing encourages the domestic manufacture of machinery by introducing vendor leasing schemes.

3. **Leasing supports industrial modernization and small business:**

   Leasing companies play an important role in providing financing to small and medium enterprises, considering first and foremost the expected cash flow, rather than their credit worthiness.

4. **Leasing creates additional competition amongst sources of finance:**

   Leasing has lowered the cost and increased the supply of finance, particularly fixed rate finance for investment. In developing countries, leasing has frequently been able to fill a gap in the finance market place and has enabled firms to rely on overdraft facilities.
5. Leasing helps in the implementation of industrial and fiscal policies:

In addition to mobilizing liquid assets in building a company's capital, leasing has proved to be an important stabilizing factor at the time of economic recession, as leasing considerably increases the efficiency of privileged taxation on capital investment.

6. Leasing gives you more flexibility:

It helps keep costs down and assures you of the ability to stay at the cutting edge of technology. It increases your cash flow, while eliminating many risks of ownership. Equipment can be kept for any period of time and returned without the concerns of a depreciation table and recovery.

7. Leasing conserves capital:

Your capital is available to use on other essential needs. Leasing also keeps your credit lines accessible.

8. Leasing gives you tax advantages:

Operating leases offer off-balance-sheet financing because the equipment does not appear as an asset on your books. Depreciation schedules are no longer necessary; your company deducts the payments as standard business expense.
9. **Lease to overcome Monopolies and Restrictive Trade Practices (M.R.P.T.) Act provisions:**

Lease is beneficial to large houses also which come under the provisions of Monopolies and Restrictive Trade Practices Act on the basis of their owned assets. A company falling under the said Act, can increase its turnover without increasing its assets, as new assets can be acquired on lease.

10. **Lease for Export and Import concessions:**

The hundred percent export-oriented units (EOU) have been permitted to acquire machinery etc. either from a foreign country or from domestic manufacturers through a lease. The machinery is then to be re-exported in case of an import lease or disposed off after its period of utility, in case of a domestic lease.

**Objectives of the Study:**

Review of literature given above makes it quite clear that there is a vast scope for further study and inquiries in the companies and the finance facilities available to them. We intend to pursue the study with the following objectives:-

1. To study the structure and function of leasing companies.
2. To examine the investment pattern of selected leasing companies.
3. To study the effectiveness of financing system provided to the leasing companies.
4. To study the operational performance of selected leasing companies and the problems connected with them.

5. The role of financing companies in development of corporate groups.

6. To examine the financial structures of selected leasing companies with a view to identify the important sources from where the funds are raised.

7. To find out the major problems in leasing companies and to suggest and recommend certain measures for the development of leasing concerns and leasing business in India.

Research Methodology:

To study and analyze a problem it is desirable to lay out methodology and the research design. Methodology stands for the correct arrangement of thoughts either for the discovery or for exposure of truth. Prof. Northrop rightly observed that "there are many different scientific methods as there are different kinds of problems." Consequently we need to describe the methodology that we have employed in our research work.

The research methodology for the present study consisted of the following steps:

1. Coverage of the study;
2. Research design;
3. Methods of data collection.
Coverage of the study:

a) The study relates to public limited companies in the leasing industry on the basis of purposive random sampling which have completed at least 5 years of its operations upto 1996-2001.

b) The study restricts itself to companies with a capital of Rs. 1 crore or more and engaged in the business of import leasing also.

c) The study is confined to those companies which are doing leasing business regularly irrespective of other activities undertaken by them, such as hire purchases, factoring, bill-discounting etc. In fact, it has been observed that most of the leasing companies are engaged in multiple financing techniques.

d) Subsidiaries of holding companies specially established for lease financing by their parent companies are not covered under the study.

Research Design:

In the present study, an attempt has been made to present a survey of selected companies to understand the problems faced by them. The survey also aims to visualize the future prospects of the leasing industry in India. For the purpose of the study the researcher has adopted the method of purposive random sampling. The sample size is of 20 companies.
Methods of Data Collection:

For the purpose of the study primary and secondary data have been collected and critically examined. The study is primarily based on the secondary data. The following techniques have been used for collecting the primary data.

Observations:

After preliminary survey and personal contact with various employees, observations were made and recorded several times, keeping in view the different aspects of the actual working of leasing companies.

Interviews:

On the basis of un-structured interviews with the key executives of the leasing companies, some information was collected. Some other employees of the concerns were also interviewed to gather other required information.

The Questionnaire:

To collect certain other financial information needed for the study, a questionnaire was got filled up through which the required information has been collected. In the questionnaire all the relevant area of study has been covered.

Efforts have been made to collect only the requisite data related to the study. Further this questionnaire was also pre-tested to see whether the respondents would face any difficulty in understanding and answering the questions.
Secondary data has been collected from annual reports of the companies, stock exchange directory, magazines, journals, financial papers and other periodicals.

**Analysis and Interpretation of Data:**

On the basis of information collected from various sources, appropriate analysis and interpretation has been made. In the present study, the main source of information has been the annual reports of the companies and the questionnaire. This information has been analyzed with the help of different accounting ratios. The trend analysis has also been frequently utilized in the study.

The information obtained from various sources, was tabulated and the results have been presented in the form of tables and charts.

**Limitations of the Study:**

It will be realized that collection of research material is an uphill task. The proposed study regarding problems and prospects of leasing industry is important because of its significant role in the economic well being of the country. Some limitations under which the study has been conducted are as follows:

1. The inability to get published data from various leasing companies was a great setback.

2. Most leasing companies in India are not pure lease financing companies but have diversified business in other fields too. Except a few, all of them are carrying on the business of leasing with one or other business.
3. In most of our libraries the copies of old/new/Acts/Rules/Reports and other publications are not available.

4. Some companies were good enough to supply their balance sheets and leasing literature. However, many of them have chosen not to supply or even reply.

5. Inspite of an Equipment Leasing Association, only 15 to 20 percent of leasing companies are members of the Association while others are not even registered with it.

6. In the present study, 'Lease Rentals', its fixation and valuation of the lessors and lessees in this regard are not included. The fixation of lease rentals itself is a vast area suitable for an independent study.

7. It was also a difficult task to contact those occupying managerial positions and / or other knowledgeable persons associated with the working of the companies.

8. The main limitation of the study is that it could not include the analysis of the latest data due to the lack of audit of the company's results.