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Lease

Lease is a contractual arrangement under which the owner of an asset (lessor) allows the use of the asset to the user (lessee) for an agreed period of time (lease period) in consideration for the periodic payment (lease rent). At the end of the lease period, the asset reverts back to the owner, unless there is a provision for the renewal of the lease contract.

Essential Elements

Parties to the Contract

There are essentially two parties to a contract of lease financing, namely, the owner and the user, called the lessor and the lessee, respectively.

Lessor is the owner of the assets that are being leased.

Lessee is the receiver of the services of the assets under a lease contract.

Assets

The assets, property or equipment to be leased is the subject matter of a lease financing contract. The asset may be an automobile, plant and machinery, equipment, land and building, factory, a running business, an aircraft and so on. The asset must, however, be of the lessee's choice, suitable for his business needs.

Ownership Separated from User

The essence of a lease financing contract is that during the lease tenure, ownership of the asset vests with the lessor and its use is allowed to the lessee. On the expiry of the lease tenure, the asset reverts to the lessor.

Term of Lease

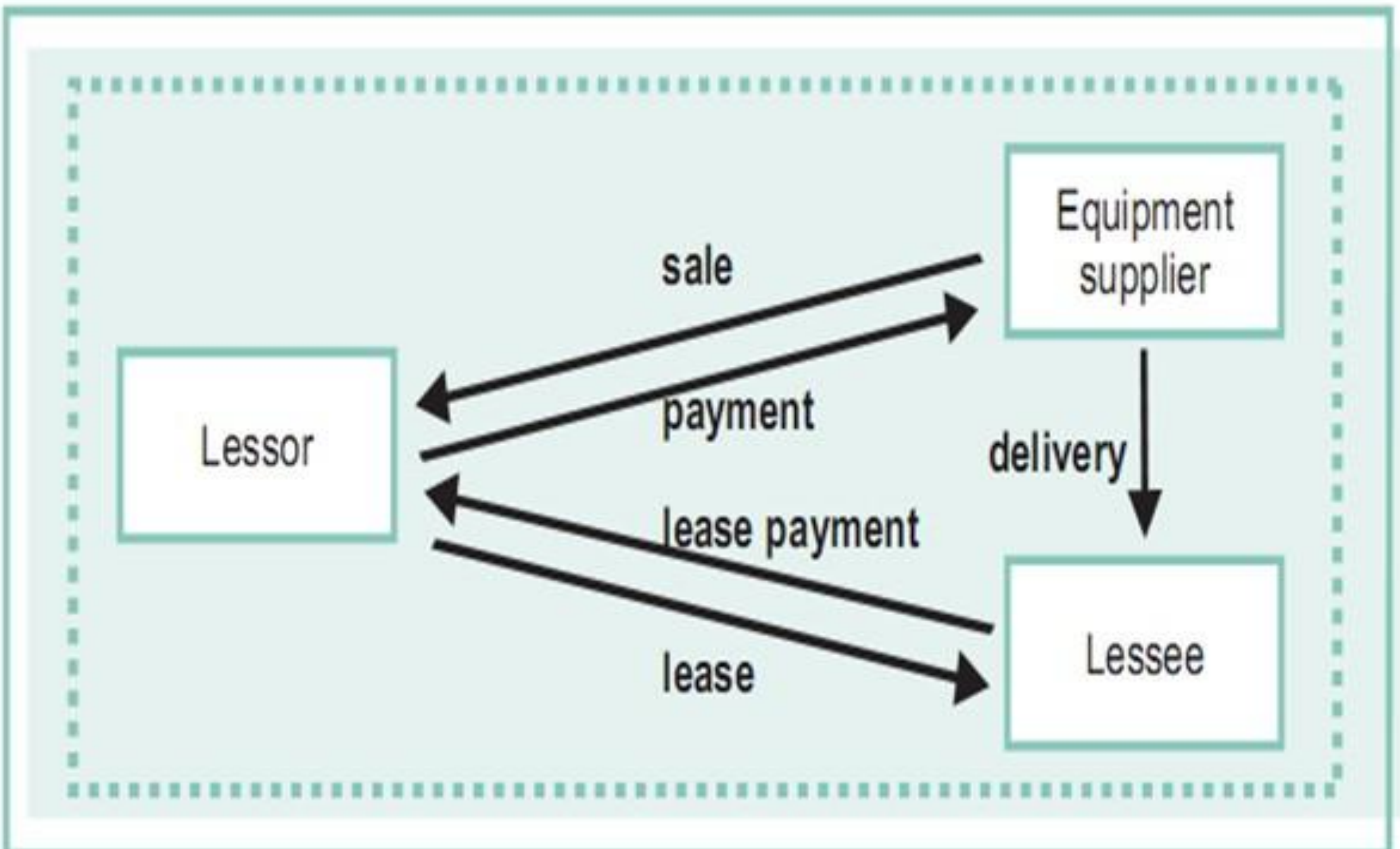
The term of lease is the period for which the agreement of lease remains in operation. Every lease should have a definite period, otherwise it will be legally inoperative. The lease period may sometimes stretch over the entire economic life of the asset (i.e. financial lease) or a period shorter than the useful life of the asset (i.e. operating lease). The lease may be perpetual, that is, with an option at the end of lease period to renew the lease for the further specific period.

Lease Rentals

The consideration that the lessee pays to the lessor for the lease transaction is the lease rental. Lease rentals are structured so as to compensate (in the form of depreciation) the lessor for the investment made in the asset, and for expenses like interest on the investment, repairs and servicing charges borne by the lessor over the lease period.


LEASE AGREEMENT
STATE OF
COUNTY OF
1. PARTIES:
2. PROPERTY:

The standard lease operation



1. The entrepreneur chooses the equipment and the equipment supplier.
2. The supplier provides a quotation.
3. The lessee submits an application to the lessor.
4. The lessor evaluates the application.
5. The lessor and lessee sign a lease contract.
6. The lessee pays the advance lease payment.
7. The lessor orders the equipment from the supplier.
8. The supplier delivers the equipment.

9. The lessor registers and insures the equipment.
10. The supplier provides after-sales services as per contract.
11. The lessee maintains the equipment (routine maintenance).
12. The lessor monitors the lease operation.
13. The lessee pays instalments as per contract.
14. At the end of the lease period, the lessee either returns the equipment or exercises the option of purchase.
15. If the option is purchase, the lessee pays the agreed final sum and the lessor transfers the ownership of the equipment to the lessee.

Leasing In India: Evolution Phases

Pre 1970	1970 - 1995	Post 1995
- Only HP companies - Automobile financing mainly for commercial vehicles	- Entry into equipment finance through: * Leasing * Hire Purchase - Commencement of car finance - Access to Capital Markets	- Exit of large no. of companies: * Small & Large * Indian & Foreign - Regulation by RBI - Few companies diversified into related financial services

Types of Leases

a)Operating Lease & Finance Lease
b)Single Investor & Leveraged
c)Sales and Leaseback and Direct Lease
d)Cross Border(Domestic and International)

Classification

An equipment lease transaction can differ on the basis of

1) the extent to which the risks and rewards of ownership are transferred,
2) number of parties to the transactions,
3) domiciles of the equipment manufacturer, the lessor, the lessee and so on.

Risk, with reference to leasing, refers to the possibility of loss arising on account of under-utilisation or technological obsolescence of the equipment, while reward means the incremental net cash flows that are generated from the usage of the equipment over its economic life and the realisation of the anticipated residual value on expiry of the economic life. On the basis of these variations, leasing can be classified into the following types:

a) Finance lease and Operating lease,
b) Sales and lease back and Direct lease,
c) Single investor lease and Leveraged lease and
d) Domestic lease and International lease.

(a) Finance Lease and Operating Lease

Finance Lease

According to the International Accounting Standards (IAS-17), in a finance lease the lessor transfers, substantially all the risks and rewards incidental to the ownership of the asset to the lessee, whether or not the title is eventually transferred. It involves payment of rentals over an obligatory non-cancellable lease period, sufficient in total to amortise the capital outlay of the lessor and leave some profit.

The IAS-17 stipulates that a substantial part of the ownership related risks and rewards in leasing are transferred when

1) The ownership of the equipment is transferred to the lessee by the end of the lease firm; or
2) The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair market value at the date the option becomes exercisable and if at the inception of the lease it is reasonably certain that the option will be exercised; or
3) The lease term is for a major part of the useful life of the asset; the title may not eventually be transferred. The useful life of an asset refers to the minimum of its (i) *physical* life in terms of the period for which it can perform its function, (ii) *technological life* in the sense of the period in which it does not become obsolete and (iii) *product market life* defined as the period during which its product enjoys a satisfactory market. The criterion/cut-off point is that if the lease term exceeds 75 per cent of the useful life of the equipment, it is a finance lease or
4) The present value of the minimum lease payment is greater than, or substantially equal to, the fair market value of the asset at the inception of the lease (cost of equipment). The title may or may not be eventually transferred. The cut-off point is that the present value exceeds 90 per cent of the fair market value of the equipment. The present value should be computed by using a discount rate equal to the rate implicit in the lease, in the case of the lessor, and the incremental rate in the case of the lessee.

According to the Accounting Standard (AS)-19:

Risks include the possibility of losses from the idle capacity or technological obsolescence and of variation in return due to changing economic conditions. Rewards may be represented by the expectation of profitable operation over the economic life of the asset and of gain from appreciation in the value of the residual value that has been realised.

A lease is classified as a *finance lease* if it transfers substantially all the risk and rewards incidental to ownership. Title may or may not eventually be transferred.

A finance lease is structured to include the following features:

1) The lessee (the intending buyer) 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 and so on;
3) The lessor purchases the equipment either directly from the manufacturer or distributor (under straight foward 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 practice 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-cancellable period called the primary lease period during which the lessor seeks to recover his investment alongwith some profit. During this 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 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 rest with the lessee.

Operating Lease

According to the IAS-17 and AS-19, an operating lease is one that is not a finance lease. In a operating lease, the lessor does not transfer all the risks and rewards incidental to the ownership of the asset and the cost of the asset is not fully amortised 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 advice. For this reason, an operating lease is also called a 'service lease'.

An operating lease is structured with the 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 an hourly, daily, weekly or monthly basis. The lease is cancellable 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 amortise the cost of assets.
3) The lessor does not rely on the single lessee for recovery of his investment. His ultimate interest is 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 a maintenance clause requiring the lessor to maintain the leased asset and provide services such as insurance, support staff, fuel and so on.

Examples of operating leases are:

a) Providing mobile cranes with operators;
b) Chartering of aircrafts and ships, including the provision of crew, fuel and support services;
c) Hiring of computers with operators;
d) Hiring a taxi for a particular travel, which includes service of the driver, provision for main-tenance, fuel, immediate repairs and so on.

Classification of Leases

Are  rewards and  risks transferred to lessee?

YES → **Finance Lease**

NO → **Operating Lease**

Situations:

- Ownership transferred
- Option to purchase the asset at price < fair value
- Lease term => major part of economic life of asset

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Summary of IAS 17 Leases

	Operating Lease	Financial Lease
Ownership	With the lessor	Transfer option at the end of the lease period is there with the lessee.
Risks and rewards related to asset	With the lessor	With the lessee
Purchase Option	Does not have any option	The lessee have a purchase option
Expenses Borne	By lessor	By lessee
Running Cost to lessee	No running or administration costs	Running cost and administration expenses are higher
Tax Benefit to lessee	No depreciation can be claimed	Interest and depreciation both claimed

(b) Sale and Lease Back

Sale–Lease Back

Sale-lease back is a lease under which the lessee sells an asset for cash to a prospective lessor and then leases back the same asset, making fixed periodic payments for its use.

Direct Lease

Direct Lease

Direct lease is a lease under which a lessor owns/acquires the assets that are leassed to a given lessee. A direct lease can be of two types: bipartite and tripartite lease.

Bipartite Lease

There are two parties in this lease transaction, namely,

1) the equipment supplier-cum-lessor and
2) the lessee. Such a 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.

Tripartite Lease

Such a lease involves three different parties in the lease agreement:

1) the equipment supplier,
2) the lessor and
3) the lessee. An innovative variant of the tripartite lease is the sales-aid lease under which the equipment supplier arranges for lease finance in various forms by:

- Providing reference about the customer to the leasing company;
- Negotiating the terms of the lease with the customer and completing all the formalities on behalf of the leasing company;
- 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.

(c) Single Investor Lease and Leveraged Lease

Single Investor Lease

There are only two parties to this lease transaction: the lessor and the lessee. The leasing company (lessor) funds the entire investment by an appropriate mix of debt and equity funds. The debt raised by the leasing company to finance the asset 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.

Leveraged Lease

There are three parties to the transaction: (i) the lessor (equity investor), (ii) the lender and (iii) the lessee. In such a lease, the leasing company (equity investor) buys the asset through substantial borrowing, with full recourse to the lessee and any recourse to it. The lender (loan participant) obtains an assignment of the lease and the rentals to be paid by the lessee as well as first mortgage assets on the leased asset. The transaction is routed through a trustee who looks after the interests of the lender and lessor. On receipt of the rentals from the lessee, the trustee remits the debt-service component of the rental to the loan participant and the balance to the lessor.

(d) Domestic Lease and International Lease

Domestic Lease
Domestic lease is a lease transaction if all parties to the agreement are domiciled in the same country.
International Lease
International lease is a lease transaction if all parties to the agreement are domiciled in different countries. This type of lease is further sub-classified into (1) the import lease and (2) the cross-border lease.
Import Lease
In an import lease, the lessor and the lessee are domiciled in the same country but the equipment supplier is located in a different country. The lessor imports the asset and leases it to the lessee
Cross-Border Lease
When the lessor and the lessee are domiciled in different countries, the lease is classified as cross-border lease. The domicile of the supplier is immaterial.

ADVANTAGES OF LEASING TO LESSEE

Significance

Advantage of Leasing: To the Lessee

Financing of Capital Goods

Lease financing enables the lessee to avail of finance for huge investments in land, building, plant, machinery, heavy equipment, and so on, upto 100 per cent, without requiring any immediate down payment.

Additional Sources of Finance

Leasing facilitates the acquisition of equipment, plant and machinery without the necessary capital outlay and, thus, has a competitive advantage of mobilising the scarce financial resources of a business enterprise. It enhances the working capital position and makes available the internal accruals for business operations.

Less Costly

Leasing as a method of financing is less costly than other alternatives available.

Ownership Preserved

Leasing provides finance without diluting the ownership or control of the promoters.

Simplicity

A lease finance arrangement is simple to negotiate and free from cumbersome procedures with faster and simple documentation

Tax Benefits

By suitable structuring of lease rentals, a lot of tax advantage can be derived

Obsolescence Risk is Averted

In a lease arrangement, the lessor, being the owner, bears the risk of obsolescence and the lessee is always free to replace the asset with the latest technology.

ADVANTAGES OF LEASING TO LESSOR

To the Lessor

Full Security The lessor's interest is fully secured since he is always the owner of the leased asset and can take repossession of the asset if the lessee defaults.

Tax Benefit The greatest advantage of the lessor is the tax relief by way of depreciation.

High Profitability The leasing business is highly profitable since the rate of return is more than what the lessor pays on his borrowings.

Trading on Equity The lessor usually carrys out his operations with greater financial leverage. That is, he has a very low equity capital and use a substantial amount of borrowed funds and deposits. Thus, the ultimate return on equity is very high.

High Growth Potential The leasing industry has a high growth potential. Lease financing enables the lessees to acquire equipment and machinery even during a period of depression, since they do not have to invest any capital. Leasing, thus, maintains the economic growth even during a recessionary period.

INDIAN SCENARIO

- In India, the concept was pioneered in 1973 when the First Leasing Company was set up in Madras and the eighties have seen a rapid growth of this business.
- Indian leasing sector is witnessing a transition from being a nascent market to an evolving market, marked by emergence a strong market for operating leases.
- Information Technology equipment, vehicles and construction equipment are the primary segments where leasing has shown significant growth.
- Other sectors where leasing is prevalent and/or is expected to gain momentum are aircrafts, containers, railway wagons, office equipment, temporary power, renewable power and medical equipment.
- Indian leasing has reached 4%-5% of global leasing volume. Roughly, annual leasing volume in India is estimated about USD 3.67 billion. Most prevalent type of lease in India is Operating lease and it is followed by financial lease.
- Top three lease providers in India are Indian Railways Finance Corporation, Hewlett- Packard Financial Services Pvt. Ltd., IBM India Private Ltd.