UNIT-2 Leasing concept - types, Advantages, Limitations

Meaning-

Leasing means an agreement between the leasing company (called lessor) and the user (called lessee), under which the former undertakes to buy the capital equipment for use by the latter. The lessor remains owner of the asset during the specified period and the owner is assured consistent payment over the agreed period. The lessee has to pay rentals to the lessor. Both the lessee and the lessor face consequences if they fail to uphold the terms of the contract. A lease is a form of incorporeal right.

Historical Background-

Leasing was introduced in the United States of America during 1940s and 1950s. It is estimated that leasing industry in the USA finances about 25 per cent of capital goods acquisition. The concept of leasing was pioneered in India by the SPIC group which established "First Leasing Company of India Limited" in 1973 at Chennai.

Later on 20th Century Leasing Company Limited was set up in Mumbai. Now, IFCI, IDBI, ICICI, State Bank of India, SIDCs, Sundaram Finance and other entities are running leasing companies in our country.

Types of Leasing

The three main types of leasing are finance leasing, operating leasing and contract hire.

1. Finance leasing

- A **long-term lease** over the expected life of the equipment, usually **three years or more**, after which you pay a nominal rent or can sell or scrap the equipment - the leasing company will not want it any more.
- The leasing company **recovers the full cost** of the equipment, plus charges, over the period of the lease.
- Although you don't own the equipment, **you are responsible** for maintaining and insuring it.
- You must show the leased asset on your balance sheet as a **capital item**, or an item that has been bought by the company.

- Leases of over seven years, and in some cases over five years, are known as 'long funding leases' under which you can claim capital allowances as if you had bought the asset outright.

2. Operating leasing

If you are considering operating leasing, remember the following points:

- it is useful if you don't need the equipment for its entire working life
- the leasing company will take the asset back at the end of the lease
- the leasing company is responsible for maintenance and insurance
- you don't have to show the asset on your balance sheet

3. Sale and Lease Back:
It is an arrangement wherein the owner of the asset may sell it to the leasing company and lease it back. Such an arrangement is adopted when the firm faces shortage of funds. The firm can overcome liquidity problem and at the same time retain use of the asset.

4. Leveraged Lease:
Under this arrangement, the lessor borrows funds from the lender and provides a part of the money to acquire the asset. The lessor services the debt out of lease rentals. Thus, there is third party (lender) in addition to the lessor and the lessee. The lender is usually a financial institution or a commercial bank. Leverage lease is used in case of very large assets such as a ship or an aero plane.

Advantages:
Leasing offers the following advantages:
1. Liquidity:
The lessee can use the asset to earn without investing money in the asset. He can employ his funds for working capital needs.

2. Convenience:
Leasing is the easiest method of financing fixed assets. No mortgage or hypothecation is required. Restrictions involved in long-term borrowing from financial institutions are avoided. Formalities involved in leasing are much less than in case of borrowing from financial institutions.

3. Hidden Liability:

Lease obligations are not reported as a liability in the company's balance sheet. On the other hand, loans raised to buy assets are reported as liability. Thus, leasing helps the lessee to report a better debt-equity ratio.

4. Time Saving:
The asset is available for use immediately without loss of time in applying for the loan, wanting for approval and sanction, etc. Lease rentals can be matched with cash flows of the lessee.

5. No Risk of Obsolescence:
The risk of the asset becoming obsolete due to technological advancements is borne by the lessor.

6. Cost Saving:
Lease rentals are deductible from taxable income. The lessee has lower obligation in bankruptcy than under debt financing.

7. Flexibility:
Leasing arrangement is more flexible. The rental schedule can be adjusted to accommodate genuine needs and problems of the lessee.

Disadvantages:
1. The lessee gets only the right to use the asset. In case the leasing company is wound up the asset may be taken back from the lessee thereby disrupting his operations.

2. The lessee cannot make alterations or improvements in the asset without the prior approval of the lessor. The lessor may also put some restrictions on the lessee.

3. The lessee has to pay lease rentals on a regular basis to the lessor.