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Leasing: A Literature Review

Abstract

The purpose of this paper is to review the determinants of leasing. The paper reviews previous literature that has focused on the types of companies operating under the label of leasing, its growth, and taxation aspects, contrasted the costs and benefits of leasing rather than owning real estate assets. It has also discussed in that leasing can increase the probability that a company will own and be responsible for managing its products at the end of life and internalize the costs of doing so.

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Introduction

Leasing is the important source of finance. It is the source of financing capital equipment. The leasing is popular in India. Land leasing is the traditional system which exists in our country since old times. It has been emerged in India since 1970. The first leasing organisation was "First Leasing Company of India Ltd.", established in Chennai. A number of other leasing companies have also come into existence such as Mazda Leasing, 20th Century Leasing Company, Express Leasing Company etc. A large number of public sector undertakings like ONGC, SAIL, HMT, BHEL, Air India, ISRO etc considers the leasing as a measure of financing their ongoing projects . In recent years there has been a growing emphasis on creating new sources of long term finance for funding leases. There are two source viz. Lease Portfolio Securitisation and Variable Rate Bonds.

Lease financing organisations in India include many private sector non-bank financial companies, some private sector manufacturing companies, Infrastructure Leasing and Financial Services Ltd., ICICI, Industrial Reconstruction Bank of India (IRBI), IFC, LIC, GIC, Housing Development Finance corporation (HDFC), certain SIDC's and State Industrial Investment Corporations (SIICs) and other organisations. The lessee companies include many leading corporations in public and private sectors.

Aim of the Study

In the multi-tier financial system of India, importance of leasing by NBFCs in the Indian financial system is much discussed by various committees appointed by RBI in the past and RBI has been modifying its regulatory and supervising policies from time to time to keep pace with the changes in the system. An overview of various issues related to the study directly or indirectly has been presented through review of literature. The important studies done in India and abroad bearing direct or indirect effect on the present study have been reviewed and presented hereunder.

Literature Review

Goswami (1983) has analyzed that inflation, heavy taxation and uneconomic operations leave many companies with major internal resources and they find it extremely difficult to finance the high cost of capital equipment required for modernization or replacement. Mobilisation of funds from the market becomes costly and time consuming process. Money available from term lending institutions and banks is often cost effective but sources are limited, the procedure is time consuming and the strings are attached to loans for conversion of the loan into equity treating managements 'control over the company. He opines that leasing can provide suitable answer to all these.

Granof (1984) has discussed that a tax exempt lease is an arrangement similar in economic substance to an installment purchase. The lessor extends credit to a municipality in exchange for the right to use an asset for a period of time, during or at the end of which the lessee has the option to purchase the property less than its market value. Each payment of rent is allocated between principal and interest. The interest is tax exempt to the lessor, as if it were interest on a conventional instrument of debt. For tax purposes the lessee is regarded as the owner of the property. The lessor is not eligible for the tax benefits, such as accelerated depreciation and the investment tax credit. The paper evaluates, and attempts to put into perspective, each of the main advantages that have been ascribed to leasing. Leasing enables a municipality to obtain funds at low interest rates by tying finance costs for the purchase of property, to offset interest costs with arbitrage earnings, to circumvent debt limitations, to avoid bond referenda, and to reduce debt issue costs.

Balasubramanian (1985) has found that there are three types of companies operating under the label of leasing. The first type of companies includes those companies which have been doing standard leasing operations for a long time; others are captive units promoted by a group of companies for the purpose of acting as buying and selling agency for group of companies, earning profits in the process of doing so and lastly, the third type of companies which have been floated not just for the purpose of leasing but for other purposes mostly for diversification of funds. Author has examined the leasing companies from the point of view of investors and entrepreneurs who avail the facilities of leasing companies. He has emphasised that where the leasing has not yet picked up, companies should enter into agreement with manufacturers by which they (manufacturers) could get definite instalment payment facilities and also could arrange a number of clients who avail the facility offered by the leasing companies. He has found that companies in the market have not indicated about any tie up either with the manufacturers or with clients. The author has also suggested accounting treatment of various transactions in the books of lessor and lessee.

Murthy (1995) has discussed the various aspects of leasing. The Author has highlighted that leasing, in its present form, started in 1973 with setting up of the First Leasing Company of India Ltd. in the country. A leasing industry entered its next phase of growth in 1982, when many financial institutions and commercial banks started their own leasing business. It was a milestone in Indian leasing industry when International Finance Corporation announced its decision to open four leasing industry includes independent leasing companies, finance and investment companies, leasing subsidiaries of manufacturing companies, group companies, financial institutions and subsidiaries of commercial banks. He has found that leasing industry is facing some problems like shortages of finances, sales tax problems, inadequate tax advantages, lack of proper accountability, legislation for leasing etc. However, the future prospect for leasing industry lies in overcoming the existing problems and finding out new areas in which leasing can easily be fit in.

Benjamin, Torre & Musumeci (1996) in their paper discussed that retail owner/managers are aware that tenants have an incentive to maximize their own wealth by under maintenance or overuse of leased property so as to increase their short-term income at the expense of the property’s long-term value. The paper analyzes many of the currently available methods for controlling unwanted retail tenant behavior. First, a rigorous understanding of retail leasing that examines the effects of tenant under maintenance and overuse is developed. Then this framework is used to evaluate the efficiency of various lease arrangements and provisions used to restrict unwanted tenant behavior. Using numerical examples, the paper demonstrates that variable lease payments that peg lease rates to the level of asset abuse (such as security deposits and penalty clauses) work better at controlling unwanted tenant actions than fixed-lease payments (such as maintenance contracts and higher lease payments).

Fishbein, McGarry, Dillon (2000) has discussed in their report that leasing can increase the probability that a company will own and be responsible for managing its products at the end of life and internalize the costs of doing so. This, in turn, provides incentives for it to focus on end-of-life issues by making products less wasteful and easier to reuse, remanufacture, and recycle. And it creates incentives to redesign products to enhance recovery of their residual value. It was ownership of large quantities of used products (in large part due to leasing) that led the Xerox to develop an economically and environmentally successful asset recovery program linked to product design.

Lasfer Meziane (2005) has contrasted the costs and benefits of leasing, rather than owning real estate assets. Consistent with the financing and agency costs hypotheses, he finds that large and high growth companies are likely to lease than to own real estate. The results also indicate that leasing companies are more efficient in using their real estate and that these benefits are compounded in share price valuation. The results indicate a strong and positive relationship between the leasing propensity and various measures of firm value, such as market-to-book, buy and hold stock returns. However, it is found that the relationship between value and leasing propensity is an inverse U-shaped optimized at about 65% leasing, suggesting that the market is also considering the costs of not owning real estate.

Altamuro M. Lynne Jenifer (2006) has discussed that the synthetic lease is a hybrid financing structure that allows a company to obtain many of the benefits of asset ownership, including capital lease treatment for tax purposes, while treating lease payments as operating expenses on the firm's income statement. Proponents of these off balance sheet transactions argue that the economic benefits to the firm and its shareholders outweigh the costs of complexity and opacity, while critics argue that the benefits of these transactions are the result of short-sighted opportunistic behavior by managers that lead to wealth extraction at the expense of other groups of stakeholders. The researcher jointly examines (1) whether the structure of the synthetic lease provides favorable financing terms for firms that choose this type of transaction, and (2) the economic and financial accounting incentives that influence the manager's financing choice. He finds evidence that supports both economic benefits associated with the lease, as well as managers using synthetic lease financing for opportunistic gains. Tests examining the role of the board of directors in the financing decision help to reconcile these two findings, as strong boards serve as a substitute for the opacity of the transaction, and prevent managers from opportunistic behavior. He also finds that synthetic lease users has lower costs associated with future bank debt, and these savings do not appear to be the result of withholding information about the synthetic lease from lenders.

Analysis and Findings

The above studies revealed that while leasing an asset, it becomes possible for a business to invest in good quality assets which might look unaffordable or expensive otherwise. Leasing expenses are also considered as operating expenses, and hence, of interest, are tax deductible .Leasing can increase the probability that a company will own and be responsible for managing its products at the end of life and internalize the costs of doing so. Leasing is a good option for a newly established business as it has lower initial cost and capital requirements. Lease financing is a well-recognized mechanism for reducing the agency costs of debt. Leases are usually easier to obtain and have more flexible terms than loans for buying equipment. This can be a significant advantage if one have bad credit or need to negotiate a longer payment plan to lower their costs.

Conclusion

From the above studies it comes to know that till 1980s the leasing companies are at boom but after that due to the absence of any standard guidelines, companies, adopted their own accounting practice due to which there is a downfall in the lease industry. In 1995, NBFCs came up with accounting standards. Cost is a major factor in sourcing assets and often businesses will feel that they only have two options: either spend a fortune to buy it or go without. However, there are many alternatives that may be far more beneficial to the company's wallet, one of which is leasing. As well as potentially saving money, availing tax benefits there are more benefits with leasing that one can't get while buying an asset. Leasing is an important source of funding for medium and small scale industries, which are key drivers of economic development in developing countries. There is substantial scope for future growth in the industry, particularly in developing countries. However, the industry faces financial and regulatory challenges which must be addressed to promote its growth. Despite of this there occur variations in the financial and operational performance of the lease financing companies. It is therefore imperative to assess the financial and operational performance of lease financing NBFCs in view of the current scenario.

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