LESSON-15
LEASE FINANCING, HIRE - PURCHASE AND FACTORING

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STRUCTURE

15.0 INTRODUCTION

In order to start and sustain a business one needs finance. In the unit one on feasibility study, you have already seen the process of estimating financial requirements. The process involved (a) making a list of all the assets (b) identifying the sources of supply (c) estimating the cost of acquisition when the assets are to be acquired on outright basis. Then investment requirements as well as entrepreneur's fear will increase. To scare away the entrepreneur's fear, the emphasis should be given to resources and not to the ownership. In this unit we intend to familiarize you with some important financial innovations i.e., leasing, hire purchase and factoring.

15.1 OBJECTIVES

After going through this unit you should be able to
- Describe the meaning of leasing
- Explain the role and importance of lease financing in economic development of a country
- Distinguish between the various types of leases
- Describe the meaning of hire purchase
- Distinguish between leasing and hire purchase
- Describe the meaning of factoring

15.2 CONCEPT 0F LEASE FINANCING

Lease financing denotes procurement of assets through lease. The subject of leasing falls in the category of finance. Leasing has grown as a big industry in the USA and UK and spread to other countries during the present century. 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. Lease as a concept involves a contract whereby the ownership, financing and risk taking of any equipment or asset are separated and shared by two or more parties. Thus, the lessor may finance and lessee may accept the risk through the use of it while a third party may own it. Alternatively the lessor may finance and own it while the lessee enjoys the use of it and bears the risk. There are various combinations in which the above characteristics are shared by the lessor and lessee.

15.3 MEANING 0F LEASE FINANCING

A lease transaction is a commercial arrangement whereby an equipment owner or Manufacturer conveys to the equipment user the right to use the equipment in return for a rental. In other words, lease is a contract between the owner of an asset (the lessor) and its user (the lessee) for the right to use the asset during a specified period in return for a mutually agreed periodic payment (the lease rentals). The important feature of a lease contract is separation of the ownership of the asset from its usage.
Lease financing is based on the observation made by Donald B. Grant:
“Why own a cow when the milk is so cheap? All you really need is milk and not the cow.”

15.4 IMPORTANCE 0F LEASE FINANCING

Leasing industry plays an important role in the economic development of a country by providing money incentives to lessee. The lessee does not have to pay the cost of asset at the time of signing the contract of leases. Leasing contracts are more flexible so lessees can structure the leasing contracts according to their needs for finance. The lessee can also pass on the risk of obsolescence to the lessor by acquiring those appliances, which have high technological obsolescence. To day, most of us are familiar with leases of houses, apartments, offices, etc.

15.5 TYPES OF LEASE AGREEMENTS

Lease agreements are basically of two types. They are (a) Financial lease and (b) Operating lease. The other variations in lease agreements are (c) Sale and lease back (d) Leveraged leasing and (e) Direct leasing.

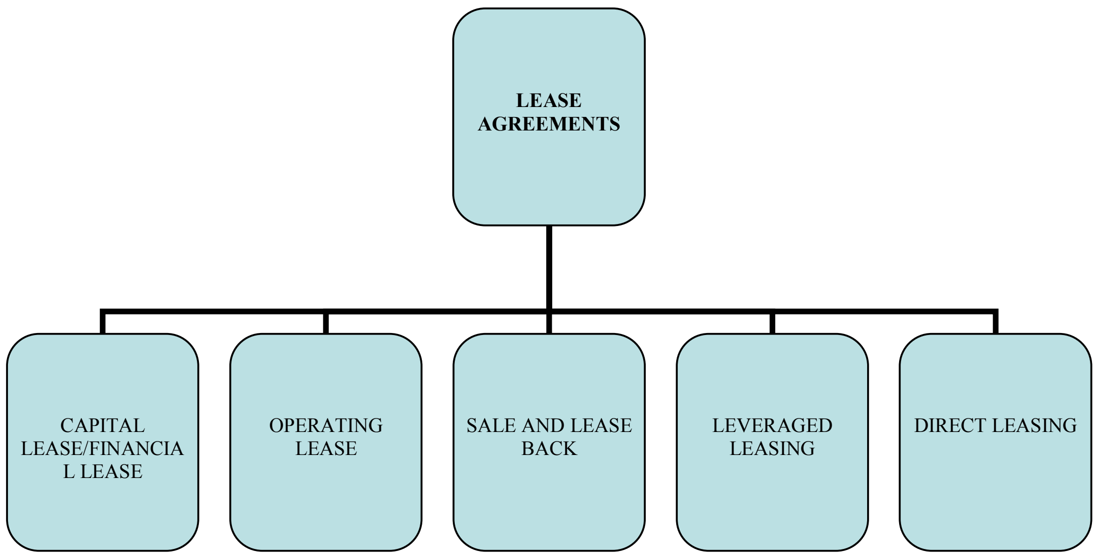


Figure 15.1: Types of leases

15.5.1 FINANCIAL LEASE

Long-term, non-cancellable lease contracts are known as financial leases. The essential point of financial lease agreement is that it contains a condition whereby the lessor agrees to transfer the title for the asset at the end of the lease period at a nominal cost. At lease it must give an option to the lessee to purchase the asset he has used at the expiry of the lease. Under this lease the lessor recovers 90% of the fair value of the asset as lease rentals and the lease period is 75% of the economic life of the asset. The lease agreement is irrevocable. Practically all the risks incidental to the asset ownership and all the benefits arising there from are transferred to the lessee who bears the cost of maintenance, insurance and repairs. Only title deeds remain with the lessor. Financial lease is also known as 'capital lease'. In India, financial leases are very popular with high-cost and high technology equipment.

15.5.2 OPERATING LEASE

An operating lease stands in contrast to the financial lease in almost all aspects. This lease agreement gives to the lessee only a limited right to use the asset. The lessor is responsible for the upkeep and maintenance of the asset. The lessee is not given any uplift to purchase the asset at the end of the lease period. Normally the lease is for a short period and even otherwise is revocable at a short notice. Mines, Computers hardware, trucks and automobiles are found suitable for operating lease because the rate of obsolescence is very high in this kind of assets.

Key Words
Explain the meaning of 'long term,' 'nominal cost,' and economic life

Activity A
On the basis of above description of financial lease and operating lease, find out three main differences between two.

15.5.3 SALE AND LEASE BACK

It is a sub-part of finance lease. Under this, the owner of an asset sells the asset to a party (the buyer), who in turn leases back the same asset to the owner in consideration of lease rentals. However, under this arrangement, the assets are not physically exchanged but it all happens in records only. This is nothing but a paper transaction. Sale and lease back transaction is suitable for those assets, which are not subjected depreciation but appreciation, say land. The advantage of this method is that the lessee can satisfy himself completely regarding the quality of the asset and after possession of the asset convert the sale into a lease arrangement. The sale and lease back transaction can be expressed with the help of the following figure.

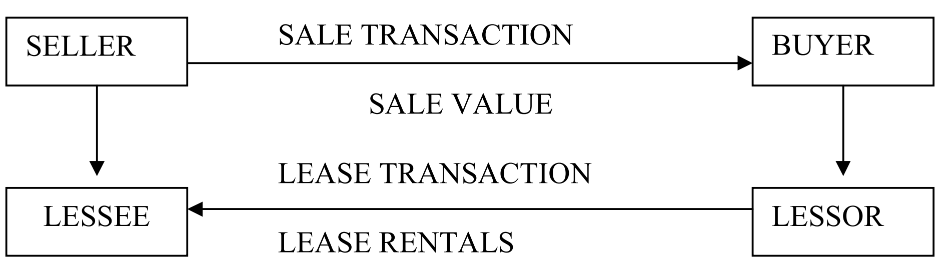


Figure 15.2: Structure of a Sale and Leaseback Deal

Under this transaction, the seller assumes the role of a lessee and the buyer assumes the role of a lessor. The seller gets the agreed selling price and the buyer gets the lease rentals. It is possible to structure the sale at agreed value (below or above the fair market price) and to adjust difference in the lease rentals. Thus the effect of profit /loss on sale of assets can be deferred.

15.5.4 LEVERAGED LEASING

Under leveraged leasing arrangement, a third party is involved beside lessor and lessee. The lessor borrows a part of the purchase cost (say 80%) of the asset from the third party i.e., lender and the asset so purchased is held as security against the loan. The lender is paid off from the lease rentals directly by the lessee and the surplus after meeting the claims of the lender goes to the lessor. The lessor, the owner of the asset is entitled to depreciation allowance associated with the asset.

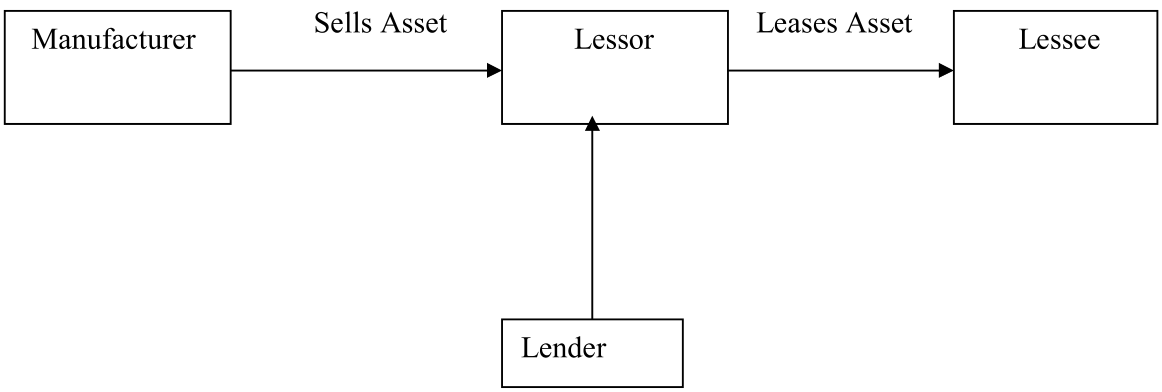


Figure 15. 3: Leveraged Lease

Activity B

Distinguish between sale and lease back lease and leveraged lease. As a lessee, which one will you prefer and why?

15.5.5 DIRECT LEASING

Under direct leasing, a firm acquires the right to use an asset from the manufacturer directly. The ownership of the asset leased out remains with the manufacturer itself. The major types of direct lessor include manufacturers, finance companies, independent lease companies, special purpose leasing companies etc

15.6 ADVANTAGES OF LEASING

There are several extolled advantages of acquiring capital assets on lease:

(1) SAVING OF CAPITAL: Leasing covers the full cost of the equipment used in the business by providing 100% finance. The lessee is not to provide or pay any margin

money as there is no down payment. In this way the saving in capital or financial resources can be used for other productive purposes e.g. purchase of inventories.

(2) FLEXIBILITY AND CONVENIENCE: The lease agreement can be tailor- made in respect of lease period and lease rentals according to the convenience and requirements of all lessees.

(3) PLANNING CASH FLOWS: Leasing enables the lessee to plan its cash flows properly. The rentals can be paid out of the cash coming into the business from the use of the same assets.

(4) IMPROVEMENT IN LIQUADITY: Leasing enables the lessee to improve their liquidity position by adopting the sale and lease back technique.

15.7 LEASING IN INDIA

Leasing has grown by leaps and bounds in the eighties but it is estimated that hardly 1% of the industrial investment in India is covered by the lease finance, as against 40% in USA and 30% in UK and 10% in Japan. The prospects of leasing in India are good due to growing investment needs and scarcity of funds with public financial institutions. This type of lease finances is particularly suitable in India where a large number of small companies have emerged more recently. Leasing in the sphere of land and building has been in existence in India for a long time, while equipment leasing has become very common in the recent times.

Activity C
Find out in your locality some companies that under take lease financing of machinery.

15.8 CONCEPT AND MEANING OF HIRE PURCHASE

Hire purchase is a type of instalment credit under which the hire purchaser, called the hirer, agrees to take the goods on hire at a stated rental, which is inclusive of the repayment of principal as well as interest, with an option to purchase. Under this transaction, the hire purchaser acquires the property (goods) immediately on signing the hire purchase agreement but the ownership or title of the same is transferred only when the last instalment is paid. The hire purchase system is regulated by the Hire Purchase Act 1972. This Act defines a hire purchase as “an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement and includes an agreement under which:

1) The owner delivers possession of goods thereof to a person on condition that such person pays the agreed amount in periodic instalments.

2) The property in the goods is to pass to such person on the payment of the last of such instalments, and
3) Such person has a right to terminate the agreement at any time before the property so passes".

Hire purchase should be distinguished from instalment sale wherein property passes to the purchaser with the payment of the first instalment. But in case of HP (ownership remains with the seller until the last instalment is paid) buyer gets ownership after paying the last instalment. HP also differs form leasing.

15.9 DIFFERENCE BETWEEN LEASE FINANCING AND HIRE PURCHASE

BASIS	LEASE FINANCING	HIRE PURCHASE
Meaning	A lease transaction is a commercial arrangement, whereby an equipment owner or manufacturer conveys to the equipment user the right to use the equipment in return for a rental.	Hire purchase is a type of instalment credit under which the hire purchaser agrees to take the goods on hire at a stated rental, which is inclusive of the repayment of principal as well as interest, with an option to purchase.
Option to user	No option is provided to the lessee (user) to purchase the goods.	Option is provided to the hirer (user).
Nature of expenditure	Lease rentals paid by the lessee are entirely revenue expenditure of the lessee.	Only interest element included in the HP instalments is revenue expenditure by nature.
Components	Lease rentals comprise of 2 elements (1) finance charge and (2) capital recovery.	HP instalments comprise of 3 elements (1) normal trading profit (2) finance charge and (3) recovery of cost of goods/assets.

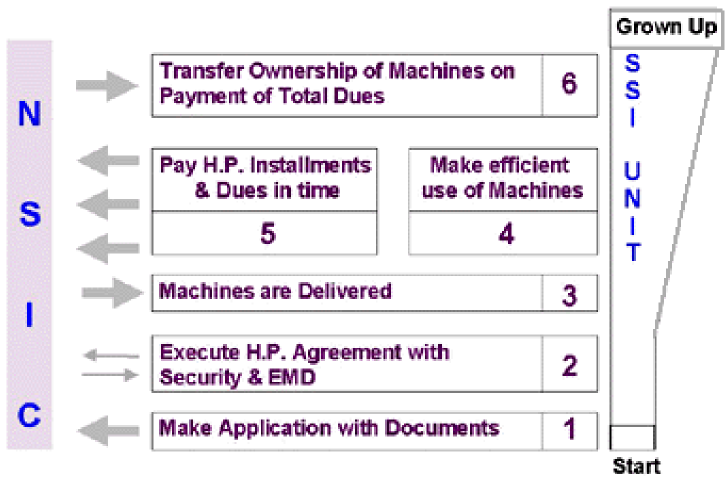
15.10 NSIC AND HIRE PURCHASE

Small scale firms can acquire industrial machinery, office equipment, vehicles, etc., without making full payment through hire purchase. With the help of assets acquired through hire purchase they can produce and sell. From the earning payments can easily be made in instalments. Ultimately the ownership of assets can be acquired. Now several agencies like National Small Industries Corporation (NSIC) provide machinery and equipment to small scale units on hire purchase basis and on lease basis. NSIC follows the following Hire Purchase procedure and Hire Purchase Scheme for financing plant and machinery to small scale units.

Hire Purchase

"Finance of Plant & Machinery to small scale industrial units/ enterprises on installment terms."

HIRE PURCHASE SCHEME - At a Glance



15.11 FACTORING

Factoring is another type of financial service provided by the specialist organizations. When small scale firms sell on credit basis, collection of receivable poses a problem. In that case factoring organizations play an important role in collection of debtors. Factoring involves sale of receivables to specialized firm, called factors. Factors collect receivables and also advance cash against receivables to solve the client firm's liquidity problem. For providing their services, they charge interest on advance and commission for other services. In other words, factoring is an arrangement under which a financial institution (called factor) undertakes the task of collecting the book debts of its client in return for a service charge in the form of discount or rebate. The factoring institution eliminates the client's risk of bad debts by taking over the responsibility of book debts due to the client. The factoring institution advances a proportion of the value of book debts of the client immediately and the balance on maturity of book debts.

15.11.1 FACTORING PROCEDURE

The agreement between the supplier and the factor specifies the factoring procedure. Usually the firm sends the customer's order to the factor for evaluating the customer's creditworthiness and approval. Once the factor is satisfied about the customer's credit worthiness and agrees to buy receivables, the firm dispatches goods to the customer.

The customer will be informed that his account has been sold to the factor, and he is instructed to make payment directly to the factor. To perform his functions of credit evaluation and collection for a large number of clients, a factor may maintain a credit department with specialized staff. Once the factor has purchased a firm's receivables and if he agrees to own them, he will have to provide protection against any bad-debt losses to the firm.

15.11.2 MERITS

1. As a result of factoring services, the enterprise can concentrate on manufacturing and selling.
2. The risk of bad debts is eliminated.
3. The factoring institution also provides advice on business trends and other related matters.

In India, subsidiaries of four Indian banks-State Bank of India, Canara Bank, Punjab National Bank and Allahabad Bank are providing factoring services.

Activity D

Match the following

Nature of Asset	Type of Lease
Aircraft/ ship with crew	Operating lease
Construction equipment	Wet lease
Sugar mill	Finance lease

15.12 SUMMARY

A lease is an agreement for the use of the asset for a specified rental. The owner of the asset is called the lessor and the user the lessee. Two important categories of leases are: operating leases and financial leases. Operating leases are short team, cancellable leases where the risk of obsolescence is borne by the lessor. Financial leases are long-term, non-cancellable leases where any risk in the use of the asset is borne by the lessee and he enjoys the returns too. The other sub-parts of finance lease are: sale and lease back and leveraged financing. Under sale and lease back lease the owner of an asset sells the asset to a party, who in turn leases back the same asset to the owner in consideration of lease rentals. Under leveraged leasing a third party (i.e. financier or lender) is involved beside lessor and lessee. Direct lease another type of leases, which is popularly used. Under this, a firm acquires the right to use an asset from the manufacturer directly. Leasing plays an important role in the economic development of a country by providing money incentives to lessee. Lease financing has several advantages. In India, the First Leasing Company Ltd. was set up in Madras in 1973. As per the industrial investment, lease finance in India just like a newborn baby. Hire purchase and factoring are the other forms of financial services. Hire purchase is a type of instalment credit under which the hire purchaser agrees to take the goods on hire at a stated rental. The system of the hire purchase is regulated by the Hire Purchase Act 1972. Small scale firms suffer from the problem of dearth of funds. In this case hire purchase system plays an important role by providing equipment; vehicles etc. on hire purchase without making full payments. NSIC also provides machinery and equipment to Small Scale units on hire purchase basis and on lease basis. Factoring the other financial service under which a financial institution undertakes the task of collecting the book debts of it client.

15.13 GLOSSARY

Capital lease: It is a lease obligation that has to be capitalized on the balance sheet. It is characterized by: it is non-cancelable; the life of lease is less than the life of the asset(s) being leased; and, the lessor does not pay for the upkeep, maintenance, or servicing costs of the asset(s) during the lease period.

Sub-lease: A transaction in which leased property is released by the original lessee to a third party, and the lease agreement between the two original parties remains in effect.

Wet lease: A wet lease is any leasing arrangement whereby a company agrees to provide an aircraft and at least one pilot to another company. 'Dry lease' on the other hand, refers to leasing only the aircraft.

15.14 SELF ASSESSMENT QUESTIONS

1) **Explain** the term Leasing. State the various types of lease agreements.

2) **What** are the advantages of Leasing?

3) **What** is the hire purchase financing? How does it differ from the lease?

financing?

4) **Write** a short note on Factoring

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15.15 FURTHER READINGS

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