

Leasing of P&M

Topics

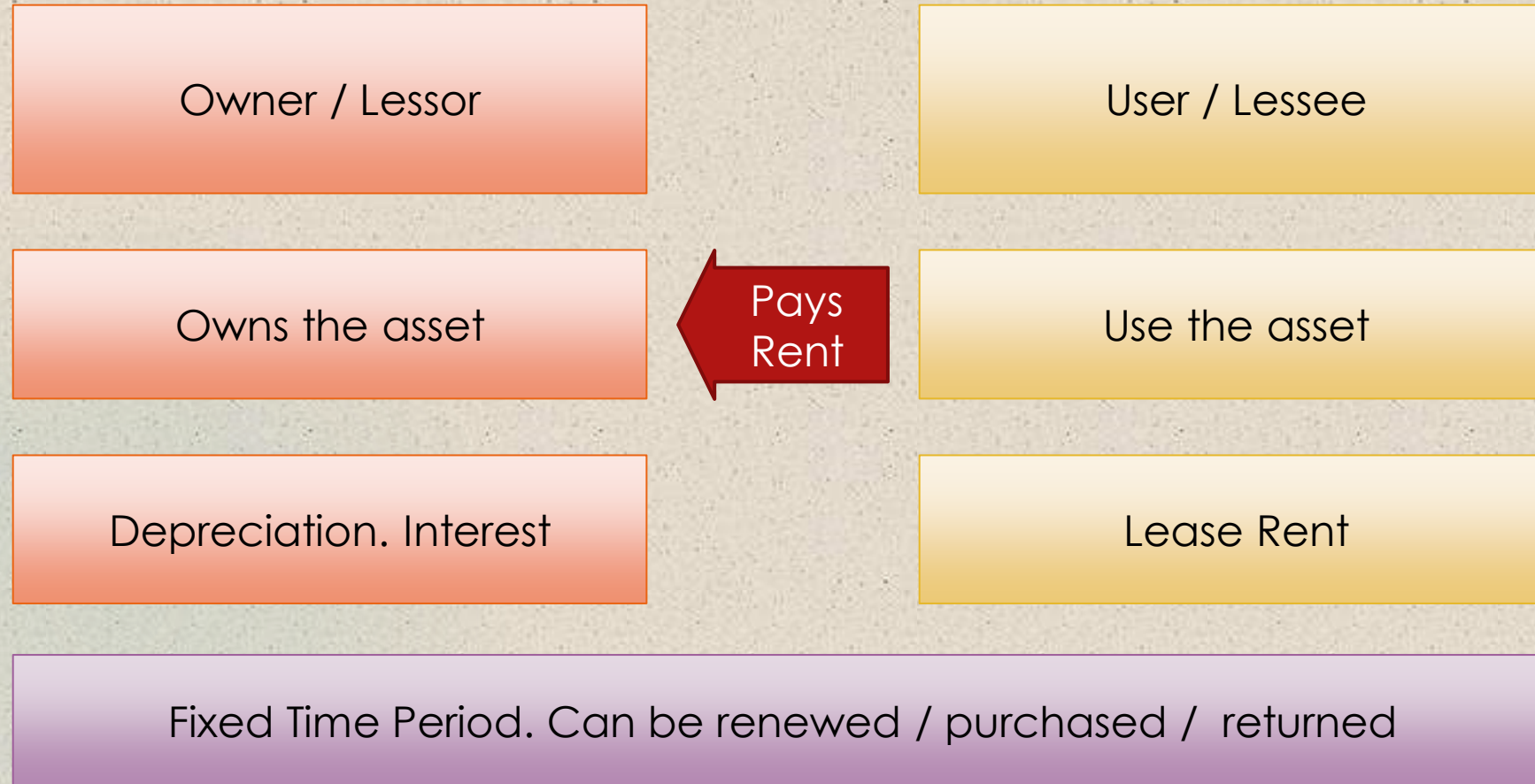
- ▶ Definition of lease
- ▶ Leasing, Hiring and Renting
- ▶ Obligations of supplier of asset, user of asset, hire purchase company/lessor in cases of loan; supplier's credit; hire purchase and leasing
- ▶ Leasing as an instance of bailment; nature of the bailment agreement; features of bailment; contracts law on bailment.
- ▶ Leasing rules
- ▶ Types of leases and their characteristics
- ▶ Structure of a lease agreement and steps in structuring a lease contract
- ▶ Leasing from point of view of lessor/lessee
- ▶ Limitations of leasing
- ▶ Treatment of leased assets in company accounts – accounting practice for leased plant and machinery as per Indian Accounting Standards
- ▶ Assessment of lease related risk
- ▶ Risk and return trade-off
- ▶ Valuation of leased plant and machinery

Ownership of an Asset

- ▶ Outright purchase.
- ▶ Take a loan and purchase.
- ▶ Hire Purchase agreement
- ▶ Leasing – dry lease wet lease.
- ▶ Pay per use.

*All type of purchases have a different cash flow
different tax treatment and different valuation.*

What is LEASE



Why Lease

- ▶ Equipment is very high cost – air crafts . Ships.
- ▶ Time of use is also large – typically more than 10 years.
- ▶ There is a good income, and depreciation reduces tax incidence.

Owner is usually the financial institution – bank / NBFC

User is the one that runs it to make profit.

- Dry Lease
 - Just the equipment and every thing else is done by the user.
- Wet Lease
 - All additional – like operator, maintenance etc is done by the lessor (Owner)
 - Generally done from one operator to another.

Some more

- ▶ Leasing & Hire purchase are similar, but has a different tax treatment.
- ▶ India is evolving in leasing.
 - ▶ Uber is a wet lease in many manners.
- ▶ Parties
 - ▶ Financier – who puts the money
 - ▶ Lessor – who owns the assets and allows to operate. EMI to the financier.
 - ▶ Lessee – who operates the asset and gives lease rent to the lessor.

In India leasing started in 1973 in Chennai.
Good growth till now.
Seen as an interesting tax planning mechanism.
Large size deals are common.

Features

- ▶ Need minimum 2 parties.
 - ▶ Lessee & Lessor
 - ▶ Lessee, Lessor & financier.
- ▶ Specific asset
- ▶ Ownership & Use of asset id defined.
- ▶ Rentals and time period is defined.
- ▶ End use
 - ▶ Lessee buys it at a nominal value
 - ▶ Lessee returns it
 - ▶ Lessee upgrades it.

What is leased

- Full plants
- Specific machinery
- Automobiles / Trucks
- Land & Building
- Ships, Aircrafts.
- Hotel equipment.
- Medical / dental equipment.
- Office equipment
 - Photocopies, Laptops etc.

Leasing & Hire Purchase

Attribute	Leasing	HP
Ownership	To the lessor. Lessee does not have the option as a pre defined option.	Hirer has an option to purchase the asset at any time during or after the hiring period
Depreciation	Lessor.	Hirer
Rental Payment	Fixed rental included the cost of asset, interest and other cost as per the contract	Asset cost plus interest
Types	Dry lease & wet lease. Can add other add on with the rental	Very similar to dry lease.
Duration	Long duration. 10 year/30 yrs	Short duration, lower value assets
Depreciation	To the lessor	To the hirer
Repair & Maintenance	Dry lease – to the lessee. In wet lease – lessor.	To the hirer.

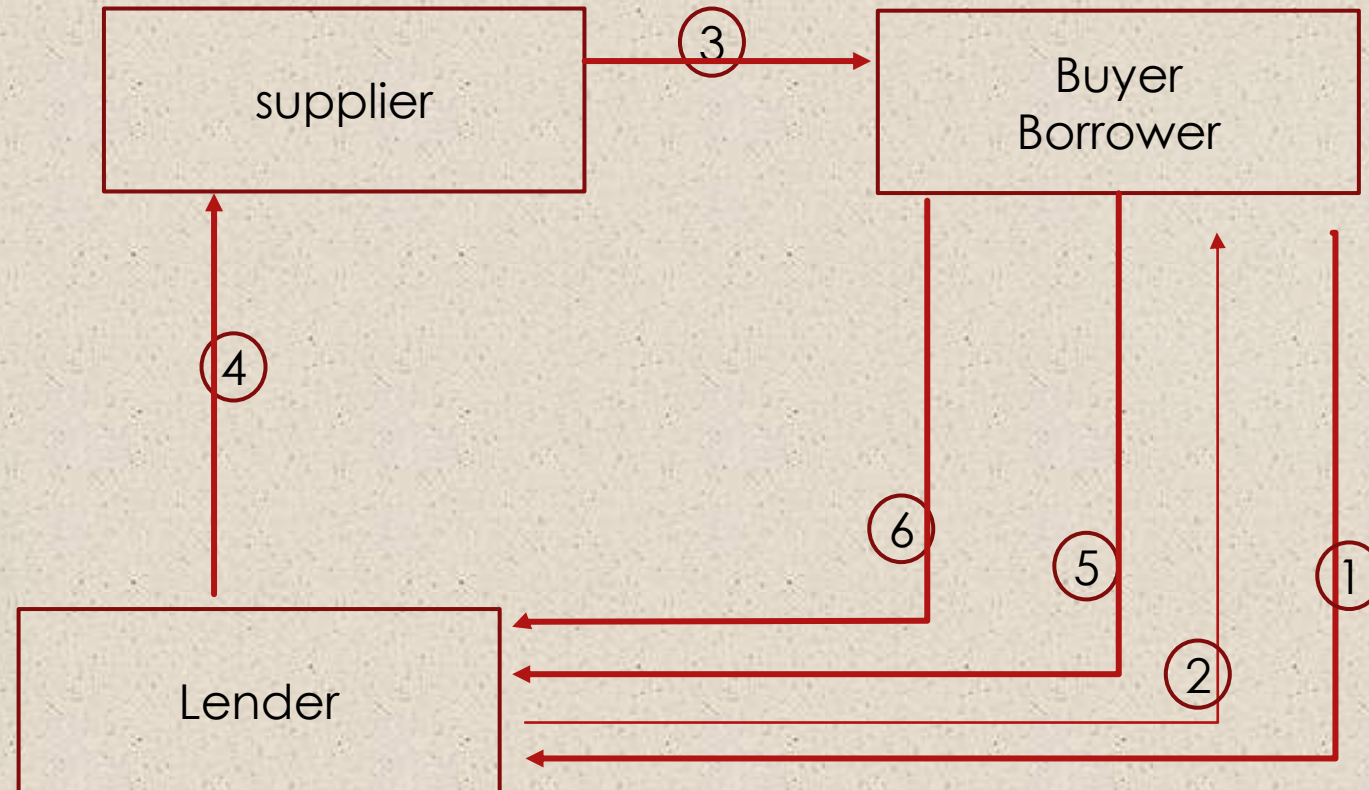
How Tax advantage is taken.

- ▶ Lessor
 - ▶ Asset Rs 1 cr. Interest 12%. Duration 15 years.
 - ▶ Lease rental = 55556
 - ▶ For yr one.
 - ▶ Depreciation 15% = Rs 15 lakh.
 - ▶ Interest earned = Rs 11,633/-
 - ▶ NET LOSS – can be off setted by other profits.
- ▶ Lessee
 - ▶ No down payment
 - ▶ Only Rs 6.67 lakh paid and
 - ▶ All this is treated as expense.

Obligations under different financing arrangement

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LOAN



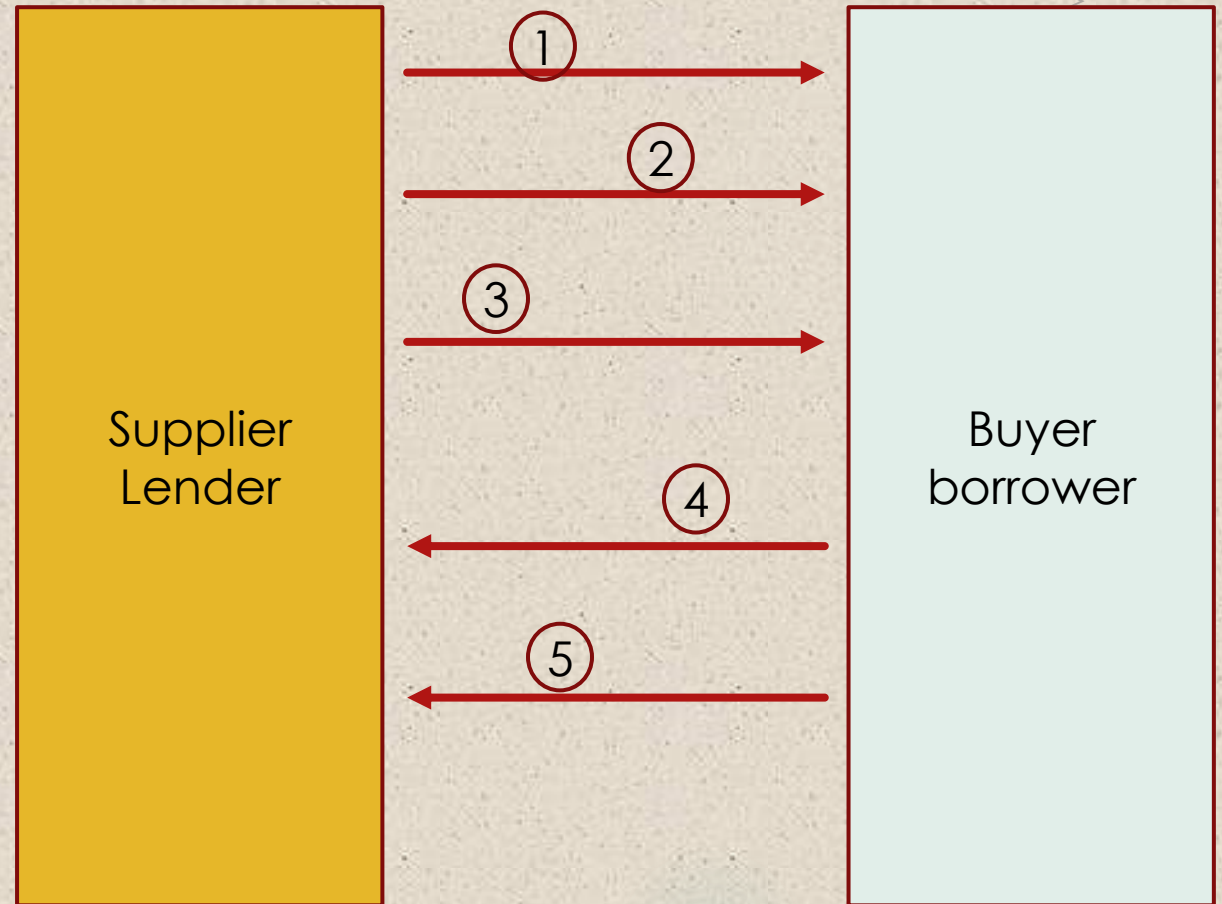
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1.	Apply for loan
2.	Loan Approved
3.	Delivery of Machine / Title
4.	Transfer of money
5.	Asset Hypothecation
6.	Pay EMI.

Obligations under different buying options

Supplier Credit

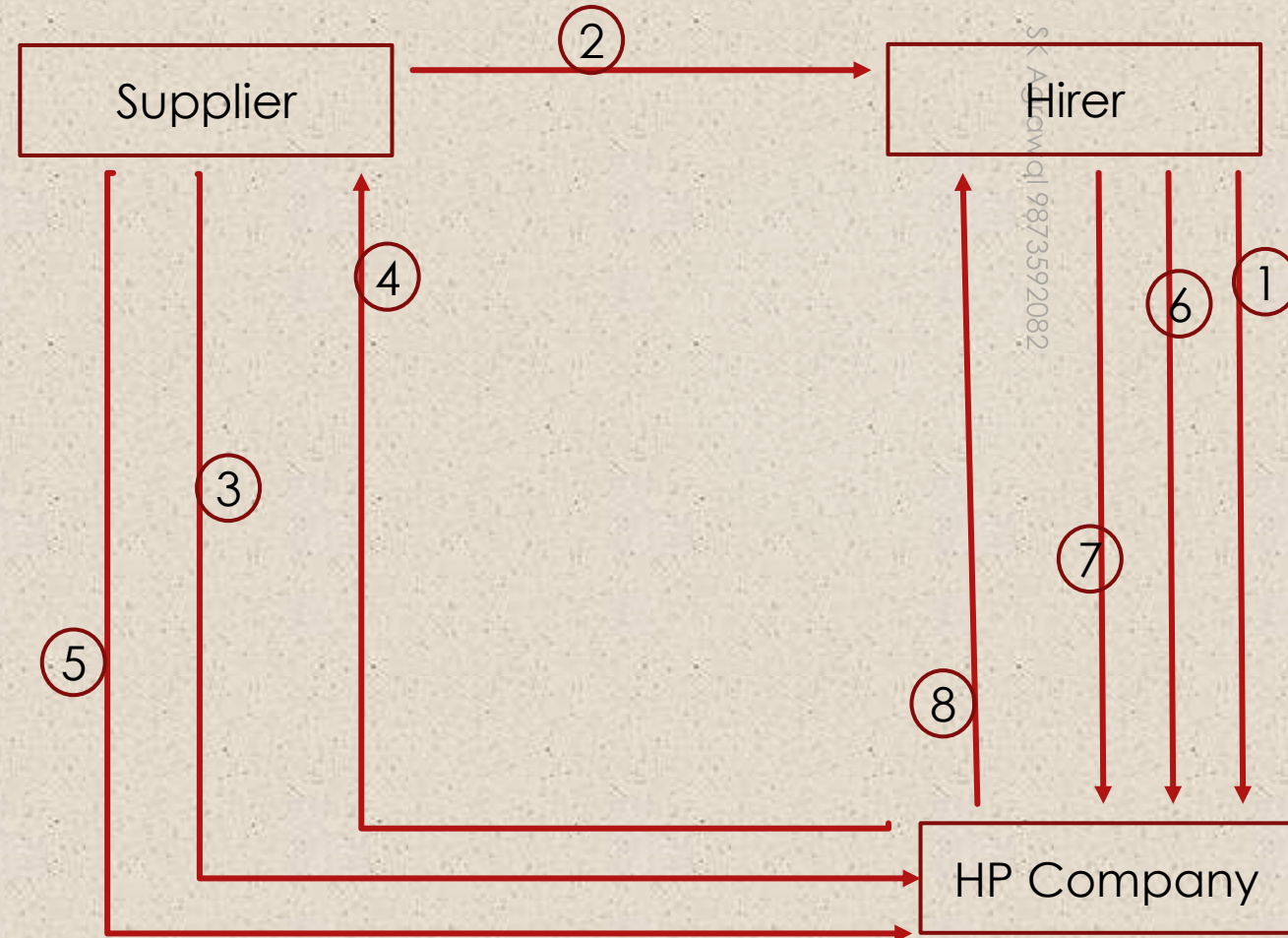
1.	Sells the asset
2.	Gives Credit.
3.	Transfer title.
4.	Makes Hypothecation
5.	Makes EMI



Obligations under different buying options

Hire Purchase

1.	Makes Agreement
2.	Deliver Equipment.
3.	Send Invoice
4.	Pay Money.
5.	Transfer title.
6.	Pay rent
7.	Execute BUY option
8.	Transfer the owner as per agreement

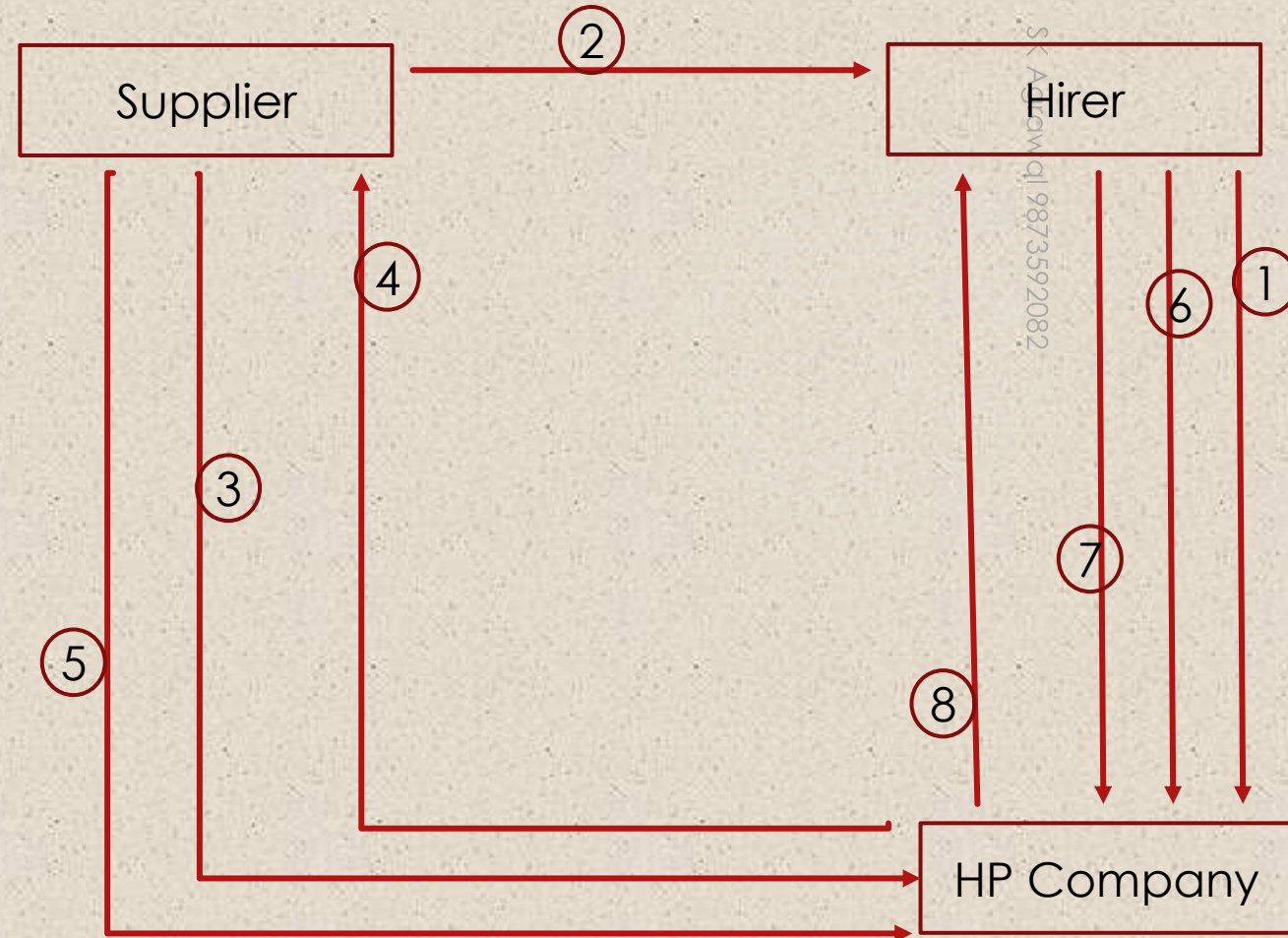


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Obligations under different buying options

Leasing

1.	Makes Agreement
2.	Deliver Equipment.
3.	Send Invoice
4.	Pay Money.
5.	Transfer title.
6.	Pay rent
7.	Do Maintenance
8.	Insure asset



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Leasing as an instance of bailment; nature of the bailment agreement; features of bailment; contracts law on bailment

- ▶ Bailment
 - ▶ Section 148 of Contract Act 1872.
 - ▶ Confined to movable asset.
 - ▶ Delivery of good, by one person to other, for a purpose, with a contract.
 - ▶ Will be returned, when the purpose is over. Or disposed as per the person delivering.
- ▶ Person delivering ::: BAILOR
- ▶ Person Taking ::: BAILEE
- ▶ Hire Purchase is a bailment.
- ▶ Bailment >>> Asset is transferred as possession (ONLY) from BAILOR to BAILEE.

In case of IMMOVABLE asset – Transfer of Property Act 1882 will apply.

Features of Bailments

- ▶ Need a CONTRACT.
 - ▶ A delivery of goods
 - ▶ Delivery made by owner or BAILOR.
 - ▶ Accepted by BAILEE
 - ▶ This is DONE for a SPECIAL PURPOSE.
- ▶ CONDITION has to be
 - ▶ Return the goods to BAILOR
 - ▶ In same condition
 - ▶ In changed condition
 - ▶ Or disposed off.

Contract Law on bailment

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- ▶ Duties of BAILOR
 - ▶ Disclose all facts about the goods.
 - ▶ To bear the expenses in unnecessary bailment.
- ▶ Duties of BAILEE
 - ▶ To take care of the goods as they are his own.
 - ▶ No unauthorised use of the goods.
 - ▶ Keep own goods and Bailor goods separate.
 - ▶ No adverse title on the goods.
 - ▶ Return the goods at the expiry / purpose finished..

Leasing Rules

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- ▶ Parties to a LEASE
 - ▶ There are minimum 2 parties – LESSOR & LESSEE
 - ▶ The parties may be individual, firm or companies.
 - ▶ Leasing may use a broker. (broker fees is usually 0.5% to 1%)
 - ▶ There may be Lease financier, who refinance LESSOR (loans)
- ▶ The Asset
 - ▶ Only tangible asset can be leased. (car, trucks, ships, TV)
 - ▶ Lease become effective by delivery.
 - ▶ Asset to have capacity to be redelivered, durable, identifiable & serveable.
 - ▶ No GOODS/ASSETS ::: NO LEASE.

Leasing Rules

- ▶ Terms of lease or Lease Period
 - ▶ The time during which the lease is operational.
 - ▶ A fixed term is a must. Else lease is illegal.
 - ▶ May be short or long. May be primary or secondary term.
 - ▶ May have a renewal clause. So after the term – lease is renewed again.
- ▶ Lease Rentals
 - ▶ Rent lessee pays to lessor
 - ▶ This covers
 - ▶ Capital cost
 - ▶ Interest
 - ▶ Repairs by lessor (as per contract)
 - ▶ Service Charges

Lease Types – Financial Lease

- ▶ Lessor transfers all the risks & rewards to lessee.
- ▶ Rental is TO BE PAID.
- ▶ Cannot be cancelled in between / there are penalty clause.
- ▶ Financier is not interest in the asset, but his returns & depreciation.
- ▶ Also called FULL PAYOUT LEASE. Financier recovers his cost and interest.
- ▶ IAS-17 states that substantial part of the ownership related to risk and reward are transferred when
 - ▶ Ownership of the equipment is transferred.
 - ▶ Lessee has an option to purchase the asset on a fixed date at a pre fixed price.
 - ▶ Lease term is the major part of the economic life.

Operating Lease

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- ▶ Lessor provides service along with the asset.
 - ▶ Manpower, maintenance, service
- ▶ Lessor – DOES NOT transfer all the risk & rewards towards ownership/
- ▶ The duration of lease is far less than the economic life
- ▶ Lessor – may re lease the asset after the first / this term is over.

Characteristics of Operating Lease

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- ▶ Time is much shorter than economic life.
 - ▶ Even for a few hours (taxi)
- ▶ Can be cancelled by either party.
- ▶ One lease cannot cover the total cost – so multiple leases will happen.
- ▶ Lessor has an interest on the RESIDUAL value as well.
- ▶ Risk of obsolescence is with the Lessor.
- ▶ This is including
 - ▶ Manpower, fuel, maintenance, other service.

Other type of leases

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- ▶ Sale & Lease Back
 - ▶ Owner of the asset – sells to the leasing company
 - ▶ Leasing company leases it back to the (ex) owner.
 - ▶ Way to generate cash for business.
- ▶ Leveraged & NON leveraged lease
 - ▶ When the LESSOR gets the money from a third party.
 - ▶ Financier >> Lessor >> Lessee.
- ▶ Specialised Service Lease.
 - ▶ Lessor is specialised in the asset. (air craft)
 - ▶ Lessor also provides services / spares etc.
- ▶ Cross Border Lease
 - ▶ Lessor and lessee are in different countries.
 - ▶ Asset – country or origin has no value.
- ▶ NET NET Lease
 - ▶ Lessee – guarantee the residual value of the asset. (May be by promise to buy it)

More details of Finance Lease

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- ▶ Lessee – selects the asset.
- ▶ Lessee – negotiated all service and other issues with maker.
- ▶ Lessor – buys the asset from maker – or from lessee.
- ▶ Lessor – leases the asset to lessee.
- ▶ Lessee may have an option to buy the equipment at a later date.
- ▶ Time of lease covers the major economic life.
- ▶ Lessee can use the asset peacefully as he feels fit
- ▶ As Lessee chooses the equipment
 - ▶ Suitability
 - ▶ Obsolesce
 - ▶ Maintenance
 - ▶ Insurance – are responsibility of lesee.

Lessor & Lessee advantage

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- ▶ Advantage to Lessee
 - ▶ Financing of capital goods
 - ▶ Lease rent is usually less than HP.
 - ▶ Ownership is assured.
 - ▶ Rentals can be structured as per business needs.
 - ▶ Simplicity
 - ▶ Tax advantage.
- ▶ Advantage to Lessor
 - ▶ Security of the asset.
 - ▶ Tax benefits
 - ▶ Higher profits compared to HP.
 - ▶ Higher growth possibilities.

Disadvantage

- ▶ Not suitable for project finance.
- ▶ Subsidies from government may not be available.
- ▶ If the value of asset – land – increases – lessee cannot take advantage.
- ▶ Loss of residual value.
- ▶ If lessee wants to discontinue a business, the penalties may be high.
- ▶ If lease rent are not received regularly, lessor bears major losses.
- ▶ If contract is not fool proof – there are problems.

Structure of Lease Agreement

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- ▶ Following terms are listed.
 - ▶ Name of lessor, lessee, asset description.
 - ▶ Term of lease.
 - ▶ Rental payment – value and date.
 - ▶ Time & Place of equipment delivery
 - ▶ Lessee to take possession, maintain & keep asset in good shape.
 - ▶ Lessee enjoys the benefits of warranties.
 - ▶ Lessee to take insurance with lessor as benefactor in case of serious damage.
 - ▶ Variations of lease rent in case of factors like interest rate & other legal policies.
 - ▶ Option of lease renewal
 - ▶ Return of asset after term of lease.
 - ▶ Arbitration in case of dispute.
 - ▶ Force Majeure.

How to treat in Financial Statement

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- ▶ Financial Lease
 - ▶ Lessor – Dr Fixed Asset. Cr Bank.
 - ▶ Lessee – Dr expense to start the asset. Cr Bank
- ▶ Annually
 - ▶ Cr Lease rental Dr Bank
 - ▶ Dr Depreciation Cr Fixed asset
 - ▶ Dr :: Lease rent Cr Bank
 - ▶ Dr :: expenses related to asset Cr Bank

Operating Lease

- ▶ Lessor
 - ▶ Dr Fixed asset Cr Bank
- ▶ Lessee – no transactions
- ▶ Annually
 - ▶ Lessor
 - ▶ Dr Depreciation Cr Fixed Asset
 - ▶ Cr Lease rent Dr bank
 - ▶ Cr Bank Dr interest for the asset
 - ▶ Dr expense to keep running the asset Cr Bank
 - ▶ Lessee
 - ▶ Dr Lease rent Cr Bank

Lease Related Risk

- ▶ Default risk. Lease rental not received.
- ▶ Residual value risk.
- ▶ Interest rate risk :: Interest rates may change drastically.
- ▶ Government policy risk
- ▶ Purchasing power risk
- ▶ Currency & cross border risk.

Risk & Returns Trade-off

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- ▶ Value is a present worth of future benefits discounted at an appropriate rate of return. In case of leasing the benefits derived from the asset the asset ownership and use are divided between lessor & lessee.

For P&M on lease, income approach is used. Mathematically, it is stated as,

$C.V. = N.I. \times Y.P.$ (Depends on the appropriate rate of interest), where

C.V. = Capital Value

N.I. = Net Income

Y.P. = Years Purchase

The multiplier or Y.P. is the summation of the present worth of series of income of Rs. 1/- receivable every year at the end of 1st year, 2nd year, 3rd year..... nth year at certain rate of interest.

Valuation of Leased Plant & Machinery

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- ▶ Lessee ::
- ▶ Asset is :: RIGHT TO USE.
 - ▶ Depreciated on a straight line.
- ▶ Liability :: Lease rental
 - ▶ Reduce as per what is paid.

Other Options

- Option 1 (status quo): involves capital allowances still being available to lessors, except under long funding leases;
- Option 2 (accounts-based regime): would replace current access to capital allowances with accounting depreciation for all leased assets;
- Option 3 (accounts-based with leasing allowance): new tax regime based on the accounting entries but providing an option to the lessee to claim enhanced or accelerated relief, based on the value of the right to use the leased asset;
- Option 4 (accounts-based with capital allowances): new tax regime based on the accounting entries, but providing an option for the lessee to claim capital allowances based on the value of the right to use the leased asset.

Thanks