



# **Module-D Unit-11**

## **JAIIB PAPER-1**

**Indian Economy and Indian  
Financial System (IE & IFS)**



## JAIIB Paper 1 IE & IFS Module D Unit 11 -Lease Finance & Hire Purchase

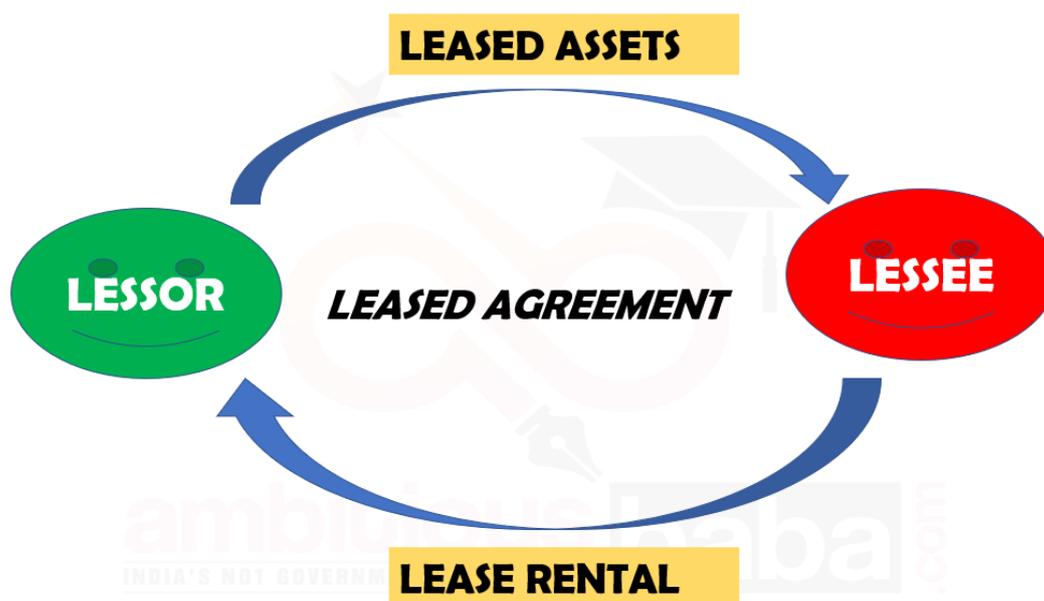
### Lease Finance

- Business enterprises need capital assets like plant, machinery, building, land, transportation equipment, etc., in order to produce goods and services.
- These can be acquired either using capital funds (equity) or borrowings from various sources (debt).
- Funding could also be a **mixture of both equity and debt**.
- There are two other methods of acquiring capital assets – **lease financing and hire purchase**.
- These are two important sources of finance, whereby, the entrepreneur resorts to, neither equity nor borrowings to acquire the assets.

### Leasing

Is a method of acquiring right to use an equipment or asset for a consideration, resulting in an entrepreneur getting the right to use the asset.

- A lease is a contract whereby, the owner of an asset (the lessor) grants to another person (the lessee) exclusive right to use the asset, for an agreed period of time, in return, for the payment of a rent (**called lease rental**).
- Capital assets like land, buildings, equipment, machinery, vehicles are usually the assets, which are generally acquired on lease basis.
- The lessor remains the owner of the asset, but the possession and economic use of the asset is vested in the lessee.



## Evolution Of Leasing In India

- **1973:** Leasing activity was initiated in India
- **The first leasing Company:** First Leasing Company of India Ltd.
- **By Farouk Irani, with industrialist Shri A C Muthiah.**
- **By 1981:** Shetty Investment and Finance, Jaybharat Credit and Investment, Motor and General Finance, and Sundaram Finance, etc., joined the leasing game.
- These firms, already involved with hire-purchase of commercial vehicles, were looking for a tax break and leasing seemed to be their ideal choice.
- **Third Stage of Growth:** In late 1982, when numerous financial institutions and commercial banks either started leasing or announced plans to do so.
- **1983:** ICICI, entered the industry, giving a boost to the concept of leasing.
- International Finance Corporation (IFC) announced its decision to open 4 leasing joint ventures in India.
- To add to the leasing boom, the Finance Ministry announced strict measures for enlistment of investment companies on stock exchanges, which made many investment companies to turn overnight, into leasing companies.
- Another significant phase in the development of Indian leasing was **the G S Dahotre Committee's recommendations**, based on which, the RBI formed guidelines for commercial banks funding leasing companies.
- The growth of leasing in India has distinctively been assisted by funding from banks and financial institutions.
- Banks themselves were allowed to offer **leasing facilities later in the year 1994, with banks like State Bank of India and Bank of India opening specialised branches for handling Lease Financing.**

## Types Of Leasing

### **Finance Lease: Also called a capital lease**

- Usually covers the full useful economic life of the assets or a period that is close to the economic life.
- The lessor receives lease rentals during the lease period so as to recover fully, not only the cost of the assets but also the interest cost.
- Usually a non-cancellable and the lessee provides for the maintenance of the assets.

### **Operating Lease**

- Period of lease is short, when compared to the useful life of the asset or the equipment being leased.

- For instance, an aircraft which has an **economic life of 25 years** may be leased to an airline for 5 years, on an operating lease.
- Lessor will recover the cost of the asset from multiple lessees.
- They are typically for assets like computers, windmills and so on.
- In operating lease, the lessor is responsible for all kinds of maintenance, insurance and all other expenses related to the leased asset.

	Finance Lease	Operating Lease
<b>Duration</b>	Finance Lease is generally for the whole useful life of the asset.	Operating Lease is generally for a shorter duration.
<b>Revocation</b>	Finance lease contract cannot be revoked.	Operating-lease contract is revocable.
<b>Maintenance</b>	In Finance Lease, all the cost relating to maintenance, taxes and insurance are to be borne by the lessee.	In Operating Lease, all such expenses are borne by the lessor.
<b>Obsolescence risk</b>	The Lessee has to bear the risk of obsolescence.	The Lessor has to bear the risk of obsolescence.
<b>Option of purchase</b>	A Finance Lease contract provides for the option to purchase the asset at the end of the contract.	No such option is available in an Operating-lease contract.

***Other types of lease finance arrangements that are prevalent are:***

- **Close- and Open-ended Lease** - In a close-ended lease, the asset gets transferred to the lessor, at the end of the lease-contract period, whereas in an open-ended lease, the lessee has the option of purchasing the asset.
- **Up-front and Back-end Lease** - In an upfront lease, higher lease rentals are charged in the initial years and lower rentals in the later years of contract. Whereas, in the back-end lease, in the initial years, the lease rentals are less with increase in the later years.
- **Percentage Lease** - In the percentage lease, the lessor needs to pay fix-lease rentals plus some percentage of the previous year's gross revenue.
- **Cross-border Lease** - In the cross-border or international lease, the lessee and the lessor are situated in two different countries.

***Lease Financing can be of three different types, depending upon how the lessee acquires the asset. These are as follows:***

**Direct Lease**

- The lessor firm itself purchases the asset and hands it over to the lessee.
- A manufacturer can also act as a lessor and can deliver the assets to the lessee, under the lease agreement (instead of delivering under the sale agreement).
- In other words, the lessee will normally specify the manufacturer, the model number and other relevant characteristics of the asset it wishes to lease and the lessor will procure for the lessee.

**Leveraged Lease**

- A leveraged lease is an arrangement, where the lessor borrows a portion of the purchase price, from some lender/financial institutions.
- This loan is secured by the assets and the lease rentals.
- The loan is repaid out of the lease rentals either directly by the lessee or the lessor.
- The surplus (i.e., the under the leveraged lease, the lessor acts as an equity participant, supplying only a part of the cost of the assets and the lender supplies the balance. The lease rentals are distributed first to the lender to satisfy the scheduled debt service payments; any surplus then going to the lessor.
- If lease payments < the debt service, the lessor or the lessee (as the contract may provide for) will have to make up the difference.

### Sale and Lease Back

- The lessee is already the owner of the assets. The to-be lessee, under the lease agreement, sells the assets to the lessor who, in turn, leases the assets back to the owner (now the lessee).
- Under the sale and lease back, the lessee not only retains the use of the assets but also gets funds from the 'sale' of the assets to the lessor.
- The 'sale and lease back arrangement' is usually preferred by firms requiring fixed assets but are short of funds.

### Advantages And Disadvantages Of Lease Finance

*The Lease Finance offers following advantages:*

- **Regular income:** Lessor gets assured rental income during the period of lease, without transferring the ownership of the asset to the lessee.
- **High profitability:** Leasing is highly profitable since the rate of return is the lease rental is higher than the interest payable on financing the asset.
- **Growth and expansion:** An entrepreneur will not have to spend a lot of money acquiring the asset. He/she can utilise the funds for further growth of the business.
- **Tax benefit:** Lease rental is deductible from the taxable income of the lessee. The lessor has the benefit of depreciation in respect of leased assets.
- **Economical:** Leasing as a source of financing is cheaper than many other sources of finance. The lessee can use the asset and earn profits, without investing money in the asset.

### Impact Of Leasing On Financial Ratios

- When an asset is acquired on lease basis, lease rentals are shown as an expense in the firm's profit and Loss account.
- Neither the leased asset nor the liability under the lease agreement are shown in the Balance Sheet.
- Hence, the debt-equity ratio remains unaffected, as compared to a firm which buys the asset with borrowed funds.

**Example:**

*There are two firms in an industry with identical balance sheets as shown below:*

**Balance Sheet**

<b>Equity Capital</b>	<b>100</b>	<b>Fixed Assets</b>	<b>100</b>
<b>Debt</b>	<b>100</b>	<b>Current Assets</b>	<b>100</b>
<b>Total</b>	<b>200</b>	<b>Total</b>	<b>200</b>

- **Debt Equity Ratio = 1: 1**
- **Firm A:** borrows Rs. 100 to buy a fixed asset, while
- **firm B :** Takes it on lease. The respective balance sheets of the two firms will appear as follows:

**Firm A**

Equity Capital	100	Fixed Assets	200
Debts	200	Current Assets	100
<b>Total</b>	<u><b>300</b></u>	<b>Total</b>	<u><b>300</b></u>

Debt Equity Ratio = 2 : 1

**Firm B**

Equity Capital	100	Fixed Assets	100
Debts	100	Current Assets	100
<b>Total</b>	<u><b>200</b></u>	<b>Total</b>	<u><b>200</b></u>

- **Debt Equity Ratio = 1:1**
- The debt-equity ratio of firm A increases from 1:1 to 2:1,
- while that of firm B remains unaffected.
- In its balance sheet, the leased asset is shown as an off-balance sheet item.
- Higher debt-equity ratio of Firm A will adversely affect its further debt taking capacity, while firm B can take further debt easily to acquire other assets or to meet its working capital needs.

### **Legal Aspects Of Leasing**

- **The Transfer of Property Act :** Defines a lease as a transaction in which, a party owning the asset provides the asset for use, over a certain period of time, to another for consideration, in the form of periodic rent.
- **Indian Accounting Standard 19 :** Defines a lease as an agreement, whereby, the lessor conveys to the lessee in return for a payment or a series of payments the right to use an asset, for an agreed period of time.

- **Sale of Goods Act:** A 'sale' means a transfer of property in goods. A lease, on the other hand, is merely a transfer of the right to use the goods and is therefore not a sale.
- A lease transaction is a deemed sale under the law and Goods and Services Tax (GST) is levied on the lease rentals.
- As there is no separate statute in India to govern the contracts of leasing, which is akin to a contract of bailment, the provisions of the Indian Contract Act apply to it.
- **According to Section 146 of the Indian Contract Act, 1872:** Bailment is "the delivery of goods by one person to another person for some purpose, upon a contract that they shall, when the purpose is accomplished, be returned or otherwise disposed of, according to the directions of the person delivering them."
- **Bailor:** The person delivering the goods
- **Bailee:** Person to whom they are delivered.
- Since equipment lease transactions fall in the category of a bailment contract, the obligations of the lessor and the lessee are similar to those of the bailor and the bailee (unless expressly specified otherwise in the lease agreement), as given in **the Indian Contract Act.**

*Briefly, these may be stated as follows:*

- ✓ The lessor has the duty to deliver the asset to the lessee, to legally authorise the lessee to use the asset and to leave the asset in peaceful possession of the lessee during the lease period.
- ✓ The lessor has the obligation to pay the lease rentals, as specified in the lease agreement, to protect the lessor's title, to take reasonable care of the asset, and to return the leased asset, at the expiry of the lease period.

### **Regulatory Aspects Of Leasing Activities**

Banks are permitted by RBI to undertake leasing activities, either through subsidiaries or through their departments.

#### **Equipment Leasing Services through Subsidiaries**

**With the prior approval of the Reserve Bank of India**



- The subsidiaries formed should primarily be engaged in leasing activities and such other activities as are incidental to equipment leasing services.
- In other words, they should not engage themselves in direct lending or carrying on the activities which are not approved by the Reserve Bank and financing of other companies or concerns engaged in equipment leasing services.

## Equipment Leasing Services as Departmental Activities

- Banks can also undertake equipment leasing services departmentally.
- Prior approval of the RBI is not necessary
- However, report to the RBI about the nature of these activities together with the names of the branches from where these activities are taken up.

***The banks should comply with the following prudential guidelines when they undertake these activities departmentally:***

- Require skilled personnel and adequate infrastructural facilities, they should be undertaken only by certain select branches of banks.
- These activities should be treated on par with loans and advances and should accordingly be given **risk weight of 100%, for calculation** of capital to risk asset ratio. Further, the extant guidelines on income recognition, asset classification and provisioning would also be applicable to them.
- The facilities extended by way of equipment leasing services would be covered within the exposure ceilings with regard to
- ✓ **Single borrower (15% of the bank's capital funds; 20% provided the additional credit exposure is on account of extension of credit to infrastructure projects)**
- ✓ **Borrower group (40% of the bank's capital funds; 50% provided the additional credit exposure is on account of extension of credit to infrastructure projects).**
- Their exposure to each of these activities should **not exceed 10% of total advances.**
- Banks are required to frame an appropriate policy on leasing business with the approval of their Boards and evolve safeguards to avoid possible asset liability mismatch.

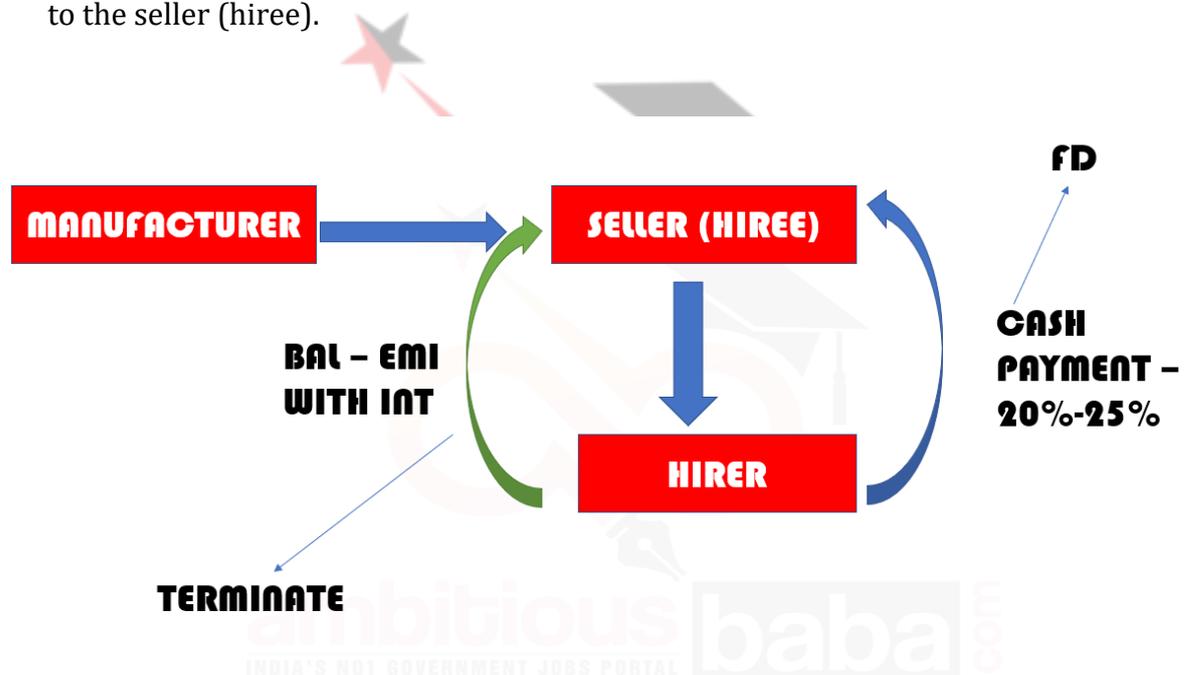
### **Hire Purchase**

- Hire purchase is another method of acquiring a capital asset for use, without paying its price immediately.
- Under hire purchase arrangement, goods are let on hire, the hirer (user) is allowed to pay the purchase price in instalments and enjoys an option to purchase the goods, after all the instalments have been paid.
- Thus, the ownership in the asset is passed on to the hirer only on payment of the last instalment.
- The amount and number of instalments is fixed at the time of delivering the asset to the hirer.
- If the hirer makes default in making payment of any instalment, the seller is entitled to recover the asset from the hirer.
- The hirer may, on his own also, return the asset to the hiree, without any commitment to pay the remaining instalments.
- The instalments for this purpose are treated as hire charges.

- Thus, the property in the asset remains vested in the seller (hiree) till, the right of purchase is exercised by the hirer, after making payment of all the instalments

**The hire purchase transaction takes place in the following manner:**

- ✓ The seller (hiree) purchases the asset from the supplier/manufacturer and hires it to the hirer who is required to make a cash down payment of, **say 20-25% of the cost of the asset.**
- ✓ The balance of the cost price of the asset with interest thereon is payable in equated monthly instalments, over a pre-determined period, **which ranges between 36 months and 48 months.**
- ✓ Sometimes, in place of cash down payment, a fixed deposit is required to be made with the seller and the entire amount of the cost is recovered through EMIs.
- ✓ The amount of FDR plus interest is returned to the hirer on payment of the last instalment.
- ✓ The hirer is entitled to terminate the hire purchase contract by giving due notice to the seller (hiree).



### **Evolution Of Hire Purchase In India**

- 1<sup>ST</sup> hire-purchase company is believed to be Commercial Credit Corporation, successor to Auto Supply Company.
- **Based in Madras (presently Chennai),**

#### **North India:**

- ✓ **1920s-** Motor and General Finance
- ✓ **1930s-** Instalment Supply Company

**Development of Hire-purchase took two forms:**

- ✓ **Consumer durables**
- ✓ **Automobiles.**

Consumer durables hire-purchase was promoted by the dealers in their respective equipment.

- Thus, Singer Sewing Machine company, or Murphy radio dealers would provide instalment facilities on hire-purchase basis to the customers of their products The other side that developed very fast was the hire-purchase of **commercial vehicles**.
- The dealers in commercial vehicles, as well as pure financing companies, were set up.
- The value of the asset being good and repossession being comparatively easy, this branch of financing activity flourished fast.

### **Legal Aspects Of Hire Purchase**

- Hire purchase agreement is not a contract of sale but a contract of bailment as, although the hirer has the right of using the goods, he is not the legal owner while the term of the agreement is operational.
- In India, all the hire purchase finance organisations are **controlled by the Hire Purchase Act, 1972**.
- However, a Bill was initiated in the year 1989, for making certain amendments which could never come into force.
- Such a transaction has two basic elements which are governed by the
- **Indian Contract Act, 1872**

### **Sale of Goods Act, 1930:**

- **Bailment:** This aspect of the hire purchase agreement is governed by Chapter IX of the Indian Contract Act, which covers finance agreements like the purchase of consumer durables such as motor vehicles, computers, household appliances like televisions, refrigerator.
- **Sale:** This aspect of the hire purchase agreement is a part of the Sale of Goods Act. The law commission had recommended in its eighth report of Sale of Goods Act that there should be a separate enactment, regulating hire-purchase transaction.
- As there were no proper laws to regulate such transactions of hire purchase, hence provisions were made by a separate act **called the Hire Purchase Act, 1972**.

	Lease Finance	Hire Purchase
<b>Meaning</b>	A lease transaction is a commercial arrangement, whereby, an equipment owner or a 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 the principal, as well as interest, with an option to purchase.
<b>Option to user</b>	Except the financial Lease, no option is provided to the lessee (user) to purchase the goods.	The hire purchaser becomes the owner of the asset after paying the last instalment.
<b>Nature of payment</b>	Lease rentals paid by the lessee are entirely the revenue expenditure of the lessee.	Only the interest element included in the hire-purchase instalments are in the nature of revenue expenditure.
<b>Who can claim depreciation</b>	Lessor can claim for depreciation.	Hire purchaser can claim for depreciation.
<b>Tax benefit</b>	In a Lease agreement, the Lessor can claim depreciation and the lessee can claim maintenance and rentals from taxable income as expense.	A hire purchaser can claim depreciation and interest payment from the taxable income, whereas the seller can claim for the interest on the borrowed fund for purchasing the assets.

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