Leasing

Lease can be defined as a right to use an equipment or capital goods on payment of periodical amount. This may broadly be equated to an instalment credit being extended to the person using the asset by the owner of capital goods with small variation.

Parties to a Lease Agreement

There are two principal parties to any lease transaction as under:

Lessor: Who is actual owner of equipment permitting use to the other party on payment of periodical amount

Lessee: Who acquires the right to use the equipment on payment of periodical amount

Types of Leasing

Operating Leasing

An operating lease is a lease whose term is short compared to the useful life of the asset or piece of equipment (an airline, a ship, etc.) being leased. An operating lease is commonly used to acquire equipment on a relatively short-term basis.

An operating lease is a contract that allows for the use of an asset, but does not convey rights of ownership of the asset. An operating lease represents an off-balance sheet financing of assets, where a leased asset and associated liabilities of future rent payments are not included on the balance sheet of a company.

Financial Leasing

A finance lease or capital lease is a type of lease in which a finance company is typically the legal owner of the asset during the duration of the lease, while the lessee not just has operating control over the asset, but also has a substantial share of the economic risks and returns from the change in the valuation

Advantages

- The first and foremost advantage of a lease agreement is its flexibility. The leasing company in most of the cases would be prepared to modify the arrangement to suit the specific requirements of the lessee.
- The ownership of the leased equipment gives them added confidence to enable them to be more accommodative than the banks and other financial institutions. The leasing company may finance 100% cost of the equipment without insisting for any initial disbursement by the lessee, whereas 100% finance is generally never allowed by banks/financial institutions.

- Banks/financial institutions may involve lengthy appraisal and impose stringent terms and conditions to the sanctioned loan. The process is time consuming. In contrast leasing companies may arrange for immediate purchase of equipment on mutually agreeable terms.
- Lengthy and time consuming documentation procedure is involved for term loans by banks/institutions. The lease agreement is very simple in comparison.
- In short-term lease (operating lease) the lessee is safeguarded against the risk of obsolescence. It is also an ideal method to acquire use of an asset required for a temporary period.
- The use of leased assets does not affect the borrowing capacity of the lessee as lease payment may not require normal lines of credit and are payable from income during the operating period. This neither affects the debt equity ratio or the current ratio of the lessee.
- Leased equipment is an 'off the balance sheet' asset being economically used by the lessee and does not affect the debt position of lessee.

Disadvantages

- The lease rentals become payable soon after the acquisition of assets and no moratorium period is permissible as in case of term loans from financial institutions. The lease arrangement may, therefore, not be suitable for setting up of the new projects as it would entail cash outflows even before the project comes into operation.
- The leased assets are purchased by the lessor who is the owner of equipment. The seller's warranties for satisfactory operation of the leased assets may sometimes not be available to lessee.
- Lessor generally obtains credit facilities from banks etc. to purchase the leased equipment which are subject to hypothecation charge in favour of the bank. Default in payment by the lessor may sometimes result in seizure of assets by banks causing loss to the lessee.
- Lease financing has a very high cost of interest as compared to interest charged on term loans by financial institutions/banks.

Difference Between Lease and Rent.

The key difference between lease and rent is their duration. Whereas a lease remains valid for the period of time specified in the agreement. A rental agreement covers a short term period that is not necessarily stated.

Capital Allocation Definition:

It is the process of distributing an organizations financial resources. The purpose of capital allocation

Methods/ Principles of Capital Allocation

1. Mergers and Acquisitions (Consolidation of companies. Merger is the combination of two companies. Acquisition is one company is taken over by the other)
2. Invest in an Organic growth
3. Repurchase share
4. Pay Down Debt
5. Pay Dividends (A dividend is a payment by a corporation the shareholders, usually a distribution of profit)

Absorption Costing

A method of calculating the cost of a product or enterprise by taking into account indirect expenses (Overheads) as well as direct cost

Advantages:

- Accounts for all production cost
- Tracks profit and loss accurately
- Accounts for all production cost

Disadvantages

- Can Skew Profit and Loss
- Doesn’t help improving operational efficiency
- Not useful for comparison of different product