EFFECT OF LEASE STRUCTURE ON FINANCIAL STATEMENTS AND PERFORMANCE OF THE COMPANY

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ABSTRACT
“Why own a cow when the Milk is so cheap? All you really need is milk and not the cow” (Donald B. Grant). This is best way to understand the concept of lease. Over the years, lease finance has been consented as one of the cornerstones of modern financial sources. It is a method of acquiring the used of an asset without buying it. Leasing has great potential in India. Leasing is sun-rise sector in India. Leasing provides firms with operational flexibility and leases are easier to finance than purchase. As such, the purpose of the paper is to ascertain the effect of lease structure on the profitability of the company as well as study the effect of lease on financial statements of company.

Keywords: lease, tax, finance, firms, sunrise industry.

1. INTRODUCTION
The main objective of the business is to maximize the owner economic welfare. The firm makes various investments to maximize stock holders wealth. After identifying various attractive projects the firm looks for the different options for financing that. They can be financed with internal funds like retained earnings, equity capital. On the other hand external finance is debt. In addition to debt and equity financing, leasing has emerged as a third important source of intermediate and long term financing of corporate enterprises during the recent few decades. Vinod Kothari (1) discuss that leasing industry originated in the western countries, and is widely used in those countries to finance long term investments. Leasing activity in India was initiated in 1973 with the first leasing company named “First Leasing Company Of India Ltd”. Since, a number of medium to large sized companies, financial institutions like IRCl, ICICI and GIC have also entered the field of leasing.

1.1 CONCEPT OF LEASING
A lease may be defined as a contractual arrangement in which a party owning an asset (lessor) provides the asset transfers the right to use the equipment to the user (lessee) over a certain agreed period of time for consideration in the form of return for periodic payment (rentals) with or without a further payment. Leasing is the process through which the use of an asset is obtained through a number of predetermined payments over a period of time. Kampumure Joseph (2009) (2) reviews that leasing is an attractive form of financing because of its flexibility. There are two types of leasing: Financial lease and Operating lease. A financial lease is that lease in which all the risks and rewards are transferred incidental to the lessee except the little of ownership. It is a long term non-cancellable contract. On the other hand operating lease is a short term cancellable lease contract, where the lessee agrees to make periodic payments to the lessor, to use an asset. Susan S. K. Lee October (2003) (3) studied that capital leases are considered equivalent to a purchase, while operating leases cover the use of an asset for a period of time and are treated by the lessee as periodic expenses. Miller, M.H. and C.W. Upton (1983) (4) analyze that “Leasing separates ownership and use as to economic activities and facilitates asset use without ownership.” Thus, leasing is a process by which a firm can obtain the use of a certain fixed asset for which it must make a number of contractual, periodic, tax deductible payments. International Accounting standard (ias.plus.com) (5) has attempted to explain the concept of leasing in a very precise manner they said lease is “an agreement whereby the lessor conveys to the lessee in return for rent the right to use an asset for an agreed period of time.” Leasing therefore enables a firm to avail the services of plant or equipment without making the investment or incurring debt obligation.

Finance Lease Fig1.3
Source: Adapted from FAO and GTZ (2004)

2. OBJECTIVE

1) To study the effect of lease structure on the financial statements of the company.
2) To analyses the effect of different lease structure on the performance or profitability of the company.

3. LITERATURE REVIEW

Aswath Damodaran (2009) \(^6\) suggests that the value that we assign a firm and its equity can be affected by how we account for operating leases. Vinod Kothari (2015) \(^7\) reveals that sum-of-year’s digits depreciation method is rarely used in practice. The straight-line method leaves a company exposed to a much greater probability of an unexpected asset impairment loss. Indra M. Pandey (2010) \(^8\) evaluates that the winners of future would be either those leasing companies which are large in size and affect economies of scale or those which are associated with business houses. Brahmaiah B (2007) \(^9\) focuses mainly on the growth, problems and prospects of leasing industry in India, concludes that the prospects of leasing are high because of the high potential in market. Daniela Popa, Halmi Mirela (2011) \(^10\) concluded that the economic growth of developed countries was mostly due to the encouragement of any type of leasing. Sahar Nasr (2009) \(^11\) analyses that leasing industry is underdeveloped in MENA, despite its potential for supporting the development of small and medium firms economic activities. Ajai Nair, Renate Kloeppinger Todd, Annabel Mulder (Feb.18,2007)\(^12\) examine the potential of leasing as tool in rural finance .The study suggests that small and medium enterprises in rural areas benefited from access to leasing.

4. CONCEPT OF FINANCIAL STATEMENTS

A financial statement is a formal record of the financial activities and position of a business. Financial statements comprise income statement, balance sheet and other statements that reveal the financial position of a firm. (Financial statements, Investopedia) \(^13\). The objective of financial statement analysis is a detailed cause and effect study of the profitability and financial position of the firm.

Example: Suppose that a company leases a machine with a fair market value of Rs. 1,00,000. They lease it for five years with annual lease payment of Rs. 23,341; the interest rate in the lease is 8% with the expected residual value will be Rs.10,000. For an operating lease the rent expense each year is the same as the (pretax) cash flow each year:

<table>
<thead>
<tr>
<th>Year</th>
<th>Rent Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>23,341 Rs</td>
</tr>
<tr>
<td>2</td>
<td>23,341 Rs</td>
</tr>
<tr>
<td>3</td>
<td>23,341 Rs</td>
</tr>
<tr>
<td>4</td>
<td>23,341 Rs</td>
</tr>
<tr>
<td>5</td>
<td>23,341 Rs</td>
</tr>
</tbody>
</table>

| Total Expenses | 116,705 Rs |

Table 4.1 is about the operating lease. But for a finance lease, the expenses (interest plus depreciation) each year do not equal the (pretax) cash flow each year, but the total expenses over the life of the lease equals the total (pretax) cash flow over the life of the lease.
In an operating lease the entire lease payments are the rent which is an operating expense. Operating lease payment is rent. In a financial lease, the interest is an operating expense (a non-operating expense) and last is depreciation expense (a non-operating expense). The expenses for the financial lease will be higher than those for the operating lease in the early years and lower in the later years. From the above example it is clear that before tax cash flow are the same whether the lease is treated as an operating lease or as a financial lease but the after tax cash flow can differ the amount as well as nature of the financial statements.

5. EFFECT ON FINANCIAL STATEMENTS

Now on the basis of above example we can see the effect of the lease structure on the different financial statements like income statement, balance sheet.

5.1 Effect on Income Statement
Operating Lease: In an operating lease the entire lease payments are the rent which is an operating expense. Furthermore, this expense is same every year, and the ending value is the beginning balance less the principal paid (100000 – 15341 = 84659 and so on). Using straight line depreciation, the annual depreciation will be 18000. [i.e. - (100000-10000)/5]
Financial Lease: In a finance lease, there are three parts of payments. First one is the interest expense (a non-operating expense), interest is a non-operating expense under a finance lease (depreciation) will be lower than under an operating lease (rent) every year, second one is principal (not an expense) and last is depreciation expense (a non-operating expense). The expenses for the finance lease will be greater than those for the operating lease in the early years and lower in the later years. (Effect of Leases on financial statements for Lessors)[14]

5.2 Effect on Balance Sheet
Operating Lease: In an operating lease, no asset and no liability is recorded at the inception of the lease. Entire operating lease payment is rent. It appears on the income statement as an operating expense.
Financial Lease: Nothing is recorded on its balance sheet in a finance lease. An asset and a liability are each recorded, in an amount equal to the present value of the minimum lease payments. At the beginning, the lessee will record an asset and a liability (lease payable). Each year the lessee will show interest expense and depreciation on its income statement. A reduction in the lease payable (because of principal payment) on the balance sheet and accumulated depreciation on the balance sheet. Thus, for the life of the lease, assets and liabilities will be greater under a finance lease than an operating lease. Total assets more than total liabilities means shareholders equity is positive; the increase in liabilities or debt under finance lease will be greater than increase in assets, so debt to equity will be higher under finance lease. The current ratio will be lower under a finance lease.

5.3 Effect on statement of cash flow
Operating Lease: Under an operating lease, the entire payment is rent, which is operating cash (out) flow. Financial Lease: Under Financial lease, the interest paid is operating cash (out) flow, but the principal paid is financing cash out (flow). Thus, under a financial lease total (after-tax) cash flow will be higher in the early years.

Operating Lease Effect On:

<table>
<thead>
<tr>
<th>BALANCE SHEET</th>
<th>No asset or liabilities are recorded.</th>
</tr>
</thead>
<tbody>
<tr>
<td>INCOME STATEMENT</td>
<td>The operating lease payment will be treated as an operating.</td>
</tr>
<tr>
<td>CASH FLOW STATEMENT</td>
<td>Cash flow from operations will includes the total lease payments for the specific accounting period.</td>
</tr>
</tbody>
</table>

6. CONCLUSION

At the end it was concluded that, leasing has been center of attraction in the last few years. From table 6.1 it was concluded that the current ratio is higher in operating lease than financial lease so it indicates that firm using operating lease are generally having good short term financial strength (Future of leasing).[15] Expenses are lower and incomes
are more in operating lease as compare to financial lease. As well as operating lease is growing significantly in India. Lessees are opting for it for a variety of reasons- Taxation, off balance sheet, freeing up regulatory capital and so on. This is the trend going on decision gone wrong may involve high cost.

<table>
<thead>
<tr>
<th>Account/Ratio</th>
<th>Operating lease</th>
<th>Financial lease</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liability</td>
<td>Lower</td>
<td>Higher</td>
</tr>
<tr>
<td>Current Asset</td>
<td>Same</td>
<td>Same</td>
</tr>
<tr>
<td>Current Liability</td>
<td>Lower</td>
<td>Higher</td>
</tr>
<tr>
<td>Current Ratio</td>
<td>Higher</td>
<td>Lower</td>
</tr>
<tr>
<td>G.P Margin</td>
<td>Same</td>
<td>Same</td>
</tr>
<tr>
<td>Net Income</td>
<td>Higher</td>
<td>Lower</td>
</tr>
<tr>
<td>Total Expenses</td>
<td>Lower</td>
<td>Higher</td>
</tr>
<tr>
<td>Net Profit Margin</td>
<td>Higher</td>
<td>Lower</td>
</tr>
</tbody>
</table>

REFERENCE