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Lease Financing

A lease is a contractual agreement whereby one party i.e., the owner of an asset grants the other party the right to use the asset in return for a periodic payment. In other words it is a renting of an asset for some specified period.

The owner of the assets is called the 'lessor' while the party that uses the assets is known as the 'lessee' (see Box A). The lessee pays a fixed periodic amount called lease rental to the lessor for the use of the asset. The terms and conditions regulating the lease arrangements are given in the lease contract. At the end of the lease period, the asset goes back to the lessor. Lease finance provides an important means of modernisation and diversification to the firm. Such type of financing is more prevalent in the acquisition of such assets as computers and electronic equipment which become obsolete quicker because of the fast changingntechnological developments. While making the leasing decision, the costof leasing an asset must be compared with the cost of owning the same.

Merits

The important merits of lease financing are as follows:

(i) It enables the lessee to acquire the asset with a lower investment;

(ii) Simple documentation makes it easier to finance assets;

(iii) Lease rentals paid by the lessee are deductible for computing taxable profits;

(iv) It provides finance without diluting the ownership or control of business;

(v) The lease agreement does not affect the debt raising capacity of an enterprise;

(vi) The risk of obsolescence is borne

by the lesser. This allows greater flexibility to the lessee to replace the asset.

Limitations

The limitations of lease financing are given as below:

(i) A lease arrangement may impose certain restrictions on the use of assets. For example, it may not allow the lessee to make any alteration or modification in the asset;

(ii) The normal business operations may be affected in case the lease is not renewed;

(iii) It may result in higher payout obligation in case the equipment is not found useful and the lessee opts for premature termination of the lease agreement; and

(iv) The lessee never becomes the owner of the asset. It deprives him of the residual value of the asset.