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Leasing and Hire Purchase

Chapter Objectives

This chapter will enable you to develop an understanding of the following:

1 *Lease financing*
2 *Leasing and economic growth*
3 *Leasing in India*
4 *Lease structure*
5 *Rights, obligations and responsibilities of the lessor*
6 *Rights, obligations and responsibilities of the lessee*
7 *Types of leases*
8 *Difference between operating and finance lease*
9 *Advantages and disadvantages of leasing*
10 *Accounting for lease*
11 *Hire purchase*
12 *Difference between leasing and hire purchase*
13 *Instalment-purchase system*
14 *Difference between hire purchase and instalment*

INTRODUCTION TO LEASE FINANCING

There are various forms of financing business assets. An entrepreneur may finance business assets through his own funds or borrowed funds. An alternative form of financing or acquisition of an asset/assets emerged in the early 1950s in the United States, wherein without owning the asset and raising funds either through equity or debt, including loan, an entrepreneur gets the right to use the asset. This alternative form of financing is known as 'leasing.'

In simple terms, lease is a method of acquiring right to use an equipment or asset for a consideration.

Lease can be defined as 'a contract between owner of an asset (lessor) and the user of the asset (lessee), under which the lessor gives the right to the lessee to use the asset or equipment for agreed period of time and consideration called "lease rental".'

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, on leases, 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.

International Accounting Standard 17 (IAS-17), on 'leases,' 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.

Leasing is suitable for financing most investments such as agricultural equipments, medical equipments, construction equipments, office equipments, machinery, aircraft, high-value cars, software, green energy and windmills, corporate jets, telecom towers, satellite, mining equipments and alternate energy, and is also available to a broad range of businesses such as corporates, hospitals, educational institutions and government agencies.

As per the 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 sales tax is levied on the lease rentals. The sales-tax rates differ in different states and in case of inter-state sale, the sales-tax rate applicable will be the state where the agreement is entered into. Moreover, a 12.36% service tax is chargeable on the interest portion of the lease rental and other charges.

Leasing and Economic Growth

- Lease is a contract between owner of an asset (lessor) and the user of the asset (lessee) under which the lessor gives the right to the lessee to use the asset for agreed period of time and consideration, called lease rental.

Leasing has developed as a complementary tool to bank loan and has increased competition in the financial sector. As no upfront payment is to be made to acquire the asset on a lease, leasing promotes investment in capital equipments, which, in turn, leads to an increase in the domestic production. Leasing leaves lines of credit free for working capital, investments, or unexpected emergencies. It provides opportunities to extend product lines and enables product-portfolio diversification.

Leasing also provides security against equipment obsolescence, thus freeing the lessee from the worries of resale of obsolete equipments. This facilitates a speedy transfer of new technology, which leads to a higher capital formation and economic growth. SME sector development is often hindered by the lack of access to long-term finance that is required for capital investment. Moreover, these businesses often do not have the track record, collateral, or expertise to obtain term-financing from banks. The cost of buying new equipment to meet the changing and growing business needs can be difficult for most small businesses. Leasing helps start-ups, small businesses and growing businesses to further capital investment.

Leasing is infrastructure-friendly and can contribute to a country's infrastructure growth. Leverage lease and sale and leaseback can help in boosting investment in infrastructure. Leasing industry has met the needs of the Indian government to finance the railways or telecommunications, or computers for e-governance in various states. The government has allowed the entry of private players in the railway-wagon leasing, which was a monopoly of Indian Railway Finance Corporation. New customized and special-purpose containers will enter the market and coal, automobiles, steel and cement companies will be the major beneficiaries as they will be able to take wagons on lease depending on their requirements.

Leasing in India

The first leasing company of India pioneered the concept of leasing in India in 1973. Till 1981, it was the only leasing company in the country. Looking at its success, many companies and development financial institutions forayed into this business. The government also encouraged competition in leasing business. The banks were allowed to enter into this business in 1994. The State Bank of India is into big-ticket finance leasing. The cost of the equipment being leased is the ticket size. The ticket size may be small, medium or big. The bank undertakes leasing contracts worth a minimum of ₹5 crore. Besides banks, many foreign-owned financial firms like GE Capital are in this business. There were around 400 companies in the leasing business in the 1990s. The government permitted companies to raise initial public offering from the capital market, to prevent leasing companies from leaning on the banking system for funds. Leasing companies, to raise funds, promised dividend rates of 18% and interest rates on deposits much higher than that paid by the banks (6–8% higher than the bank-deposit rate). Many non-banking finance companies in leasing business cheated depositors and proved to be fly-by-night operators. The leasing industry got into deep trouble with these scams. Two of the largest leasing companies sold off their business to a leading financial institution. The RBI brought these leasing companies into its regulatory ambit in 1998 and subjected them to prudential norms. The regulator classified them into deposit-taking and non-deposit-taking NBFCs. The non-deposit-taking NBFCs were subject to higher and stricter provisioning norms so as to prevent the flow of bank credit to them. NBFCs accepting deposits have to appoint a trustee and create a floating charge over the SLR securities that were held as special reserves to backstop the deposit liability. Equipment-leasing companies and hire-puchase companies are classified as Asset Finance Companies (AFC). The RBI has defined AFC as any company which is a financial institution carrying on as its principal business the financing of physical assets supporting productive/economic activity, such as automobiles, tractors, lathe machines, generator sets, earth-moving and material-handling equipments, moving on own power and general-purpose industrial machines. The principal business for this purpose is defined as an aggregate of financing real/physical assets supporting economic activity and income arising there from is not less than 60% of its total assets and total income, respectively.

LEASE STRUCTURE

1. Lease is a contract between two parties: the owner, called the lessor, and the user, called the lessee. It is not necessary for the lessor to own an asset, if he has the right to use the asset, but can sublease unless the original lessor has restricted the right to sublease.
2. Any asset, article or property can be leased. Only tangible assets such as an automobile, aircraft, machine, consumer durable, land, building, factory can be leased. But, nowadays, software is also leased.
3. The contract is for a specified time period and the lessee has to return the asset at the end of the lease period. Lease contracts are usually structured for a tenor of 5–7 years. A financial lease contract may include two types of lease periods known as the 'primary lease period' and the 'secondary lease period.' An original lease-contract period is known as the 'primary period' or 'minimum lease term,' for example, 5 years. This is the length of the contract that the lessee agrees to be bound with the contract terms and conditions, and is non-cancellable. It is the period over which the lessor expects to recover his investment. If the lessee wishes to end the agreement

early, then he will normally be subject to termination costs as contained within the lease contract. The contract ends at the the end of the primary lease period and the asset is returned to the lessor. The following options are available to the lessee at the end of the primary lease period: (i) Option to buy the asset at a mutually agreed price or at a fair market value; (ii) Option to renew the lease; and (iii) Option to return the asset.

If the lessee wants an extension to the primary lease period, he can get provided there is a clause in the lease agreement or the lessor agrees to it. Any extension to the primary lease period is known as a secondary lease period. It allows the lessee to use a substantial part of the remaining asset value.

4. The amount paid by the lessee to acquire the right to use the asset is known as 'lease rental.' In case of a financial lease transaction, lease rental comprises of principal repayment plus interest. If it is an operating lease, the lease rentals include interest on principal, service charges, depreciation charges and other incidental costs such as repairs and maintenance, and insurance. Lease rentals are payable after the delivery of the asset for the lease period.

Sometimes, the lessee may be required to pay an upfront payment in the form of advance lease rental or security deposit. Leasing companies charge a lease-management fee—an upfront, non-refundable fee for services rendered like processing/marketing and so on.

Lease rentals may be equated monthly instalments (EMIs) or structured. EMIs are instalments of equal amounts paid every month during the lease tenor by the lessee to the lessor. Structured rentals are not equated over the lease tenor and are tailor-made to fit the lessee's cash inflows from the use of the asset. They are of two types: Stepped-up rentals wherein the lessee pays smaller rental amounts at the beginning of the lease period and larger rental amounts towards the end of the lease period and Stepped-down rentals wherein the lessee pays larger rental amounts at the beginning of the lease period and lower rental amounts towards the end of the lease period.

Rights, Obligations and Responsibilities of the Lessor

- Obligation of acquiring the lease asset according to the lessee's specification.
- Right of ownership of the leased asset.
- Right to claim depreciation on the asset.
- Right to ensure that the asset is put to fair use and within the limitations contained in the agreement.
- Right to recover the rentals and other sums payable by the lessee under the agreement.
- Right to sue in case of conversion of the asset by the lessee.
- Right to terminate the lease contract in case of misuse of leased goods by the lessee or if the lessee does not pay the lease rentals.
- Right to reimbursement of damages in case of misuse of leased assets.
- Right to the recovery of the leased asset in the event of the lessee's failure to pay the lease rentals or lessee's bankruptcy.
- Responsibility towards the lessee for legal deficiencies of the leased asset (if the third person exercises a right over the lease asset, which excludes, diminishes or limits lessee's unrestricted possession of the asset) and responsibility towards the lessee for suffered damages in this respect.

Rights, Obligations and Responsibilities of the Lessee

- Obligation to pay the lease rentals periodically as specified in the lease agreement.
- Obligation to keep the asset insured at all times for an amount equal to the full insurable value of the asset.
- Obligation to return the leased asset to the lessor upon expiration or earlier termination of this lease agreement.
- Right to use and operate the asset during the lease period, according to the terms of the lease agreement.
- Right to terminate the financial lease contract if the asset has not been delivered in line with the contract (if the supplier does not deliver the asset, delivers the asset with delay or if the asset has a material deficiency).
- Right of damage compensation and termination of the lease rental payment until the delivery of the leased asset is in line with the lease contract.

- Responsibility for the damage caused by using the lease asset.
- Responsibility for a sudden devastation or damage of the leased asset from the moment of taking over the asset.

TYPES OF LEASES

Types of Leases

- Financial Lease
- Operating Lease
- Sale and Leaseback
- Leverage Leasing
- Close and Open-ended Lease
- Upfront and Back-end Lease
- Percentage Lease
- 3N Lease
- Cross-border Lease

1. Financial Lease Financial lease is also known as Capital lease—a means of financing capital equipments. A financial lease is a lease that transfers substantially all the risks and rewards incident to the ownership of an asset to the lesse, though the lessor is the legal owner in substance. Title may or may not eventually be transferred. It is the alternative to own funds, bank credit and borrowing, through the issue of debt securities. According to AS-19, whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form.

In financial lease, the asset is leased for a long period. Generally, the time duration is equal to the economic life of the asset. Economic life is either:

1. the period over which an asset is expected to be economically usable by one or more users; or
2. the number of production or similar units expected to be obtained from the asset by one or more users.

This lease is non-cancellable in nature; and at the end of the lease period, the lessee has the option to buy the asset. The AS-19 defines a non-cancellable lease as a lease that is cancellable only:

1. upon the occurrence of some remote contingency; or
2. with the permission of the lessor; or
3. if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or
4. upon payment by the lessee of an additional amount, such that, at inception, continuation of the lease is reasonably certain.

Thus, in the case of a finance lease,

1. the entire risk incidental to the ownership of the asset and the benefits arising from the use of the asset are transferred to the lessee except the legal title which may or may not be eventually transferred;
2. the lessor transfers the ownership of the asset to the lessee by the end of the lease term;
3. the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable, such that, at the inception of the lease, it is reasonably certain that the option will be exercised;
4. the lease term is for the major part of the economic life of the asset even if the title is not transferred;
5. at the inception of the lease, the present value of the minimum lease payment amounts to at least substantially all of the fair value of the leased asset; and
6. the leased asset is of a specialized nature, such that, only the lessee can use it without major modifications being made.

Indicators of situations which individually or in combination could also lead to a lease being classified as a finance lease are:

1. if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
2. gains or losses from the fluctuation in the fair value of the residual fall on the lessee (e.g., in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and
3. the lessee can continue the lease for a secondary period at a rent which is substantially lower than the market rent.

2. Operating Lease A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incident to ownership. Both AS-19 as well as IAS-17 define operating lease as a lease other than a finance lease. An operating lease is a lease in which the period of lease is short when compared to the useful life of the asset or the equipment being leased. An operating lease is mostly used to acquire assets on a relatively short-period basis. 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. The lease period being short, the 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.

Difference Between Operating and Finance Lease

Point	*Financial Lease*	*Operating Lease*
Duration	Financial Lease is generally for the whole useful life of the asset.	Operating Lease is generally for a shorter duration.
Revocation	Financial-lease contract cannot be revoked.	Operating-lease contract is revocable.
Maintenance	In Financial 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.
Obsolescence Risk	The Lessee has to bear the risk of obsolescence.	The Lessor has to bear the risk of obsolescence.
Option of Purchase	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.
Economic Service	Being a Capital Lease, it is only an exchange of money for money and does not result in the creation of economic services.	It is basically an economic service.

3. Sale and Leaseback In this type of lease, the owner of an asset sells that asset to the lessor and then gets the asset back on lease from the lessor. The purpose of the leaseback is to free up the original owner's capital while allowing the owner to retain possession and use of the property.

A sale and leaseback can be beneficial to both the buyer as well as the seller. The seller gets a lump-sum of cash quickly which improves the liquidity. And the lessor gets the benefit in terms of tax credit and a flow of regular income.

The sale and leaseback arrangement is popular among companies which are facing short-term liquidity crisis. Oil and Natural Gas Commission (ONGC), undertook an international 'sale and leaseback' agreement with 10 Japanese lessors, led by Sumisho Leasing for an equipment owned by the ONGC, aggregating $60 million. The payment terms were fixed at a rate of 10.5% with the amount repayable in 14 equal semi-annual instalments, following a grace period of 6 years, so that the aggregate lease tenor extended to 13 years. The ONGC simultaneously swapped the fixed-rate borrowing with a floating-interest rate so that the cost of funds was reduced to 60 basis points below Libor.

4. Leverage Leasing Under leveraged-leasing arrangement, a third party is involved besides the lessor and the lessee. The lessor borrows a part of the purchase cost (say 80%) of the asset from the third party, that is, the lender and the asset so purchased is held as a security against the loan. The lender is paid off from the lease rentals directly by the lessee and the surplus after meeting the claims of the lender goes to the lessor. The lessor, the owner of the asset, is entitled to a depreciation allowance, associated with the asset.

5. 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, where as in an open-ended lease, the lessee has the option of purchasing the asset.

6. Upfront 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. Where as in the back-end lease, in the initial years, the lease rentals are less but increase in the later years.

7. Percentage Lease In the percentage lease, the lessor needs to pay fix-lease rentals plus some percentage of the previous year's gross revenue.

8. 3N Lease (Net and Net-net Leases) In the Net and Net-net leases, the lessee is responsible for maintenance, insurance and taxes of the property.

9. Cross-border Lease In the cross-border or international lease, the lessee and the lessor are situated in two different countries.

Commonly-used Lease Terminology

1. Wet lease: A wet lease is a leasing arrangement whereby one airline (lessor) provides an aircraft, complete crew, maintenance and insurance (also known as an ACMI lease) to another airline (lessee), who pays by hours operated. Kingfisher Airlines wet leased four new Airbus aircraft to Air India in January 2008. Jet Airways wet leased two aircrafts to Oman Air for a period of 6 months each, with effect from May 2009, under the ongoing, route-restructuring and cost-saving programme, undertaken by the company. The operational control and maintenance responsibility remains with the company. The aircraft remains on Indian registry and is operated with the company's crew.

Under wet lease as opposed to dry lease, a carrier leases its aircraft to another airline along with its crew. The lessee provides fuel, covers airport fees and any other duties, taxes and so on. The flight uses the flight number of the lessee. A wet lease, generally, lasts from 1 month to 2 years. It is typically utilized during peak traffic seasons or annual heavy-maintenance checks, or to initiate new routes. Ground handling is usually done by the lessor even though this can vary from country to country. In some cases, the lessee provides these services.

2. Dry lease: 'Dry lease' refers to leasing the aircraft alone. A wet lease without crew is occasionally referred to as a 'moist lease.'

Advantages and Disadvantages of Leasing

Leasing is a popular financing option for the following reasons:

Advantages of Leasing

- No large outlay
- Tax Advantages
- Budgeting
- Hedge against risk of obsolescence.

(i) No Large Outlay Leasing could provide 100% financing as the lessor buys the equipment and leases to the lessee. The lessee need not make large cash payments for the purchase of the needed equipment. It finances a higher percentage of the price of the leased asset when compared to a bank loan. In addition, the lessor also finances the value-added tax (VAT). Leasing frees the working capital for more productive use. This can significantly help to maintain cash flow, which is critical to all businesses. Poor cash flow is the main cause of small business failures, and leasing can help to keep it under better control. It also allows using better equipment that would be too expensive to buy outright. Leasing has been helpful for start-ups and growing firms where finance is stretched. A leasing arrangement does not limit the firm's ability to raise credit.

(ii) Tax Advantages Under a finance lease, the lessor gets the benefit of tax depreciation. Lease rentals are considered as an operating cost, which means that it is possible to deduct them from taxable profits (as a trading expense). As lease rentals are fully tax-deductible, the cost of the asset is written-off in the lessee's books over the lease period. Leasing permits a more rapid amortization of the asset. In case of front-end-loaded leases, the write-off is as high as 50% of the cost in the very first year.

(iii) Budgeting As a lease agreement is almost always a fixed contract, it is relatively easy to budget and forecast with. The amount can be worked into business budgets much more easily than an irregularly-occurring lump-sum; allowing to keep a much better control over the current and future cash flow.

(iv) Hedge Against Risk of Obsolescence In an operating lease, the obsolescence risk is borne by the lessor. Likewise, the lessee is saved of the trouble of having to dispose of the asset that he is not using—by simply terminating the contract or returning it to the lessor.

- **Flexible finance:** Leasing contracts can be structured to accomodate the cash-flow needs of the lessee, in accordance with production flows and cash cycles. It is flexible on terms and repayment periods. It is simple to negotiate and administer. Moreover, the leasing company does not require any collateral, as the lessor retains the ownership of the leased asset. A leasing plan can be tailor-made to suit the requirements of the lessee.
- **No coercive covenants:** Leasing companies do not impose coercive conditions—such as restrictions on the transfer of shares, issue of bonus shares, right to appoint nominee directors, convertibility clause. Loan agreements with banks usually contain coercive covenants.
  - **Inflation-friendly**: Leasing is fixed-rate financing; Even though the costs go up over the years, the lessee pays the same agreed rate and the equal monthly-lease rentals.
  - **Vendor-leasing:** Leasing companies have helped companies dealing in computer hardware and electronic copier machines to multiply their sales through vendor-leasing programmes.

Disadvantages of Leasing

Disadvantages of Leasing

- No ownership
- Long-term expense
- Cost of maintenance
- Restrictions on use of equipment.
- Termination of the contract in case of default.

Although leasing is a preferred alternative means of financing, it may not be suitable for all kinds of equipments or industries.

(i) No Ownership The main disadvantage of leasing is that business will never own the asset. It remains the property of the leasing company during and after the lease. The only exception is in the case of a financial lease. It may happen that when the lessee decides to purchase the asset, it would have depreciated significantly.

(ii) Long-term Expense Although leasing allows businesses to avoid paying a large lump-sum, over a long period of time, it often works out considerably more expensive. Over the course of a standard lease, a business pays the cost of the equipment as well as the leasing company's charges. Moreover, as lease cannot be terminated before the original term is completed, it can pose a major financial problem for the lessee when the business experiences a downturn.

(iii) Cost of Maintenance In leasing, the lessee is responsible for maintaining the equipment, as specified by the terms of the lease, and failure to do so can prove costly to him.

(iv) Restrictions on Use of Equipment Sometimes, the lease agreement may pose some restrictions on the use of the equipment, thereby making it uneconomical for the lessee.

(v) Consequences of Default If the lessee makes default in payment of lease rentals, the lessor can terminate the contract and take back the leased assets. In case of financial lease, the lessee needs to pay for damages and higher lease rentals in case of default.

Accounting for Lease in the Book of Lessee

1. **Accounting Treatment for Finance Lease** Finance lease will be capitalized in the books of the lessee and shown as both liabilities as well as assets in the balance sheet, at a present value of the committed lease rental. The asset will be capitalized under the 'fixed assets' category in the balance sheet, and the future lease-rentals payable will be shown in the liabilities side of the balance sheet.
   - The lessee will be entitled to depreciate the assets in the books of accounts. Costs, including depreciation, incurred in earning the lease income are recognized as an expense.
   - The total amount of lease rental is to be segregated into two parts, that is, principal amount and financial charges. Financial charges will be treated as expenses and shown in P&L account where as the principal amount will be deducted from the liability of the lease payable.

2. **Accounting Treatment for Operating Lease** Lease rentals under the operating lease will be treated as an expense and will be shown in the P&L account.

Accounting for Lease in the Book of Lessor

1. Accounting Treatment for Finance Lease
- In the books of the lessor, the leased asset will be shown in the balance sheet as a receivable at an amount equal to the net investment in the assets.
- The lease-payment receivable will be treated as a repayment of the principal.

2. Accounting Treatment for Operating Lease
- The asset will be shown in the balance sheet as a fixed asset and depreciation will be charged by the lessor as per the depreciation policy.
- The lease rentals received by the lessor will be shown in the P&L account as income.

Legal Aspect of Leasing

In India, we do not have a separate law for leasing. Lease contracts are treated as special cases of contract and the provisions relating to the bailment in the Indian Contract Act govern equipment-leasing contracts also. According to these provisions, the lessor and the lessee have the following duties to perform:

1. The lessor has the duty to deliver the equipment or assets to the lessee and also give him the legal authority to use the assets for the lease agreement.
2. The lessee has the duty to pay the lease rental as specified, in time, and also take reasonable care of the assets and return back the assets on expiry of the lease agreements.

Taxation Aspect of Leasing

Income-tax aspects relating to financial and operating lease are given as follows:

- Lease rentals paid by the lessee are tax-deductible expenses. Lease rental received by the lessor is treated as income and is taxable under the head of 'Profits and Gain' from business and profession.
- Irrespective of the type of leases, the lessor alone can claim depreciation as deduction and not the lessee.

HIRE PURCHASE

A hire-purchase agreement is a contract whereby the owner of the goods lets them on hire to another person called the 'hirer or hire purchaser' on payment of rent, to be paid in instalments, and upon an agreement that when a certain number of such instalments is paid, the title in the goods will pass to the hirer. The hirer may return the goods at any time without any obligation to pay the balance rent.

- Hire purchase agreement is a contract whereby the owner of the goods lets them on hire to hire purchaser on payment of rent, to be paid in instalments and the title in the goods will pass to the hirer on the payment of last instalment.

Essentials of Hire Purchase

- The delivery of goods will be given by the owner of the goods to the hire purchaser.
- Payment is to be made in instalments.
- Ownership of the goods passes to the hire purchaser only on payment of the last instalment.
- In the event of any default by the buyer, the seller can take back the possession of the goods, and the money paid by the buyer will be adjusted as rent for using the assets.

Difference Between Lease and Hire Purchase

Basis	*Lease*	*Hire Purchase*
Meaning	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.
Option to User	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.
Nature of Expenditure	Lease rentals paid by the lessee are entirely the revenue expenditure of the lessee.	Only interest element included in the hire-purchase Instalments is revenue expenditure in nature.
Components	Lease rentals comprise two elements: (1) Finance charge and (2) Capital recovery.	Hire-purchase instalments comprise three elements: (1) Normal trading profit, (2) Finance charge and (3) Recovery of cost of goods/assets.
Depreciation	Lessor can claim for depreciation.	Hire purchaser can claim for depreciation.
Tax Benefit	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.

Accounting for Hire Purchase

In the Books of Hire Purchaser

- In the books of the hire purchaser, the cash price of assets is capitalized and the asset is shown on the assets side in the balance sheet and the cash price, as reduced by the down payment, is shown on the liability side.
- Depreciation is charged by the hire purchaser based on cash price and his depreciation policy.
- The total finance charges paid by the purchaser are allocated over the hire period using several available methods, namely, the sum of the year digit, straight-line method of depreciation and so on.

In the Books of Hire Seller

- The seller should record the transaction as receivables (current assets) in the balance sheet.

Legal Aspects of Hire Purchase

A hire-purchase agreement is not a contract of sale, but only a bailment; and the property in the goods remains in the owner during the continuance of the bailment. In other words, a hire purchase is an agreement of bailment plus an agreement to sell.

The contract of hire purchase is governed by the special contract of bailment and Sale of Goods Act.

Taxation Aspect of Hire Purchase

In case of a hire-purchase transaction, the deduction can be claimed in respect of hire-purchase charges.

INSTALMENT PURCHASE

Instalment-purchase system is a credit sale in which the seller gives the facility to the buyer to pay the money in agreed instalments. In this kind of transaction, the possession and legal ownership of goods are passed to the buyer immediately.

Essential characteristics of this system are as follows:

- The buyer gets the immediate possession and ownership of the goods.
- The payment of price has to be made in agreed instalments.
- In the event of default by the buyer, the seller can sue the buyer for recovery of the balance payment.

Difference Between Instalment Purchase and Hire Purchase

Basis	*Hire Purchase*	*Instalment Purchase*
Transfer of Ownership	In a hire-purchase system, the ownership of the asset is transferred after the payment of all instalments.	In an instalment purchase, the ownership in goods passes to the buyer immediately at the time of sale.
Recovery of Goods	In case of hire purchase, if the buyer fails to pay the instalment, the seller can recover the goods back.	If the buyer fails to pay the instalment, the seller cannot recover the goods back.
Forfeiture of Instalment	In a hire-purchase transaction, in the event of the buyer's default, the seller can forfeit all the money paid by the buyer as rent for using the assets.	Whereas, in the case of an instalment purchase, the money paid by the buyer is taken as payment towards the selling price and the seller can sue only for the balance.

Conclusion

There is tremendous potential for the leasing industry in India. This industry can play a vital role in promoting investment and thereby economic growth.

KEY TERMS

Back-end Lease	Financial	Leverage Lease	Operating Lease	Upfront Lease
Close-ended Lease	Hire Purchase	Lessor and Lessee	Percentage Lease	Wet Lease
Cross-border Lease	Instalment	Net Lease	Sale and Leaseback	
Dry Lease	Lease Leasing	Open-ended Lease		

SUMMARY

1. Lease is a method of acquiring right to use an equipment or asset for a consideration.
2. A lease transaction is a deemed sale under the law and sales tax is levied on the lease rentals.
3. There are different types of leases. The main types are Financial Lease and Operating Lease.
4. A financial lease is a lease that transfers substantially all the risks and rewards incident to the ownership of an asset to the lessee, though the lessor is the legal owner in substance.
5. An operating lease is a lease in which the period of lease is short when compared to the useful life of the asset or equipment being leased. An operating lease is mostly used to acquire assets on a relatively short-period basis.
6. A hire-purchase agreement is a contract whereby the owner of the goods lets them on hire to another person called hirer or hire purchaser on payment of rent, to be paid in instalments, and upon an agreement that when a certain number of such instalments is paid, the title in the goods will pass to the hirer.
7. Instalment purchase system is a credit sale in which the seller gives the facility to the buyer to pay the money in agreed instalments.

REVIEW QUESTIONS

1. What is leasing? State the importance of leasing.
2. State the obligations, rights and responsibilities of the lessor and the lessee.
3. Distinguish between: Lease and Hire purchase; Hire Purchase and Instalment Purchase; and Financial Lease and Operating Lease.
4. What is a wet lease? How is it different from dry lease?
5. What are the elements in a lease structure?

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