FNCE20005 CORPORATE FINANCIAL DECISION MAKING

TUTORIAL 3: RAISING CAPITAL – DEBT AND LEASES - SOLUTIONS

SECTION A

QUESTION 1

We disagree with this statement. Leasing is a form of debt and should be treated as debt by management when it evaluates its company's capital structure. Similarly, prospective lenders can be expected to take into account the effect of lease commitments on a company's ability to service debt. The basis for statements such as the one in the question is that, formerly, a company was not required to disclose its finance lease obligations in its financial statements. Therefore, leasing was a form of 'off-balance sheet' financing, and a popular view was that the leasing of an asset(s) did not reduce a company's access to other forms of debt. In other words, leasing used to increase a company's access to debt but not anymore. The current Australian accounting standard requires disclosure of lease. Therefore, the lease is now "on the balance sheet".

QUESTION 2

Leasing aircraft under operating leases provides an airline with flexibility. In particular, if there is a downturn in demand for air travel, leased aircraft can be returned to the lessor at no cost to the lessee. In contrast, if an airline wishes to sell surplus aircraft, there are likely to be delays in finding buyers and the price may be depressed, particularly if other airlines are experiencing similar declines in demand. The main disadvantage of leasing is that it is likely to be more costly than owning. This is to be expected, because aircraft lessors will charge for providing the option to cancel the lease. Hence, to obtain a degree of flexibility at a reasonable cost, airlines usually lease only some of the aircraft they use.