PART-B

ESSAY QUESTIONS WITH SOLUTIONS

5.1 DEFINITION – SERVICES OF MERCHANT BANKS

Q9. What is Merchant Banking? What are the Services of Merchant Banks?

Answer : Q.10 Imp.

Model Paper-I, Q13(a)

Merchant Banking

Merchant Banking is defined differently in different countries. Though there is no universal definition for merchant banking functions and services offered by a merchant banker. It is also called as investment banking.

As per the Securities and Exchange Board of India (SEBI), 1992 defines, "merchant banker as a person who is engaged in the business of issues management either by making arrangement regarding selling, buying or subscribing to the securities as manager, consultant, advisor or rendering corporate advisory service in relation to such issue management".

Merchant banking is an institution that covers a broad range of activities like management of customer services, corporate governance, portfolio management, credit syndication, acceptance credit, counselling, insurance etc.

Functions/Services of Merchant Banks

Following are the functions and activities of a merchant banker in India.

1. Corporate Counselling

Broadly speaking, corporate counselling covers all the financial activities of a merchant banker. It refers to the activities undertaken to ensure effectiveness and efficiency in a clients performance. A merchant banker offers suggestions and opinions on various aspects like organizational size, locational factors, financial reporting, working capital management obtaining soft loans etc. A merchant banker acts like a managerial economist and a financial and investment expert, while performing basic corporate functions like reorganization, financial rearrangement, monitoring and rehabilitation services and exploring the possibilities for takeover of sick units etc.

2. Project Counselling

Project counselling is corporate counselling related to project finance. It includes preparing project reports, decisions related to financial structure of the project, project appraisal, suggesting on the feasibility and implementation of the projects, arranging foreign collaborations etc. (Merchant help clients in identifying a potential project and getting it approved by the Indian government). The projects can be appraised based on its location, technical, commercial ability.

3. Credit Syndication or Loan Syndication

Credit syndication function covers loan procurement and project financing through syndicates or consortium. Merchant bankers helps in estimating the total cost of a project by considering the location, size and promoter's interest in the project and advise on the financial institution to be approached. They prepare loan applications, and submit the same to the selected financial institutions. They also arrange for bridge finance and monitor the project to ensure that due diligence is exercised in the company's obligations under various regulations.

(i) Loan syndication refers to the assistance to get term loans provided by the merchant banks for the projects.

(ii) Such loans can be obtained either by a single financial institution or by group (syndicates or consortium).

(iii) Merchant banks assists clients to approach a particular financial institution (for term loans) on the basis of type of industry, location of unit and project cost.

(iv) They arrange bridge finance and monitor the project to ensure that due diligence is exercised in company's obligations.

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4. **Issue Management**

Issue management concerns all the activities related to the management of the public issue of the clients corporate securities i.e., equity shares, preference shares, debentures, bonds etc. It involves pre-issue management and post-issue management. As issue managers, merchant bankers prepare action plan and budget for the issue. Pre-issue management covers issue through prospectus, offer for sale and private placement, marketing and underwriting of issues and pricing of issues. Merchant bankers arrange for stock exchange clearances and listing of securities and ensure that the activities are in compliance with SEBI guidelines and regulations.

5. **Underwriting of Public Issue**

Merchant bankers also function as underwriters and aid in raising capital through external resources. Issues underwritten by reputed underwriters are easily subscribed and service high premium. Merchant banker can underwrite upto 15% of an issue. The lead managers should underwrite a minimum of 5% of a issue or ₹ 2.5 lakh whichever is less.

6. **Portfolio Management**

Portfolio management refers to the management of investment in different kinds of securities of different companies. Merchant bankers function as portfolio managers and advise clients on closing investment mix, based on the client's objectives and tax bracket. They analyze market and economic surveys and plan accordingly for profitable investment strategies.

7. **Financing Working Capital**

Merchant bankers also provide working capital finance to their clients. They also accept credit and discount bills for their clients to ensure that funds are not blocked.

8. **Negotiate in Merger and Acquisition**

Merchant bankers also perform specialized functions like advising on mergers and acquisitions. They play the role of middlemen and help in negotiations between their client and other parts of the merger. They conduct auditing and SWOT analysis before advising on the mergers and acquisitions. They explore global companies and examines pros and cons of acquisition proposals. After appraising merger/acquisition proposals for financial liability, they negotiate and monitor implementation of the merger. Merchant bankers ensure legal compliance in mergers and acquisitions.

9. **Venture Financing and Lease Financing**

Merchant bankers also offer venture financing and lease financing services to their special clients. They advise on the liability of lease deal and help in preparing lease deed and other documents.

10. **Foreign Currency Financing**

Merchant bankers also finance foreign trade transactions. They aid in export-import trade finance compliance with law obtaining different types of foreign currency loans and managing exchange risk. This function also includes arranging for the syndication of different forms of guarantees, letters of credit, bridge loans etc.

11. **Other Functions**

Merchant bankers also provide various other services acting as managers, consultants or advisers. They offer investment advisory services to the foreign investors and NRI's, even provides assistance in off-shore financies (joint venture, foreign collaborations etc.,).

Q10. What are the features of merchant banking? SIA

Answer :

The features of merchant banking or merchant bankers are as follows,

1. Issue management business is one of the business in which merchant bankers are mostly engaged.
2. Merchant bankers provide various services in issue management by making arrangements such as selling, buying and subscribing to securities.
3. Merchant bankers acts as a managers, consultant, advisor and portfolio manager in relation to issue management.
4. Specialist services are provided by merchant bankers which usually involves acceptance of bills of exchange, portfolio management, corporate finance and underwriting.
5. Large number of decision makers are employed by merchant banks.
6. Merchant banks concentrate on fee and commission income.
7. Merchant banking focus mainly on short and medium term engagements.
8. Merchant bankers provide special and sophisticated services at national and international level.
9. Merchant banking possess quick decision process.
10. Merchant banker's organization structure in India is established on any one form among the four forms i.e., institutional base, bankers base, private base and broker base.

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5.1.1 Problems and Scope of Merchant Banks

Q11. Explain in detail about the problems of merchant bankers.

Answer :

The problems of merchant bankers are discussed below,

1. Restrictions on Net Worth

SEBI has laid restrictions on the net worth of the merchant bankers. The minimum net worth for merchant bankers should be ₹ 1 crore. The merchant bankers whose net worth is below ₹ 1 crore have to shut down their business. Due to this reason, most of the young people and specialized professionals are restricted to enter into merchant banking business.

2. Restrictions on Scope of Activities

The regulations of SEBI has approved merchant bankers to deal only with issue related activities which restricted the activities and scope of merchant bankers.

The guidelines specifies that the merchant bankers should undertake only issue related activities, excluding portfolio management. This regulates and limits the scope of activities of the merchant banks.

3. Negligence of the Issuing Company

The issuing companies are creating a problem to the merchant bankers by neglecting the timely allotment of securities and not providing or refunding the application money on time.

4. Lack of Expertise

The scope of merchant banking is very broad, still it lacks expertise. In order to provide adequate merchant banking services, it should expand its expertise and help in the growth of merchant banking business.

5. Fraudulent Issue of Share Capital

The companies are creating problems to the merchant bankers by fake issue of share capital. This will damage the trust of the share holders on the merchant bankers, who deal with such issues.

6. Risky Competition

There are so many merchant banks due to which heavy competition is occuring among themselves. This will have bad effect on the profit margins and commissions of the merchant bankers.

7. Lack of Regulatory Framework

The merchant banks in India does not have any specific regulatory frameworks inorder to guide, regulate and control its activities. As this is a major problem, therefore specific regulatory framework should be formulated for the development of the merchant banks.

Q12. Explain the scope of merchant banking in India.

Answer :

The scope or role of merchant banking in India is discussed below,

1. New Issue Market's Steady Growth

The new issue market's growth has been outstanding since 1990-91. The capital issues by non-government public companies amounted to only 90 crores in the 1970s, it was increased to ₹ 1000 crores in 1980s and further increased to ₹ 12,700 crores in the first four years of 1990s. It was estimated that the figure ₹ 12,700 would raise upto ₹ 40,000 by the end of 1994-95. Even there is an increase in the capital issues from 363 to 900 from 1990-91 to 1993-94.

2. Foreign Investors Entry

The foreign institutional investors were allowed to invest both in primary and secondary markets and also the Indian companies were allowed to tap the foreign capital through euro issues, this was a remarkable development in the history of the Indian capital markets in the year 1992. Foreign direct investment have also shown fairly increment due to various incentives offered to them. Merchant bankers advise the NRI's on foreign direct investment in India and also the merchant bankers provides the services to the joint ventures in other countries by the Indian companies.

3. Fluctuations in the Financial Institutions Policies

The leading policies of the financial institutions laid emphasis on security orientation rather than on project orientation, but this scenario has been changed. Merchant bankers are required for providing expert services to corporate enterprises on project appraisal, financial management etc. Due to the policy of decentralization and encouragement to small and medium industries, the demand for technical and financial services provided by the merchant bankers will be at a peak.

4. Debt Market Development

The debt market has been functioning through the National Stock Exchange (NSE) and over the counter Exchange of India. As per the estimations of experts of ₹ 40,000 crores worth capital issues in the year 1994-95, a major portion of it will be contributed by the debt market. Many opportunities are being provided by the debt market development to the merchant bankers.

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5. **Financial Instrument's Innovations**

Due the innovations in the financial instruments, the role of merchant banker has been extended as market makers. The innovations that has been observed in the introduction of financial instruments are the non-convertible debentures with detachable warrants, cumulative convertible preference shares, zero coupon bonds, deep discount bonds, triple option bonds, secured premium notes, floating rate bonds, auction rated debentures and so on.

6. **Restructuring of Corporates**

With the introduction of LPG i.e., liberalization privatisation and globalization, the competition in the corporate world is soaring to great heights. The corporates need to be strong enough to withstand the competition. Some corporates in order to survive the competition, reviews their way of functioning, structure and their strategies. This has given way to corporate restricting which includes mergers, acquisitions, splits, disinvestment and financial restructuring.

7. **Disinvestment**

The government released ₹ 2000 crores from disinvesting the public sector undertaking equity shares in the year 1993-94. The method of periodic sale of public sector shares was proposed to be shifted to round the year off loading of shares directly on the stock exchange from the year 1995-96. The shares of the identified public sector would be sold by the government at any time during the year when they get a good price above minimum stipulated level.

5.1.2 Evolution, Functions and Types

Q13. Discuss about the evolution and growth of merchant banking in India.

Answer :

Evolution of Merchant Banking

The concept was developed in London when the merchants started floating bonds in London Money Markets to aid government of underdeveloped countries. The funds were raised for the long-term needs of the developing economics. Later, merchants moved to domestic business through syndication of short-term and long-term finance. With time, the scope of merchant bankers extended to underwriting of new issues, serving as registrars and share transfer agents, debenture trustees, portfolio managers etc. They also undertook specific functions like negotiating agents for mergers and takeover. The growing concept of merchant banking gained prominence in America and other countries also. Euro dollar and other innovative instruments were introduced and new financial centers were established in Singapore, Hong Kong, Dubai etc.

Growth of Merchant Banking in India

Specialized merchant banking services originated in India in 1969, when the ANZ Grindlays bank set-up the merchant banking division. It started with the management of public issues and selected consultancy services for corporate enterprises. SBI became the first Indian commercial bank in 1973 to offer merchant banking services. ICICI was the first development financial institution to offer Merchant Banking services in 1974. Thus, the early seventies mark the growth of merchant banking in India. In addition to the traditional services commercial banks, broker firms and financial institutions started offering merchant banking services.

In the mid-eighties, amendments in Banking Regulation Act, were made to encourage commercial banks to offer wider variety of financial services through their subsidiaries. By late eighties 33 merchant banks were operating including, Bank of India, Bank of Boroda, Canara Bank, Punjab National Bank and UCO Bank. Initially these players dealt with new capital issues management only.

In 1992, reforms were made in the capital markets and Indian economy was deregulated. SEBI was conferred statutory powers, Capital Issues Control Act was enacted and office of the controller of Capital Issues was abolished. All these reforms contributed to the improvement in efficiency and regulation of capital markets resulting in greater need for merchant banking. Merchant bankers assumed greater responsibility towards the investors in both legal and moral aspects. Considering the growing needs of the markets, nationalized banks opened up subsidiaries companies to operate as merchant banks.

By the end of 1992, there were 115 merchant banks. The number increased to 501 in just two years. Besides, we now have global merchant bankers like Merrill Lynch, Morgan Stanley, Goldman Sachs, Jardie Fleming etc.

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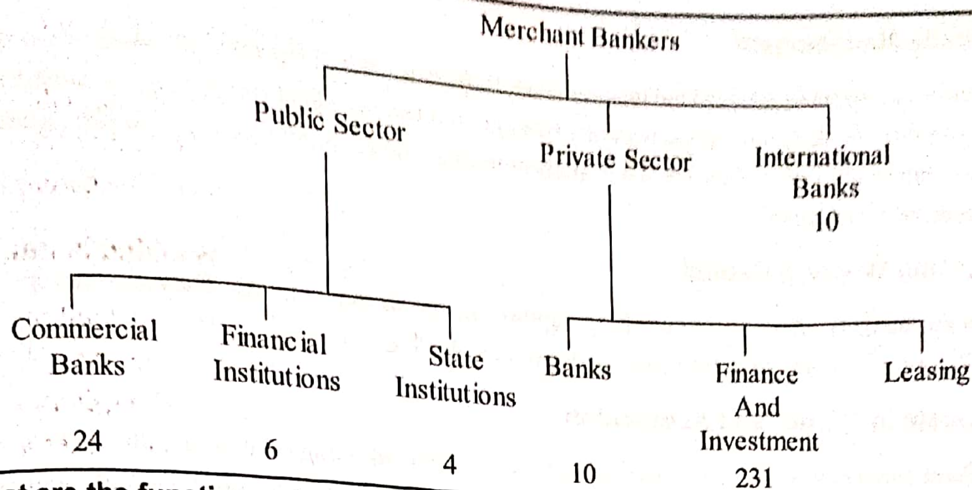

Q14. What are the functions of merchant bankers?

Answer :

The mechanism/functions of a merchant banker in India are as follows,

1. Corporate Counselling

Corporate counselling covers all the financial activities of a merchant banker. It refers to the activities undertaken to ensure effectiveness and efficiency in a clients performance. A merchant banker offers suggestions and opinions on various aspects like organizational size, locational factors, financial reporting, working capital management obtaining soft loans etc. A merchant banker acts like a managerial economist and a financial and investment expert, while performing basic corporate functions like reorganization, financial rearrangement, monitoring and rehabilitation services and exploring the possibilities for takeover of sick units etc.

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4. Issue Management

Issue management concerns all the activities related to the management of the public issue of the clients corporate securities i.e., equity shares, preference shares, debentures, bonds etc. It involves pre-issue management and post-issue management. As issue managers, merchant bankers prepare action plan and budget for the issue. Pre-issue management covers issue through prospectus, offer for sale and private placement, marketing and underwriting of issues and pricing of issues. Merchant bankers arrange for stock exchange clearances and listing of securities and ensure that the activities are in compliance with SEBI guidelines and regulations.

5. Underwriting of Public Issue

Merchant bankers also function as underwriters and aid in raising capital through external resources. Issues underwritten by reputed underwriters are easily subscribed and service high premium. Merchant banker can underwrite upto 15% of an issue. The lead managers should underwrite a minimum of 5% of a issue or ₹ 2.5 lakh whichever is less.

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6. Portfolio Management

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11. Other Functions

Merchant bankers also provide various other services acting as managers, consultants or advisers. They offer investment advisory services to the foreign investors and NRI's, even provides assistance in off-shore financies (joint venture, foreign collaborations etc.,).

Q15. Explain about the different types of merchant banking. SIA

Answer :

As per the 1992 guidelines of Securities Exchange Board of India (SEBI), merchant bankers are classified into four categories. They are depicted in the following figure,

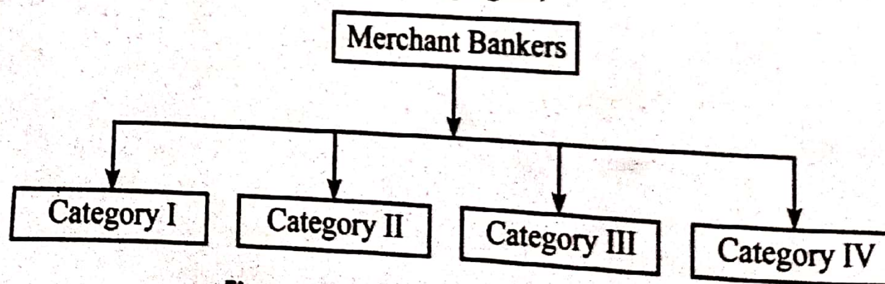

Figure: Categories of Merchant Bankers

1. Category I

Merchant bankers carrying on issue management activities belonged to category I. They act as issue manager, advisor, consultant, underwriter and portfolio manager. The activities perform by them includes preparation of prospects, tie up financiers, determining the financial structure, final allotment of securities, underwriting, consultant to an issue, portfolio management etc.

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2. Category II

The second category constitutes merchant bankers playing the role of advisors, consultants, co-manager, underwriter and portfolio manager. They are not allowed to act as issue manager of their own, however can act as co-manager.

3. Category III

Under third category, the merchant bankers could only acts as underwriter, advisor or consultant. They are not allowed to undertake issue management of their own or act as co-manager.

4. Category IV

Merchant bankers of fourth category are authorized to act only as consultant or advisor to an issue of capital.

Capital Adequacy Norms for Four Categories of Merchant Bankers

The capital adequacy norms which are set by SEBI for four categories of merchant bankers are as follows,

Category of Merchant Bankers	Minimum Net Worth (₹)
Category I	5 Crores
Category II	50 Lakhs
Category III	20 Lakhs
Category IV	NIL

FEES

SEBI is authorised to collect a fee for initial registration and renewal fee with effect from 1999. Merchant bankers have to pay ₹ 5 lakhs as registration fees at the time of certificate issued by the board. The registration fee should be paid within 15 days of notification given by the board. In case of renewal, the merchant bankers have to pay renewal fee of ₹ 2.5 lakhs every three years from the fourth year of initial registration.

5.2 VENTURE CAPITAL: MEANING, FEATURES

Q16. What is venture capital? State its features.

Answer : Imp Q-11 SIA

Venture Capital

According to National Venture Capital Association. "Venture Capital means money provided by professionals who invest alongisde management in young, rabidly growing companies that have the potential to develop into significant economic contributions".

According to the 'Jane Koloski Morris, Editor, Venture Economics', "Venture capital means providing seed, start-up and first stage financing' and also 'funding the expansion of companies that have already demonstrated their business potential but do not yet have access to the public securities market or to credit oriented institutional funding sources".

Features of Venture Capital

The features of venture capital are as follows,

1. Equity Participation

Venture capital financing is a real or potential equity participation via direct purchase of shares, options or convertible securities.

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2. Long-term Investment

Venture capital financing is a long-term illiquid investment as it can't be easily converted into cash on demand.

3. Participation in Management

Venture capital financing ensures and facilitates greater role of venture capitalist in the enterprise's management. In this way, the venture capitalist safeguards and increases his investment by actively participating and supporting the enterprise.

4. Co-promoter

Venture capitalist acts as co-promoter in the operations of an enterprise and shares the risks and rewards of an organisation.

5. Disinvestment

The venture capitalist disinvests his holdings either to the promoters or to the people in the market. The main criteria for disinvestment is not profit but capital appreciation.

6. Commercialization of New Ideas

Venture capital firms provides finance only to those firms who are commercialising the new ideas or new technologies and not for those firms/organisations/enterprises which are involved in trading, booking, financial services, agency, liaison work or research and development.

7. Provides Financial Assistance

Venture capitalists provides financial assistance and other required assistance to medium and small scale industries.

Q17. Discuss about the different stages of venture capital.

Model Paper-III, Q13(a)

Answer :

The stages of financing in the venture capital industry is classified into two broad categories as follows,

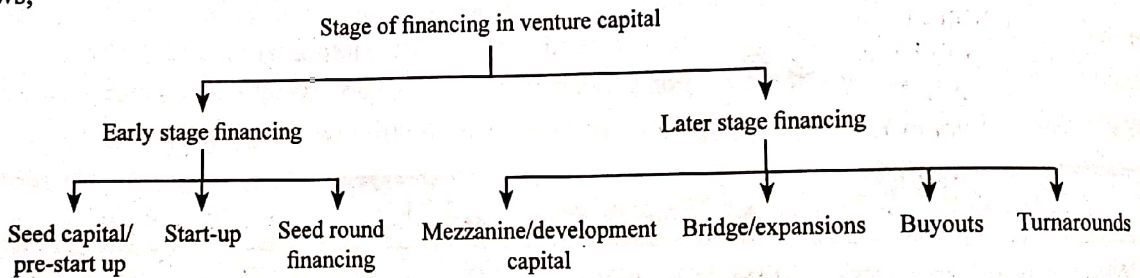

Figure: Stages of Venture Capital Financing

1. Early Stage Financing

The early stage financing comprises of the following,

(a) Seed-capital/Pre-start Up

Seed capital is the first stage of early stage financing wherein new ideas and concepts of the promoters form the basis of a pre-commercialization research project which is mostly expected to result in a prototype which may or may not lead to the establishment of the business. This stage is basically an "applied research" phase and it moves towards the development stage further resulting in prototype product testing and ultimately to the commercialization process.

This stage involves greater marketing risk. As a result, only few venture capital institutions makes the seed-capital investment in the pre-commercialization stage of product development.

(b) Start-up

Start-up stage of VC financing enables the commercial manufacturing to begin. In this stage, venture capitalists provides finance mainly for the product development and initial marketing. This stage holds greater significance because the product/service is commercialized for the first time in collaboration with the venture capital investments.

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(c) Second-round Financing

This stage indicates that the product has already been launched in the market, but the business has not grown enough to make public offerings in order to attract new customers. The time-period is less when compared to start-up investment. The VCIs provides/makes huge investment at this stage than at any other stage. A part of financing is also done in the form of debt, in order to provide some income to them.

2. Later Stage Financing

Later stage financing includes already existing businesses which needs additional financial support but cannot make public offerings. It includes the following,

(a) Mezzanine/Development Capital

Mezzanine capital provides finance to those existing businesses which have already gone through the high-risk early stage, have gained profits but not that enough to make public offerings and raise money from the capital market/conventional sources. Venture capital financing helps in purchasing new plant and machinery, widening the marketing and distribution facilities, re-finance of an existing debt, capturing new areas, establishing new management and so on.

The development capital is usually provided for a time-period of one to three years and holds medium risk level. It forms an important part of venture capital institutions' activities.

(b) Bridge/Expansion

Bridge or expansion capital is financed for a period ranging from one to three years and holds lower levels of risk. Bridge capital or expansion capital is used for expanding business by growing their own productive assets or by acquiring other firm's assets. In simple words, it depicts the last round of financing before a planned exit.

(c) Buyouts

Buyouts means transfer of management control. Buyouts are basically of two types,

(i) Management Buyouts (MBOs)

(ii) Management Buyins (MBIs).

(i) Management Buyouts: In MBOs, venture capital institutions provides finance to allow smooth functioning of the business and helps the existing operating management and the investors to acquire an existing product line or business.

(ii) Management Buyins (MBIs): MBIs are the funds which are offered to allow an outside group or a third party usually managers to form a group and buy an ongoing company. MBIs pull in together three important elements, a management team, a target company, an investor. The time period for buyouts ranges from one to three years with usually low risk perception.

(d) Turnarounds

Turnarounds are a sub-set of buyouts and includes buying the authority or control of a sick company. Turnarounds need two types of inputs, 'money' and 'management'. The venture capital institutions need to recognise good management and operation leadership. Turnarounds have medium to high levels of risks and their time-period ranges from three to five years. Turnarounds are becoming popular day by day and are being accepted on large scale and draws major part of VCIs attention.

5.2.1 Scope and Importance of Venture Capital

Q18. Explain the scope and importance of venture capital.

Answer :

Scope of Venture Capital

The scope of venture capital is described under the following points,

1. Promoting a Enterprise

Venture capital is used in establishing an enterprise. It helps in creating awareness about the various available opportunities, in constructing a plant layout, in finalizing all the formalities like applications, registration, etc., of the enterprise. It is also known as "seed capital", because it acts as a seed of the enterprise.

2. Formation of the Firm

During the formation of the company, the type of organization i.e., sole proprietorship business or partnership firm or company can be decided on the basis of venture capital. Because, finance is the basic requirement and it is used for the various purpose like, during the registration of the firm, making business contracts, getting incorporation certificate, getting business transaction certificate etc. The venture capital varies according to the changes in scale of production. If the scale of production is more, then venture capital will be high and if the scale of production is less, then venture capital will be low.

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3. Product Production

A company after incorporation has to start its production. Inorder to start production, adequate capital is required otherwise, it will become difficult to manage the payment of returns to the sources of production.

4. Management and Control of the Organization

Inorder to appoint employees and other required staff in the organization, venture capital is required. Employees plays crucial role in every organization because a owner cannot perform all the tasks individually. Further, capital is also required to verify the performance of employees i.e., to analyze the quality of the product, and the working strategy of the employees to check the consistency of the employees in achieving the targets of the organization etc.

5. Marketing the Product

After the goods are produced they need to be marketed. The requirement of venture capital varies according to the gap between the production and marketing. If the gap is more, then the amount of venture capital will be more and if the gap is less, then the amount of venture capital will be low. The firm has to make payment to the parties to whom payments are to be made, irrespective of the receipt of the capital.

6. Development and Expansion of the Firm

The basis for the firm depends on the timely inflow of capital. The development of the organization is done by emergence of new ideas, which results in the requirement of additional capital. Proper implementation of the ideas results in increasing profits and attaining stability of the organization.

7. Registering in Stock Exchange

It will be beneficial for the firm to register in the stock exchange. The registration process is not easy. Inorder to get registered, all the directions of SEBI and the stocks security (Regulation) Act should be abide by the firm. For this, venture capital is required.

8. Other Fields

The venture capital is required not only for the above fields, but also for the social development offerings, obtaining new opportunities, assistance in development programs and for development of the enterprise.

Importance of Venture Capital

The importance of VCF can be explained as follows,

1. Benefits to Investing Public

(a) The investors would be able to reduce or avoid risk by investing in venture fund as these venture capital institutions invest in a profitable venture out of their experience and knowledge.

(b) Venture capital institutions analyses the business prospects very carefully.

2. Benefits to Promoters

(a) Public issue of equity share involved lots of efforts such as statutory obligations, underwriting and brokers arrangement. Venture fund eliminates all these efforts.

(b) In order to go public, it needs large amount of investment for maintaining share registry cell, stock exchange listing, fee, printing and posting expenditure of annual reports. Assistance from venture funds does not incur such expenditure.

3. Benefits in General

(a) The time period between a technological innovation and its commercialization is reduced.

(b) Develops new processes and products.

(c) Assists in business borrowings.

(d) Improves the productivity and better utilization of capacity.

(e) Paves the way for the private sector to share the responsibility with public sector.

5.3 LEASING – DEFINITION AND STEPS

Q19. Define Leasing. What are the steps involved in leasing? SIA

Answer :

Lease

According to the Institute of Chartered Accountants of India (ICAI), "A lease is an agreement where by the lessor conveys to the lessee, in return for rent, the right to use an asset for an agreed period of time".

According to James C.Van Horne, "Lease is a contract whereby the owner of an asset (lessor) grants to another party (lessee) the exclusive right to use the asset usually for an agreed period of time in return for the payment of rent".

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Leasing

Leasing is an agreement which is made between two parties i.e., the leasing company or lessor and the user or lessee where in the former makes arrangement to buy capital equipment for the usage of the latter for a pre-determined agreed period of time in return for the payment of rent.

Steps Involved in Leasing

Leasing is a financial arrangement between the two parties which provides an opportunity to a lessor to avail the benefits of using an asset without owning or purchasing it. The process of leasing involves the following steps,

1. Lease Selection

In a lease transaction, the first step is to select an asset which has to be taken on lease. The lessee select an asset after considering various requirements like lease payments, duration of leasing period, its terms and conditions and so on. After finalizing the nature and type of asset, the lessee then approaches the leasing company or the lease broking company with the objective of finalizing the lease deal. A lease agreement is negotiated broadly.

2. Order and Delivery

Depending on the selection made by the lessee, the lessor places an order with the manufacture of the asset which is to be leased. The asset must be delivered by the manufacturer to the concerned site of a lessee. After the receipt of the asset, the lessee is required to issue an acceptance notice to the lessor.

3. Lease Contract

A lease agreement is signed by both the parties after deciding the terms of the lease contract. Generally, leases are full payout with different terms and conditions. Usually, lease period ranges between 3 to 5 years.

4. Lease Period

During lease period, the lessee make regular payment of lease on which both the parties have to agree. The lessee ensures the lessor that the leased asset would be properly maintained.

In addition, the lessee must get warranties and after-sales services from the lessor. The lessee may either renews or terminates the leasing contract at the end of the lease period. The lessee is not provided with the purchase option in the lease agreement itself.

Q20. What are the characteristics of leasing? Who are the parties involved in leasing?

Answer :

Characteristics of Leasing

The following are the characteristics of a lease,

1. The Parties

Lease agreement involves two parties i.e., the lessor and the lessee. Lessor is the person who transfers the right to use an asset in consideration of a periodical rental payment whereas lessee is the person who acquires the right to use an asset from the lessor for periodical rental payment for an agreed period (pre-determined) of time.

2. The Asset

Leasing is mostly used to finance the use of fixed assets of high value. The asset is the property which is to be leased out such as automobile, an aircraft, plant and machinery, building, and so on. In leasing the ownership of an asset is segregated from the use of the asset. During the lease period, ownership lies with the lessor where as its use is being transferred to the lessor.

3. The Term

The term of lease agreement is known as lease period. It is considered as illegal to have a lease without a specified period of term. In case of a perpetual lease, lease period is for an infinite period of time and in case of financial lease, lease period is in connection with the economic life of the asset. Sometimes, the lease period is being divided into primary lease period and secondary lease period.

4. The Lease Rentals

Lease rentals forms the consideration which is payable by the lessee as being mentioned in the lease transaction. Rentals are ascertained in order to cover up cost i.e., interest on the lessor's investment, any repairs and maintenance costs which forms the part of the lease package, depreciation on the leased asset and any other service charges in relation to the lease.

Constituents/Parties Involved in Leasing

The leasing industry involves various participants. These participants play an important role in lease agreement. They are,

1. Lessors

Lessors are of different types such as specialized leasing companies, one-off lessors, manufacturer-lessor, banks-sponsored leasing companies, financial institutions, in-house lessors, etc.

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Each type of lessor can be dealt as follows:

(i) Specialized Leasing Companies

These companies are specialized in the business of leasing assets. They attract their targets through advertisements, etc. The volume of their business transaction is very large. They posses a massive build-up of capital strength and enlarge their business activities through grand alliances and tie-ups.

(ii) One-off Lessors

Such companies enter into leasing business with an aim to derive the benefits of depreciation and taxes.

(iii) Manufacture Lessors

Manufacturer lessors are those parties who are engaged in manufacturing the capital assets, that are available for the purpose of leasing. Some of the developing manufacturing companies have been engaged into the business of leasing include IBM and United Shoe Machinery Corporation in US.

(iv) Banks-Sponsored Leasing Companies

These companies are operating as subsidiaries of the banks and are developed with the objective of undertaking the leasing business.

(v) Financial Institutions

Financial institutions form another important part of the leasing business. In India, institutions like ICICI etc., has provided leasing services.

2. Lessees

The lessee comprises wide range of companies i.e., from blue chip companies to small units, which get the financial services from the lessor companies. The considerations for which and the conditions under which such companies operate changes over a course of time. Most of the Indian lessees belong to the private sector.

3. Lease Brokers

Lease brokers are those intermediaries who are operating between the lessors and the lessees. Such individuals are responsible for recognizing the suitable lessor for a prospective lessee and vice versa. Lease brokers have adequate information about different types of lessors, they also maintains relationship which is helpful for lessors and the lessees as they provide financial benefits through tough negotiations.

4. Lease Financiers

Lease financiers are those banking institutions which provide financial support to the lessors with an objective of attaining the leased assets. Such assistance is provided as a result of the hypothecation of the leased asset and also by the provision of lease rentals.

5.3.1 Evolution, Advantages and Disadvantages

Q21. Discuss in detail about the evolution of leasing industry in India.

Answer :

In India, the concept of financial leasing was established during 1973. Chidambaram group has set up the first leasing company in 1973 in Madras. The main activity of the company was to lease industrial equipments. The twenty fifth century leasing company limited was established in 1979. By 1981, four more financial companies were involved in leasing. Other companies were motivated to enter into leasing industry by considering the performance of first leasing company limited. The first all India financial institution which had offered leasing in 1983 was Industrial Credit and Investment Corporation. An amendment of Banking regulation Act, 1949, facilitated the commercial banks to enter into leasing business. In October 1986, SBI was the first commercial bank to set up as a leasing subsidiary in capital market.

Expansion of leasing industry refers to increase in the number of lessors and volume of lease business. The lessors include financial institutions, banks, equipment manufacturers etc. Expansion of lease business in India are on the basis of the guidelines framed by the government.

Lease financing organizations of India has wide scope of operations which also includes private sector non-bank financial companies, few private sector manufacturing services, ICICI, IDBI, capital market subsidiaries of nationalized banks, IFC, LIC, GIC, HDFC, SIDCs, SIICs etc. On the other hand, companies acting as lessees includes leading corporations of both private, public sector and manufacturing companies. One of the major reasons for the growth of leasing industry in India is the entry of banks into the leasing business.

Merchant banking division of Industrial finance corporations started financing leasing companies, equipment leasing and financial services. The number of leasing companies increased to about 400 in 1990.

In some later years, the adverse trends in capital market and other factors led to a situation where there existed only 20 to 25 private leasing companies which were active apart from the institutional losses. The total volume of leasing business from both private and public sector leasing companies were upto ₹ 5000 crores in 1993.

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Q22. What are the advantages and disadvantages of leasing?

Answer :

Advantages of Leasing

Following are the advantages of leasing,

1. Allows Alternative use of Funds

A leasing arrangement enables the firm to use and control the asset without investing huge capital. The firm is supposed to make only the periodical rental payments. It also helps in saving considerable amount of funds for the alternative uses which would be otherwise tied up in fixed capital.

2. Faster and Cheaper Credit

On the basis of the tax structure of the lessee it costs usually less than the other methods of obtaining an asset. It also enables the firms to obtain new equipment without undergoing through any formal scrutiny method. Therefore, the acquisition of assets in the leasing agreement is cheaper and faster than any other source of finance.

3. Flexibility

The leasing arrangements may be designed greatly as per the requirement of the lessee than that of the ordinary financing. The lease can be designed in order to meet the lessees cash flows. The leasing can be avoided during those months where the cash flows are below the expected level.

4. Protection Against Obsolescence

A firm would be able avoid the risk of obsolescence by entering into operating lease agreement. This is greatly useful for those assets which becomes obsolete very quickly.

5. Hundred Percent Financing

The lease financing helps the firm to use the asset without making any down payment i.e., 100% financing is being guaranteed/offered to the lessee.

Limitations/Disadvantages of Leasing

Following are the limitations/disadvantages of leasing,

1. Inappropriate for Project Finance

Incase of project finance, leasing is not considered as an appropriate/suitable mode. The main reason behind this rentals would be repayable after entering into lease agreement where as, in case of new projects cash creation would be initiated only after a long gestation period.

2. Absence of Subsidy

Few tax benefits/incentives like the subsidy would not be present on the leased machinery or the equipment.

3. Less Benefit to Lessee

During the lease period the value of real assets like land and building would increase. Therefore, such a case the lessee would not get the benefit of a prospective capital gain.

4. Loss to Lessor

In case, lessee is unable to pay rentals on regular basis then in such a case lessor would incur a loss especially when the asset is a complicated one and less liquid.

5. No Protection

In the lease agreement it is the lessor who purchases the asset from the supplier and not the lessee. Therefore, the lessee is not subjected to any protection if supplier commits any breach of warranties with regards to the leased assets.

5.3.2 Types of Lease – Financial Lease – Operating Lease – Leverage Lease – Sale and Lease Book

Q23. Explain the various types of lease.

Answer : SIA (D)

Model Paper-I, Q13(b)

The lease is broadly classified into following types,

1. Financial lease
2. Operating lease
3. Other types of lease.

1. Financial Lease

According to the International Accounting Standard (IAS) No.17. "A Financial Lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset. Title may or may not eventually be transferred".

The financial lease covers the complete economic life of the asset. During the lease period, the lessor receives the lease rental to recover the full cost of the asset and also the reasonable return on the funds. Infact finance lease is also known as capital lease.

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Finance lease is generally noncancellable in nature and the lessor provides for the proper asset maintenance. The asset would be returned to the lessor or managed as per the lease contract at the end of the period. Lease rental is usually considered as a payment for the usage of the asset only and a responsibility of repairing and maintaining the asset usually lies with the lessee.

From the lessee's perspective it has been viewed that the finance lease assures the lessee an uninterrupted use of the asset. The lessor may not be involved in dealing with the asset. On the basis of the requirement, the lessee may select the asset and may even negotiate the price and the delivery schedule and so on with that of the supplier. But, the lessor makes the payment to the supplier and such arrangement is concurrent to the signing of the lease contract.

2. Operating Lease

According to IAS-17, "An Operating Lease is one which is not a finance lease".

An operating lease is an agreement where in the lessee obtains the use of an asset on a periodical basis. It is a lease arrangement for a period which is usually shorter than the life of an asset. An asset may be leased by the lessor to the different lessees one after the other. During the lease period, the lease rental payable by one lessee is insufficient to completely cover the asset cost plus return. Therefore, the present value of lease payment is usually lower than the actual price of the asset.

The asset is returned back to the lessor at the end of the life of the lease who can either offer it to sale to the lessee or any other person or lease it to any other lessee. Usually, operating lease covers a maintenance clause requiring the lessee to maintain the asset. The maintenance includes the repairs, insurance and the tax payments. Under the lease rentals, lessor will include a suitable compensation for the expected cost of maintenance of the leased asset.

Usually, the operating lease is cancellable by any of the party and is greatly expensive than a finance lease as the lessee needs to compensate the lessor as the lessor assumes the ownership risk and the lessor does not bear any assets risk of becoming obsolete. Few of the assets which may be acquired on operating lease basis are vehicles, amusement equipments, furniture and fixtures and so on.

3. Other Types of Lease

Other types of lease are as follows,

(i) Cross Border Lease

A cross border lease refers to the situation when a lessor leases an equipment to a lessee who does not come under the jurisdiction of the lessors territory. Under the cross border lease, on the basis of the circumstances in the international capital market the attitude of the parties changes.

(ii) Direct Lease

Direct lease is a one of the type of finance lease where in lessor purchases the asset and transfers it to the lessee. Under the lease agreement, a manufacturer can also act as lessor and deliver the assets to the lessee.

(iii) Leveraged Lease

When the lessor borrows a part of the purchase price from any leading institution then such a lease is known as leveraged lease. Under this lease, with the help of assets and the lease rentals, the loan is being secured. The lessee or the lessor directly repay the loan out of the lease rentals.

In leveraged leased, the lender finances the asset. Initially the lease rentals are distributed for payment to the lender in order to satisfy the debt obligation and any surplus and the remaining amount would be sent back to the lessor. For costly assets, the leveraged lease may be more useful.

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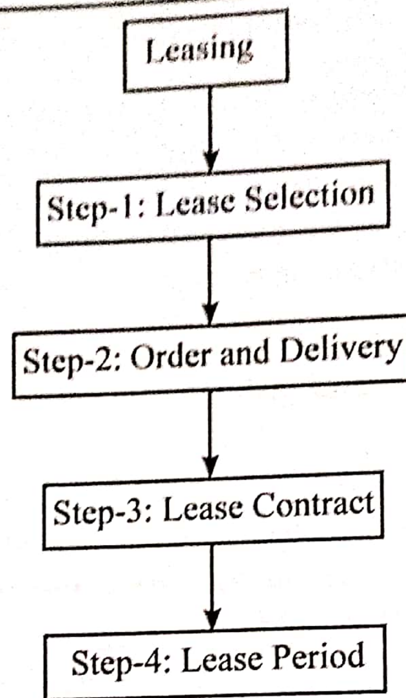

Figure: Steps Involved in Leasing

Step-1: Lease Selection

In a lease transaction, the first step is to select an asset which has to be taken on lease. The lessee select an asset after considering various requirements like lease payments, duration of leasing period, its terms and conditions and so on. After finalizing the nature and type of asset, the lessee then approaches the leasing company or the lease broking company with the objective of finalizing the lease deal. A lease agreement is negotiated broadly.

Step-2: Order and Delivery

Depending on the selection made by the lessee, the lessor places an order with the manufacture of the asset which is to be leased. The asset must be delivered by the manufacturer to the concerned site of a lessee. After the receipt of the asset, the lessee is required to issue an acceptance notice to the lessor.

Step-3: Lease Contract

A lease agreement is signed by both the parties after deciding the terms of the lease contract. Generally leases are full payout with different terms and conditions. Usually, lease period ranges between 3 to 5 years

Step-4: Lease Period

During lease period, the lessee make regular payment of lease on which both the parties have to agree. The lessee ensures the lessor that the leased asset would be properly maintained.

In addition, the lessee must get warranties and after-sales services from the lessor. The lessee may either renews or terminates the leasing contract at the end of the lease period. The lessee is not provided with the purchase option in the lease agreement itself.

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