

ASSET-BACKED LENDING VS. LEASING

BASICS, LEGAL, ENFORCEMENT, ACCOUNTING, TAXATION

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COVERAGE

- Asset backed Funding
- Forms of asset backed funding
- Lease and its benefits
- Asset backed Lending vs. Leasing
 - Legal aspect
 - Enforcement
 - Accounting
 - Taxation

ASSET BACKED FUNDING

Need for Leverage

- Doing business only through own capital may not be the most efficient use of capital.
- The credit position of the business can be leveraged to borrow funds.
- Borrowing is an important source of funding.

Asset purchase

- Traditional thought – Buy the asset with either own or borrowed funds.
- Challenges:
 - Affects cashflows, reduces current liquidity;
 - Obsolescence risk - stuck with the asset;
 - Acquisition of right to use is enough to serve the purpose, there is no need to own the asset.

Asset-backed funding

- Fundamental principle – Capital is precious and should be deployed for core business activities
- Benefits:
 - Reduces immediate cash outflow;
 - Acquire right to use the asset;
 - Permits higher leverage – since it is financing for the asset and not to the entity;
 - Multiple modes of funding & structuring the transaction – helps in reducing cost of borrowing;
 - May also be capital market oriented e.g. securitisation;

MULTIPLE FORMS OF ASSET BACKED FUNDING

Secured lending

- Simple loan;
- Financial Contract;
- Hypothecation of asset;
- Registration of security interest;
- Difficulties in enforcement mechanism.

Leasing

- Transfer of right to use and control;
- Finance lease;
- Operating lease;
- Ownership lies with the lessor;
- EOT options:
 - Renew,
 - Return,
 - Buy the asset.

Conditional sale

- Suitable for consumer lending;
- No taxation/ accounting benefits;
- Sale concludes on full payment
- Types:
 - Credit sale,
 - Instalment sale.

Hire purchase

- Financing instrument;
- Type of instalment credit;
- Option to buy at the end of term;
- Deferred purchase.

Rental contracts

- Short term;
- Non-financial contract;
- No transfer of title;
- For utility assets;
- E.g. renting a car.

Securitisation

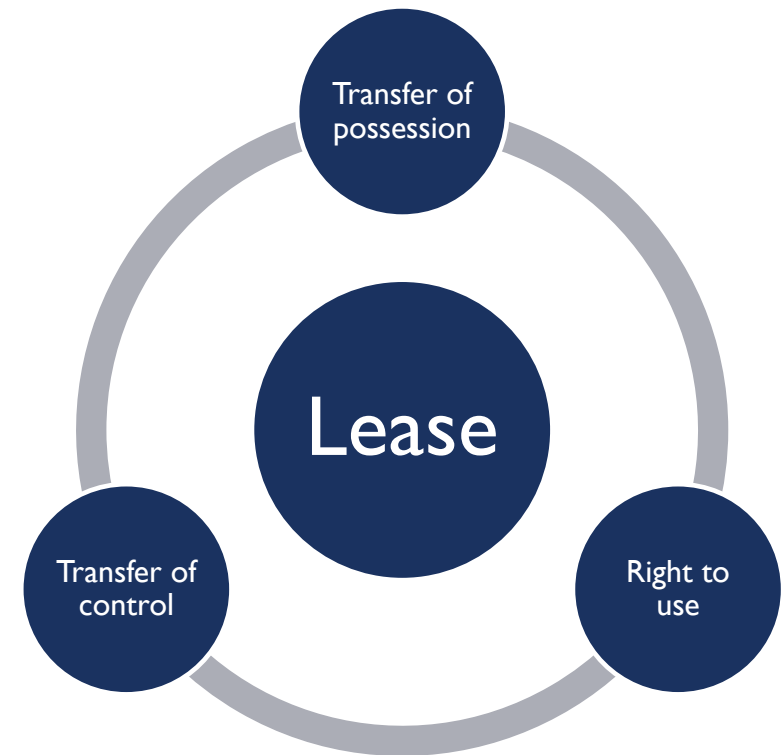
- Raising funds by transferring financial receivables to a separate entity (SPV);
- SPV issues tradable securities;
- Bankruptcy remote.

Factoring / forfeiting

- Sale of accounts receivables (invoices) to a 3rd party;
- Create short term liquidity;
- Recourse / non-recourse basis.

LEASE

- A transaction where possession of asset is handed over with the intent that it will revert at the end of the term
- A form of bailment
- Parties – Lessor & Lessee
- The funding revolves around the asset
- Legal ownership is with the lessor
- Asset cost (less the Residual Value) funded by the lessor is repaid by the lessee in form of rental



BENEFITS OF LEASING

For Lessee

- Asset light Balance Sheet
- Peripheral assets may be taken on lease
- Technology / obsolescence risk is avoided
- 100% funding of asset saves working capital
- RV reduces the aggregate servicing burden
- Tax deductible rentals
- Interest rate risk may be avoided

For Lessor

- Retention of ownership
- Ease of enforcement
- New customer pull / product differentiation
- Depreciation (Taxation)
- Concentration limits are not breached (only for operating lease)
- OEM Support in estimating RV

LEGAL ASPECT

Asset Backed Lending

- Motive: Financing of asset
- Ownership of asset: With the borrower
- Security interest: Created in the name of the lender
- Product liability: Lender not liable as it is only involved in financing the asset and not the selection of asset
- Income for lender: In the form of interest
- Bankruptcy remote: No, since it will form part of borrower's liquidation estate. Lender will be a secured creditor
- Regulatory – it is a financial activity

Leasing

- Motive: Financing of asset (Financial lease)
Letting out of asset (Operating lease)
- Ownership of asset: With the lessor
- Security interest: Not applicable
- Product liability: Lessor may be made liable since the asset is purchased in its name from supplier
- Income for lender: In the form of rentals
- Bankruptcy remote: Yes, since the legal ownership is with the lessor
- Regulatory – Financial Lease is considered as a financial activity

ENFORCEMENT

Asset Backed Lending

- Registration: CERSAI, MCA, NeSL
- Financial Creditor under IBC, 2016
- Enforcement of security:
 - Under SARFAESI Act, 2002
 - Through court intervention

Leasing

- Registration: CERSAI, NeSL (*for Financial Lease, since it is covered under 'financial asset'*)
- Financial Lease - Financial Creditor under IBC, 2016
- Operating Lease – Operational Creditor under IBC, 2016
- Enforcement of security:
 - Under SARFAESI Act, 2002 (Financial Lease)
 - Through court intervention
 - With / without notice of repossession (Operating lease)

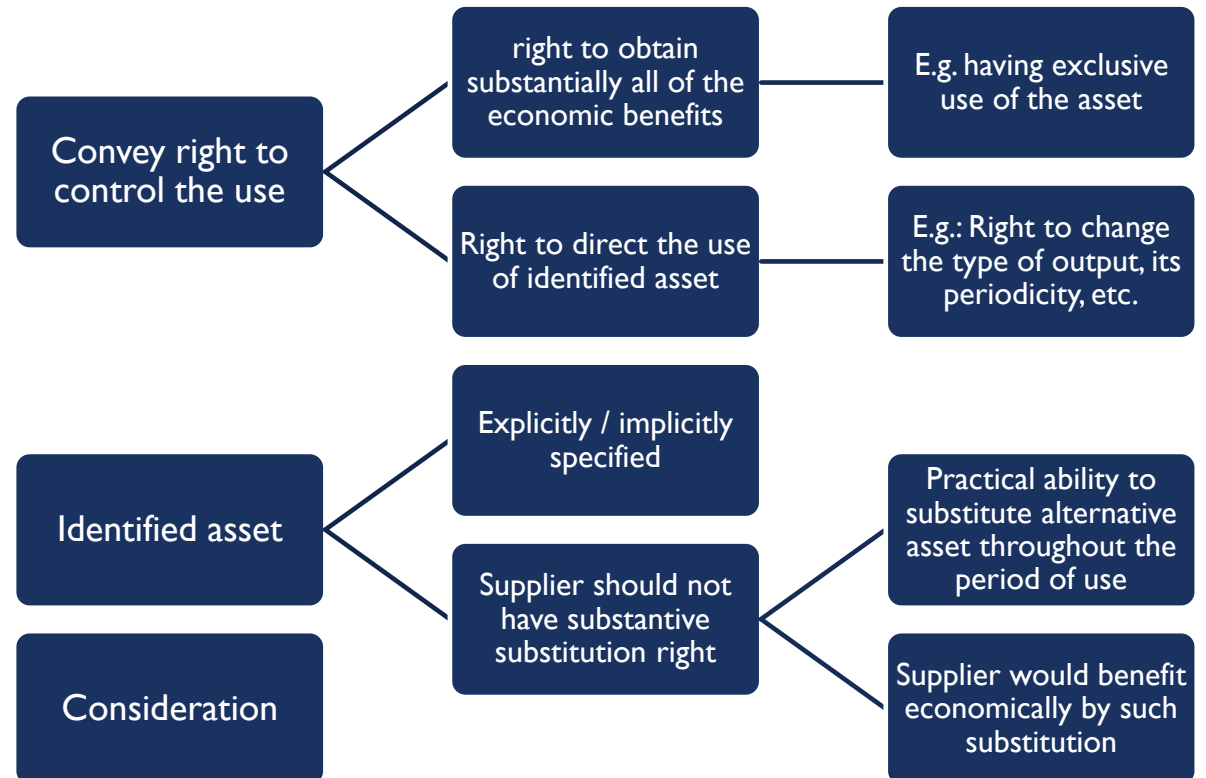
ACCOUNTING

Asset Backed Lending

- IndAS 32, 107, and 109
- Financial instrument: any contract that gives rise to a financial asset of one entity and a financial liability/ equity instrument of another entity.
- Financial asset:
 - Includes a contractual right to receive cash.
 - Amortised cost method: Business model test, SPPI test
- Financial liability:
 - Includes a contractual obligation to deliver cash
 - Amortised cost (if held for trading, then FVTPL)

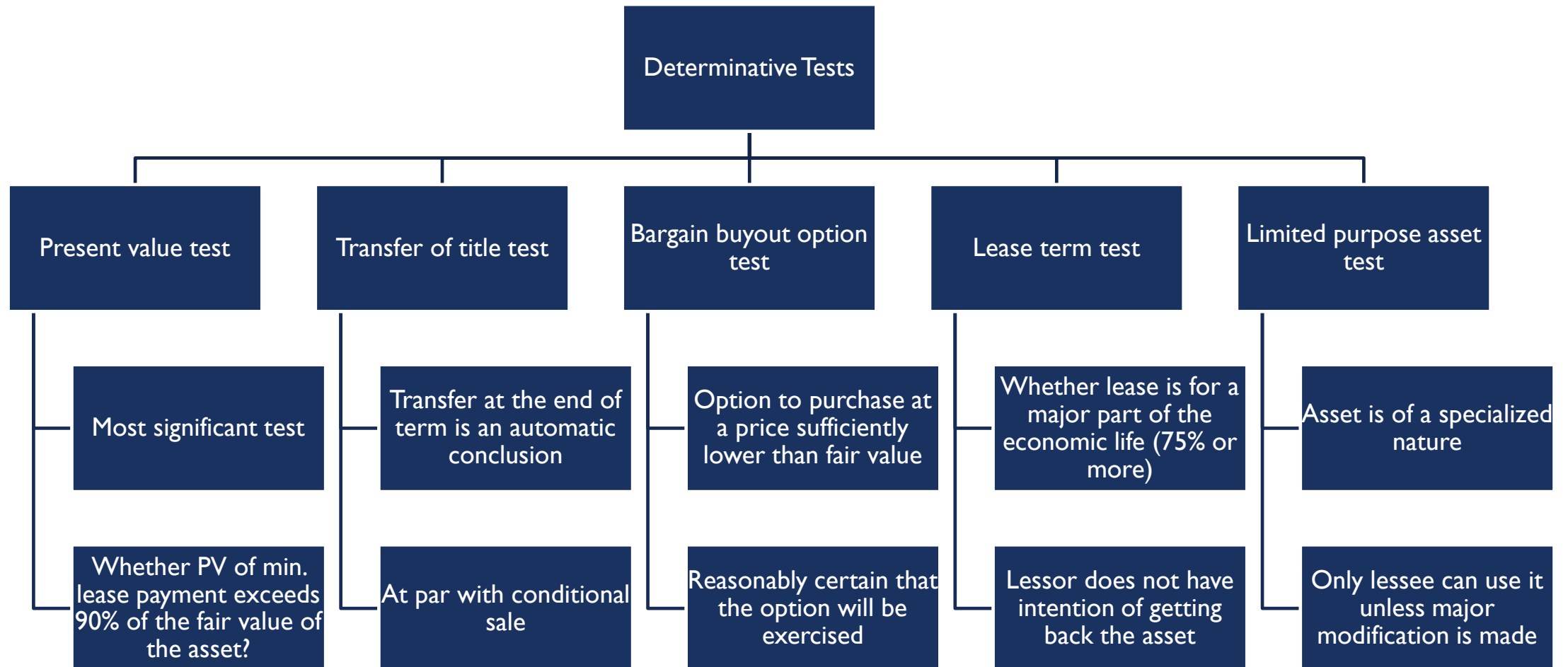
Leasing

- IndAS 116



FINANCE LEASE v. OPERATING LEASE (INDAS 116)

A lease is classified as an operating lease if it does not transfer **substantially all the risks and rewards** incidental to ownership of an underlying asset.



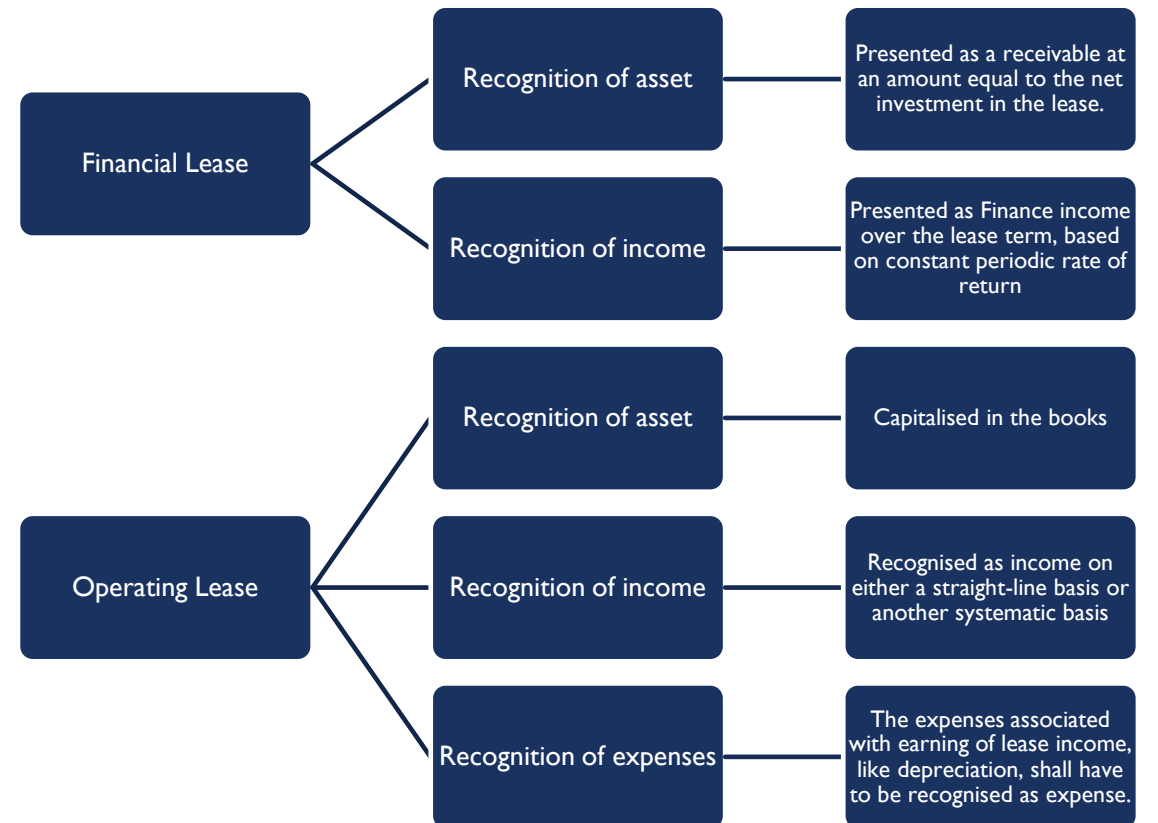
ACCOUNTING TREATMENT

For Lessee

- Right-of-use (ROU) asset
 - Initial recognition
 - Measure the ROU asset at Present value of the lease payments discounted at the interest rate implicit in the lease or the incremental borrowing rate
 - Subsequent recognition
 - ROU asset minus depreciation as per IndAS 16
 - Will ownership be transferred at EOT / or is there certainty - depreciated over the useful life of the asset
 - In any other case - depreciated over the useful life of the asset or the lease term whichever is shorter.
- Lease liability
 - Initial recognition
 - PV of lease payments discounted at IRR / incremental borrowing rate
 - Subsequent recognition
 - Reduce the carrying amount upon making lease payments

For Lessor

- Classify lease either as financial or operating



TAXATION

Asset backed Lending

- Interest component of the EMI is booked as income for the lender and expense for the borrower;
- To be included in Profits and Gains of Business and Profession;
- Depreciation will be allowed to the borrower since the asset will be owned by the borrower;
- Interest income is exempted from GST.

Lease

- Lease rentals
 - Income for the lessor income. To be included in Profits and Gains of Business and Profession.
 - Deducted as expense by the lessee
- Depreciation for tax purposes is delinked from book depreciation.
 - Depreciation allowed = Legal ownership + Beneficial ownership
 - Assessee should use the asset in his own business. Leasing companies satisfy the test of business use since the assets are put to use by the lessor in his business of letting out assets.
- Leasing is considered as of service. Chargeable to GST at the rate of the asset being leased;
- Differentiating factor between lending and leasing is that GST is chargeable on whole on rentals (and not limited to the capital recovery component).
- GST paid by lessor on purchase of asset will be set-off by the ITC from leasing service but over the lease tenure.



Thank You!