Do Low Profit Companies Prefer Lease over Loan because of Taxes?

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Abstract

Businesses have a large number of options available with regards to the investment and financing of fixed assets. These assets could be purchased outright, hired, rented or leased. Because the accounting treatment differs substantially, so some time business prefers one financing option over others. As leases come in many sizes, shapes, and forms, but four types of leasing transactions are made i.e. service lease, financial lease, sale and lease back, and averaged lease. The focus of this study is to find out the factors due to which low profit companies prefer lease financing over loan. The major dimensions are tax benefit, rental payments, no requirement of collateral and simple documentation. One important point is that leasing is done at some fixed rate of interest. It allows a business to better predict its future cash flows. But in case of bank financing (credit) a floating rate is kept, which makes business volatile to market rate variations. We have taken the cross sectional data of 30 companies and have analyzed it through multiple linear regression.

Keywords: Lease, Floating interest rate, Financial lease, Sale and lease back, Averaged lease

Introduction

Leasing may be defined as the contract between two parties in which one party intimates the use of an asset to the other party for a given duration of time at a pre-determined rate. There are many types of lease but the four types are very important:

(i) Averaged lease which is basically for accounting purposes. The structure is used by two firms which are finding off-balance sheet reporting of their asset based financing;

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(ii) Operating lease which is not capital lease. It is used for short term equipment lease. The use of the equipment is acquired by the lessee for a part of the useful life of the asset. Maintenance and insurance services may be provided by the lesser;

(iii) Finance Lease in which lessee is responsible for maintenance, taxes and insurance. This lease can not be concealed as it is full pay out lease;

(iv) Sale-Lease back is a special arrangement in which lesser purchases the equipment from that company which owns it and brings it in use. By purchasing that equipment, the lesser who then becomes its owner and returns it back to the original owner for using that equipment. Down payment is not required in leasing deal. Value of the asset which is expected to be depleted during the lease duration is only to be financed by lessee. When deal duration is over, the lessee may purchase that asset keeping in view the remaining value of that asset. Collateral is not required in leasing deal. Lease payment is usually very less than the down payment as in case of loans.

Globally, Leasing is considered as very advantageous business. USA is on top and Japan is at number two but interestingly, the fast growing economies of the world, China and India have very less contribution in the ‘Leasing’. However Pakistan’s progress in ‘Leasing Market’ is commendable. In Pakistan, ‘Leasing’ was started in 1983. Regulations regarding the ‘Leasing Process’ have been very clear and whenever any change or amendment is required to overcome the difficulties and impediments, the same can be processed very easily by Regulators. State Bank of Pakistan was the regulator of Leasing Process till 1997 and after that Security and Exchange Commission Pakistan (SECP) has become the regulator. Moreover, for easing the rules and regulations, ‘Leasing Association of Pakistan’, is playing very active role.

Traditionally, Small and Medium Enterprises (SMEs) have been the important customers of the “Leasing Companies” Transporters of Pakistan used to obtain loans from informal sources on higher interest rate. Now they are availing the leasing facilities with respect to different spare parts and items. Leasing companies’ initiative for consumer and auto financing is contributing towards enhancing the living standards of the people. By following the Leasing companies, banks have also started the leasing business which has an edge over the leasing companies in the capital market.

Literature Survey

Leasing takes several different forms, the four most important being, operating lease, financial lease, sale and lease back, and averaged lease. Operating lease provide for both financing and maintenance. Financial lease differs from operating lease because it does not provide maintenance service, it is not cancelable and it is fully amortized (Brigham & Ehrhardt, 2005).

For tax purposes, the lessee can deduct the full amount of the lease payment in a properly structured (tax- oriented) lease. The asset's purchase price must not be significantly lower than its fair market value. If the lessee does not exercise this option, the lessor takes possession of the asset and is entitled to any residual value associated with it.

Pinches (1996) have stated that from the lessee's point of view, the lease payments are an expense of doing business and are deductible for tax purposes. Ratnatunga, Romano & Lourens (1993) mentioned that any lease agreement that includes the option to purchase is treated as a hire-purchase agreement for taxation purpose, unless the amount payable by the lessee for the acquisition of the leased item is determined without regard to payments previously made under the lease agreement. Further explaining, Lourens (1993) explained that in the case of a lease that is not a hire purchase agreement , the lessee is entitled to a full deduction of the lease rental paid, but cannot claim any depreciation allowance in respect of leased asset.

Claudio Romano (1993) observes that if lessee purchases the total leased asset, cash outlay of lease will be higher. The reason behind it is higher interest rate in lease calculations as compared to the rate charged on a straight loan. As a matter of fact, for compensation of lessor's risk which he is bearing in estimation of salvage value etc, the lessee pays higher rate.

Ansari et al. (2003) stated that tax consideration could be important where a company decided to use lease financing. This is because manufacturing and financial institutions derive different benefits from owning and renting assets. Accelerated depreciation of assets is not particularly beneficial for lower profit companies whereas this has many advantages for companies that are earning huge profits and are therefore subject to high level of taxation. These companies can get benefit if lessor decides to pass some tax benefits to their customers through lower rental charges.

Highlighting the accounting treatment of leasing Eugene (2000) mentioned that lease financing was attractive to some because the lease obligation did not appear on the company's financial statements. As a result leasing was regarded as "hidden" or "off-balance-sheet" method of financing. Now many long term leases must be shown on the balance sheet as a "capitalized" asset with an associated liability being shown as well. For these leases reporting of earnings is effected. Other leases may be fully disclosed in the footnotes of the financial statements.

Eugnene (1999) highlighted lease as an expense over which tax is employed and does not take a lease similar to a purchase. So a company can subtract the financial outlay on lease from its income. Stating about balance sheet management he further maintains that as a lease is not measured as a long-term liability, so it does not appear as debt in financial statements.

According to Rachid (2008) another way to differentiate the lease from loan is the absence of down payment in lease financing. In loan financing a fix amount of down payment has to be paid and the rest amount is financed through loan.

Ronald W. Blasi (2011) mentions that While after-tax earnings are reduced by tax expense, just as they are by other business expenses, the reduction is less (a favorable result) if a tax benefit actually reduces the firm's federal income tax liability. This positive effect on reported earnings is equal to the firm's marginal tax rate multiplied by allowed deductions or by the face amount of any allowable tax credit. He further expounds that although a firm's earnings for financial reporting purposes and for income tax purposes are both negatively affected when tax benefits do not reduce tax liability, the effect of tax benefits on reported earnings is quite different from the effect on tax liability.

Objectives

Objectives of this study are:

- To determine whether any relationship exists between financial lease and low profitability, if exists what kind of relationship is and how much strong.
- To find overall relationship of asset on financial lease with profitability, depreciation and tax liability.

Hypothesis

Our main hypothesis is, "Companies with low profitability rely more on financial lease, to finance their fixed assets".
Second hypothesis is that low profit companies prefer leasing because of tax benefits.

Data Collection

The desired data for study is collected from the Karachi stock exchange listed companies. Initially 100 listed companies were researched, following are the data collected from the annual reports with their financial statements:

Data	Financial Statement
Sales	income statement
Total assets	balance sheet
Total fixed assets	balance sheet
Assets subject to finance lease	schedule of fixed assets in notes
Total depreciation expense	schedule of fixed assets in notes
Depreciation on assets subject to finance lease	as above
Tax liability	income statement
Profit after taxation	income statement

Explanation of Variables
i) Dependent Variable

Change in fixed assets due to financial lease $\Delta FA = Y$

ii) Independent Variables
Profitability $Pt = X1$
Taxation $Tax = X2$
Depreciation $Dep = X3$
Measure of Profitability:

$$\text{Return on assets} = \text{ROA} = \frac{\text{Net Profit after Taxation}}{\text{Total Assets}}$$

Companies having ROA ≤ 10 percent will be considered as low profitable.

Variables' Proxies
After obtaining the data following are the ratios in percentages that the data is converted to

$$\text{Profitability} = \frac{\text{net profit after taxation}}{\text{Total assets}}$$

$$\text{Tax to sales ratio} = \frac{\text{taxation}}{\text{Net sales}}$$

Depreciation = given in the property, plant and equipment schedule in notes

Change in fixed assets due to finance lease ratio =

$$\frac{\text{Assets (subject to finance lease)}}{\text{Total fixed assets}}$$

Methodology

For testing the hypothesis data is collected from the Karachi stock exchange listed companies. Specially manufacturing concern companies are selected. Initially 70 companies are searched from textile, sugar and cement sector after complete analysis 31 companies are selected for hypothesis testing.

Multiple Regression Equation:

Standard Multiple Regression Equation:

$$Y = \beta o + \beta 1X\Box + \beta 2\ X1 + \beta 3X2 + \ldots\ldots,+ \beta\ nXn$$

After substituting the desired dependent and independent variables the equation become

$\Delta FA = f\ (Pt, Tax, Dep)$

$\Delta FA = \beta o + \beta 1Pt + \beta 2Tax + \beta 3Dep$ ……..1

Results

Summary of Results

$\Delta FA = 24.09538863 - 0.82971Pt + 0.111116995\ Tax - 0.7941Dep$

t-value	*(4.5)	*(-3.1)	(2.0)**	(-1.98)
p values	0.0001	0.0003	0.1000	0.1100

R square 0.60

F-calculated 5.65

*Where *, ** & *** represents significance at 1%,5% and 10% respectively*

The coefficient of each independent variable symbolizes the average change in the dependent variable for a one unit change in the variable that is independent, remaining all other variables constant. Hence following are the calculated results:

Coefficient of R Square = 0.60037 explains that the multiple regression equation reduces the total variation this equation is 60.03% is reliable to be used for estimation and consequently the estimate would be 60.037% reliable. F calculated value is greater than critical value which confirms that overall model is significant.

Profitability

In the equation -.8297Pt represents ROA and shows that 1 percent decrease in ROA or Profitability will increase the change in fixed assets due to financial lease by -.8279 percent and vice versa. Negative sign is depicting an inverse relation between profitability and change in fixed assets due to financial lease. *t*-value of -3.1 is also showing the significant relationship of ROA and profitability. It means as the profitability of a company increases it moves away from financial leasing. So here it can be safely said that a decrease in the profitability leads company towards lease financing rather than loan.

Tax

Coefficient value 0.1111Tax shows that 1 percent increase in tax liability will change fixed assets due to financial lease by .1111 percent. It shows that as tax increases, low profit companies increase their financing through lease. But the t-value of 1.98 is showing the insignificant relationship at 10%. P-value of .111 is showing that the relationship is significant at 11% error.

Depreciation

The coefficient value of depreciation is -0.7941D. It shows that 1 percent decrease in depreciation expense will increase financing of fixed assets due to financial lease by -0.7941 percent and vice versa and there exist inverse relation between variables. It explains that those companies will prefer leasing if depreciation expenses are decreasing. Here t-value of -4.6 is showing the significant relationship.

Findings

Change in fixed assets due to financial Lease is positively related with tax liability but this positive increase in taxes is very much low. It means that if tax liability increases the company will go for leasing in order to reduce tax in long run. However the relationship of profitability and depreciation with change in fixed assets due to financial lease are inversely related. That as an when profitability of the companies decreases they tend to move to finance their fixed assets through financial lease and vice versa. This is the core objective of the study. Similar is the case with the depreciation that the lessee does not have to finance the salvage value of the asset, second it is not in the advantage of the lessee to charge higher percentages of depreciation on leased asset. So decrease in the depreciation increases the fixed assets subject to finance lease and vice versa.

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