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ECONOMIC ASPECTS OF FINANCIAL LEASING IN BUSINESS INVESTMENTS

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Abstract: *Leasing, as a financial instrument, was able to affirm itself in many developed countries as one of the most effective and accessible mechanisms for financing the expansion and development of the means of production, asset finance necessary for the development and for the application of new technologies in business. Leasing is a modern way of financing through which the customer enjoys a good, the payment being spread over the period of the lease, and the installments paid being deductible according to the type of leasing contract. Compared with other forms of financing, leasing has the advantage of eliminating red tape required for the granting of credits and the financial guarantees only with the asset that is the subject of the lease.*

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1. CONCEPT, ECONOMIC CONTENT AND CHARACTERISTICS OF LEASING OPERATIONS

Changes occurring in the global economy, the requirements of scientific and technical progress on the replacement of fixed assets and the need for more efficient use of financial resources imply the use of new methods of renewing the technical-material base. Out of these considerations leasing, in recent decades, has become a non-traditional and effective investment tool.

Operations similar to "leasing" were known in ancient Babylon 2000 years BC. Including leasing practice in economic relations took place in the year 1877, when telephone company "Bell" decided not to sell the telephone appliances made by them, but to lease them. Leasing appeared first in the United States, gradual penetrating in other countries, particularly in Europe.

There are several different definitions accepted of the term "leasing". From the point of view of financial specialists leasing is an original financing technique, medium-term or long term, practiced by a financial company, having as legal support a contract of lease of goods. A broader definition of the concept of leasing could be the following: a trade and financing method by location by financial institutions specializing in these operations, by financial institutions or directly by manufacturers, to companies that carry out particular operations, or do not have sufficient borrowed or own funds to buy them. On the other hand, leasing is a rental technique - carried out by specialized financial companies - of equipment to beneficiaries who do not have borrowed or own funds to purchase them from manufacturers.

The harmonization of the legal framework for international leasing was accomplished on the 28th May 1988, by the adoption of the Convention on international financial leasing by

the Commission of the International Institute for Uniformity of Private Law (UNIDROIT), at Ottawa, to which 59 countries participated and signed.

In Europe, the representative of the leasing industry is the European Federation of National Associations of Leasing Companies - Leaseurope, founded in 1973. Although Leaseurope was founded with the intent to be a forum in which to discuss the specific problems of this new form of financing, it has become an institution for promoting the interests of its members in negotiations with the European Union Commission, the International Council for Accounting Standards etc.

Basically, one can say that leasing operations involve a method of financing, lending and development of the technical-material base of enterprises with limited possibilities to attract sources of financing and a method of long term investment in assets of funds available or borrowed.

2. PARTICULARITIES OF THE DECISION MAKING PROCESS WITHIN THE ANALYSIS OF INVESTMENT PROJECTS FINANCED THROUGH FINANCIAL LEASING

Investment decisions are intended to identify and select the most profitable projects for the investment of money on the long term. We believe that the following factors contribute when considering an investment decisions with a greater responsibility:

- Making investments puts a hold on important financial funds on the long-term, therefore, the company is waiving its internal flexibility and becomes more vulnerable;
- Investment decisions involve the expansion of operations based on increased future cash flows, so that the investment decision implies the identification and proper planning of revenues expected during the life cycle of the investment project;
- Investment decisions define the business's strategies. The investment process is an important component of strategic management.

In our opinion, the analysis of investment projects financed through leasing should be based on the following steps:

- Defining the investment project;
- Identification of the financial flows related to the investment project;
- Project selection based on the updated net value (UNV) or the internal rate of return (IRR);
- Project implementation.

1. Defining the investment project: At this stage, the company identifies a set of independent projects, which would come out of the overall strategy of the company. The investment projects which completed each other are combined to create independent projects. Anything company, in the search for investment projects, starts with the specific advantages which it has and is trying to capitalize.

Typically, investment projects can be built according to the following alternatives:

- Investment projects of specialization and deepening of the profile of activity, developing products and new technologies;
- Diversification investment projects (investment portfolio), respectively the buying of social capital of other companies.

2. *Identification of the financial flows related to the investment project*: It is the most important phase of the investment process. The decision regarding the implementation of the investment project is influenced decisively by the size of the financial flows. The risk of the investment project also depends on the ability of managers to estimate correctly the size of the

cash flows. We believe that there are three financial flows that characterize the investment process, namely:

a. The cost of the investment - a net negative financial flow, consisting of the expenses that
the company makes to put together the expected business: purchasing and installing the equipment, initial value of necessary intangible assets (patents, licenses) and the original value of the current assets.

$CI = V_{FA} + V_{IA} + V_{CA} + O.C. – V_{LFA}$, where:

CI- the cost of the investment,

V_{FA} - the value of fixed assets invested,

V_{IA} - the value of intangible assets invested,

V_{CA} – the initial value of current assets,

O.C. – other investment costs,

V_{LFA} - the liquidation value of fixed assets replaced. Typically, the liquidation value of the fixed assets is determined by the following relationship:

Selling price - (selling price - stock value) * tax rate on income

b. Financial flows during the life of the investment project - Profit is not a good indicator of the outcome of the economic activity, because it may vary depending on what methods are applied for the assessment of costs. Thus, the evaluation of the operational results of the investment is made based on the cash flow. There are two main components of cash flow:

- net profit - as a result of operational activities;
- depreciation and amortization - the recovery of the amount invested in fixed assets and intangible assets.

$PF = NP + D + AIA + I \pm \Delta WC - OF$, where:

PF - the annual positive flows generated by the investment,

NP - the net profit,

D - the annual depreciation of fixed assets,

AIA - the annual amortization of intangible assets,

I – interest on loans and leasing used to finance the investment,

Δ WC – the changes in the working capital,

OF - other financial flows (the cannibalization effect of income).

c. Financial flows related to the liquidation of the investment - In the event of liquidation of the investment there are two financial flows:

- The liquidation value of assets over the long term. Liquidation value of fixed assets is determined by the following relationship:
  Selling price - (selling price - balance amount) the rate of income tax
- Amount of revolving fund, as the ceasing of activity will also mean the recovery of the amounts invested in stocks and claims.

$LF = V_{LFA} + WC$, where:

LF- liquidation flow,

V_{LFA} - the liquidation of fixed assets,

WC- working capital when the investment is liquidated.

3. *Project selection based on the updated net value* (UNV) or the internal rate of return (IRR): In this phase, the manager must compare positive flows with the negative ones, in order to decide whether to implement the project. Using the well-known criteria of the updated net value (UNV) and the internal rate of return (IRR), he will decide on the effectiveness of the analyzed project. An important step is to determine the rate of update. The

rate of update, used in the estimation of the efficiency of the investment projects, should reflect more variables:

- Expectations for return of capital providers;
- Opportunity cost of capital;
- Inflation level;
- Risk of project, etc.

If the UNV is positive, the investment will be implemented. UNV shows by how much the value of the company will increase if the project will be implemented.

By determining the IRR the company can establish the economic profitability of the project. As a rule of thumb, the project is implemented if the IRR is greater than the weighted average cost of capital corresponding to the project. Typically, a project that is acceptable under the criteria of the UNV, will automatically also be accepted under the criteria of IRR, therefore, in some cases it is sufficient to calculate only the first indicator indicator.

4. *Project implementation*: The decision of implementing the project depends, in addition to the UNV and the IRR, on the investment budget allocated by the business for the investment project. Usually, the company may waive some investment projects keeping their financial capabilities in mind, simply because there are other projects that have a greater UNV or IRR.

Investment decisions are intended to identify and select the most profitable projects for the investment of money on the long term. We believe that the following factors contribute when considering an investment decisions with a greater responsibility:

- Making investments puts a hold on important financial funds on the long-term, therefore, the company is waiving its internal flexibility and becomes more vulnerable;
- Investment decisions involve the expansion of operations based on increased future cash flows, so that the investment decision implies the identification and proper planning of revenues expected during the life cycle of the investment project;
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3. THE ADVANTAGES OF LEASING IN FINANCING INVESTMENTS

The causes for the rapid growth of the funded lease are found in those advantages which this financing method offers, compared to the purchasing of assets with cash or with contracted loans. The analysis of the qualities of the leasing operations, in comparison with traditional forms of financing investments, proved that financial leasing is a much more attractive method in the investment activity.

The indicator according to which one compares leasing and credit is the total expenditure for each source of funding. The basic principles of choice between two sources of funding refer to: the amount of lease payments and the amount of payments for credit are incomparable; we can not compare the credit interest rate with the commission established by the leasing company for its services; we must take into account all of the expenses for maintenance for every possible funding source; we must take into account the tax benefits for leasing and for credit; the analysis of cash flows should be consistent with the term of full depreciation of the asset, without limitation to the maturity terms of the sources of funding; all cash flows are discounted to the same period.

Using in a significant extent leasing in the business investment activity offers additional benefits over other methods of financing the assets:

- Increased financing availability of the company;

- Through leasing one can ensures rapid recovery of assets in case of insolvency of the company which is the lessee;
- Leasing allows splitting the risk between the lessor and the lessee;
- Flexibility;
- A number of tax benefits through cost-benefit accounting.

One of the main benefits of funding by leasing concerns, firstly, the right of the Contracting Parties of the lease to use the depreciation of the leased object with the coefficient of acceleration up to 2. This leads to the reduction of payments related to income tax during the first years after purchasing the asset as well as reducing the payments for property tax.

Leases may also be considered a form of privatization, which has advantages both for the state – temporarily preserving the ownership of the economic agent concerned, with the possibility of being definitively privatized after the customer has proven management skills - and for the actual customers, with the possibility to drawn into this action capable managers, who, having no capital, couldn't engage in such business.

Other advantages of leasing include:

- the possibility of larger investments by companies which do not have own financial resources, but have real possibilities of development;
- the cost of capital assets is spread over the useful operating life;
- avoiding capital restraints;
- allows precise quantification of the costs of leasing over the entire duration of the contract;
- helps avoid bureaucracy, the leasing company taking over all operations related to the purchasing of the asset.

4. ESTIMATING RISK FACTORS FOR INVESTMENT PROJECTS THROUGH LEASING

Leasing is the solution that allows overcoming the difficulties arising from an inappropriate economic environment - expensive and limited funding, bureaucracy of the banking system, and also allows businesses to obtain the right to use, with minimal initial financial efforts, machinery, equipment, technological equipment, that will generate increased productivity, profitability and increased profits.

The quality of the investment project is determined, in a large part, by calculating the risk factors of the project. For an investment project with the financing by leasing risk factors are associated with the long-term character of the financing. All participants (direct and indirect[1]) in the investment project are subject to risk.

For any investment project on the long term, one of the main factors which determine the dynamics of the indicators of the project is inflation[2]. If the project is oriented towards leasing of imported equipment, a risk factor is, of course, the currency exchange rate.

Another risk factor, to be taken into account in the evaluation of investment projects financed through leasing refers to the need for credit (medium-term and long-term), to avoid disruptions in the funding flows. In this context, it is necessary to quantify the credit risk, called the risk of insolvency risk. This risk expresses the likelihood of actual receipt of the given credit and the afferent interest in due time. Non-compliance is a prime credit risk to which leasing companies need to develop protective measures. An additional risk is related to the refusal of the leasing beneficiary to pay until the equipment is properly manufactured,

[1] Lessor and Lessee
[2] By inflation we refer to a general increase in price levels.

maintained and repaired. Through a permanent supervision of the risk level one can manage credit risk on the basis of two fundamental principles: dividing risks and limiting risks.

Other categories of risk that appear in leasing operations are: project risks, risks that relate directly to the asset took through leasing, portfolio risk, risk related to interest rate, tax risk, legislative risk etc.

CONCLUSION

In conclusion, we can state that leasing companies should establish their own systems of risk assessment and control, so as to avoid their occurrence or, when risks do appear, to have good methods and techniques of risk management. The use of financial leasing as an effective investment in fixed funds of the enterprises, depend not only on the existence of laws, but also on the accuracy of leasing operations, effective risk management and a favorable investment climate.

The liberalization of the economies of Central and Eastern Europe states, amplified by their wish to integrate into the world economy, provided an upward dynamic for the leasing market, attracting substantial foreign investments in this sector. In recent years, the contribution of leasing transactions indicates an increase in the percentage of total investments in fixed capital in these countries.

Factors stimulating the development of leasing constitute fiscal advantages in comparison with bank lending (accelerated depreciation, including the award of lease payments to production costs etc..), how accessible the financing of fixed assets is, and moderate risks for sellers of automobiles and machinery manufactured by local producers.

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