Impact of Financial Leasing Decision on Industrial Companies

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Abstract: The objective of the study is to provide a comprehensive analysis of the leasing market in Egypt, the analysis of the regulatory, tax, legal, and marketing framework related to leasing for the sake of development and improvement of such market activities in order to promote the impact of different variables in case of applying financial leasing. This paper will contribute to the literature of the non-bank financial institutions and specifically on financial leasing decision in industrial companies. The ultimate goal of the paper is to influence policies, regulatory frameworks and institutional setups, in order to enhance enterprises' access to financial services, especially small-scale ones. This paper will help to understand the critical role the financial leasing sector could play in developing the financial markets and ultimately come up with policy recommendations on how to reap the benefits of such an underutilized non-bank financial institution, which could enhance growth and development in the industrial companies. In that context, this paper is divided into three sections. The first section Introduction & Theoretical backgrounds. Section two Literature review Section three research methodology, equivalent ways to analyze& conclusions. This research concludes with specific policy the implications identifying the necessary financial, legal, regulatory, and institutional framework for developing the financial leasing decision in industrial companies, and enhancing its potentials in improving firms' access to finance.

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Introduction

The activity of the financial lease has proved its importance as a competitive tool of the finance to industry, commerce and agriculture sectors in different countries, so that this type of financing is one of the most efficient financing schemes, and is appreciated where its contribution to economic development in the applied countries, that it provides the necessary funds for investment in economic projects and promote the role of banks and investors in the process of economic and social development and attracting foreign investment and enable business to obtain capital assets to be established or operated easily and in an appropriate manner.

Firms generally own fixed assets and report them on their balance sheets in financial statements , but it is the use of building and equipment that is important, not their ownership. One way of obtaining the use of facilities and equipment is to buy them, but an alternative is to lease them. Leasing has grown popularity and today it is the fastest growing form of capital investment. The popularity of leasing is evidenced in the fact that 546 of 600 companies surveyed by the AICPA[1] in 1996 disclosed lease data **(Myers 1964).** Prior to the 1950s in the USA, leasing was generally associated with real estate-land and buildings **(Brigham and Gapenski 1985)**. Today, however, it is possible to lease virtually any kind of fixed asset. In 1984 about 20 percent of all new capital equipment acquired by businesses in the USA was financed through lease agreements. Since then, leasing is the most popular method of financing not only in the USA, but also globally (**LFG 1996)**. It was estimated that leasing, in the late 90s, provides about one-eighth of the world's equipment financing requirements **(Kieso and Weygandt 1998)**. In 2004, financial leasing was the fastest growing way of financing fixed assets all over the world. It was raised by 26% counting around 580 billion dollars. The USA part count $241 billion taking over the funds provided through the USA banks credit, bonds and equity. In addition, in the USA it shows that fixed assets purchased by the biggest 500 companies 35% of those assets financed by leasing in 2004 **(Alrai 2007).**

Volume of leasing in the Egyptian market[2] amounted to 9 billion during the past five years after applying the leasing law funding the actual implementation, while the number of financial leasing contracts is 899 contracts. .

Studies have confirmed that the number of leasing companies in Egypt now amounts to 267

[1] The American Institute of Certified Public Accountants

[2] According Interview with Mr. Mohab Sultan Financial and Administrative Manager- Sogelease Egypt

companies[3], and its activity is growing annually at 20 percent. They pointed to studies that the funding lease in the world amounted to 450 billion dollars in year 2000 and that is the most important sources of medium-term financing in the markets and economies. Grow lease operations for nearly a quarter of a century in the United States and succeeded in the financing of industrial investments and spread, especially in western countries and some developing countries, including Arab and Islamic countries.

Lease financing[4] has proved its importance as a competitive tool of the industrial, commerce and agriculture in different countries, so that this type of financing is considered of the most efficient financing plans, and is appreciated for its significance contribution to the economic development of the States that undertaken it.

Objective:-

The objective of the study is to provide concerned interest parties (i.e. policy makers, lessor, investors, etc.) a comprehensive overview of the state of the leasing market in Egypt for further improvement and development. Therefore, considerable attention is paid to the analysis of the legal, marketing, and regulatory and tax frameworks related to leasing activities. The importance of this study comes from the fact that this theoretical and empirical work is designed to track and evaluate the leasing market in Egypt. Consideration could be given to the importance of leasing in Egypt from the logic of its advantages, which is in fact:

• One of the effective means to provide funding for the medium industries and small-scale, which is the main engine of economic growth.

• less expensive and more flexible than banks to ease of transaction procedures, as it overcomes the problem of bad use of funds as the payment is submitted directly to the supplier or seller, not the lessee.

Problem definition

Leasing plays an influential role in the economies of many developing countries where it contributes to increasing economic growth through the provision of necessary liquidity to finance the purchase of equipment and devices. It was anticipated enactment law of the financial lease No. 95 of 1995 that this activity is growing rapidly as one of the most important means of financing for being an effective means of providing finance for projects of small and medium-sized enterprises, but these hopes did not materialize and the shrinking role of leasing in the financial services sector to provide a limited number of financial products only, with little has been hardly noticeable in the industrial sector of small and medium-sized enterprises.

Important questions

Is leasing the ideal alternative for companies that have exhausted their energies in the traditional borrowing and for small and medium-sized enterprises and successful institutions that need to purchase fixed assets to be able expand with its activities?

Does lease payment (instalments & interests) affect the tax paid by the lessee & lessor?

Does the regulation, tax, legal and marketing factors influence the decision to go to financial leasing?

Hypothesis

To examine the effect of regulatory and tax issues, legal, and marketing on the use of financial leasing, the following null hypothesis is proposed:

H0 : There is no significant relationship between the financial leasing and independent variables (tax and accounting issues, legislations, and marketing)

2- Theoretical background

1.1.1 Leasing

Lawrence(2003) define lease is a rental agreement that extends for one year or longer. The owner of the asset (the lessor) grants exclusive use of the asset to the lessee for a fixed period of time. In return, the lessee makes fixed periodic payments to the lessor. At termination, the lessee may have the option to either renew the lease or purchase the asset. A lease is a contract that allows an individual or a firm to make economic use of an asset for a stated period of time without obtaining ownership interest in it.

Lessor – owner of the asset (usually has the right to the residual value, often has rights to depreciation). Lessee – the user of the asset (makes the lease payments, may have a purchase option, often responsible for all maintenance, insurance, property taxes, etc. for the asset).

2.1.2 Stanleyand **Geoffry(** (2002) explain the advantages to leasing[5]

- Lower payments because tax benefits accrue to lessor

[3] According Interview with Mr. Jean–Paul Decrock General Manager-Sogelease Egypt

[4] According Interview with Mr.Jean – Paul Decrock General Manager- Sogelease Egypt

- Lease agreements tend to be more flexible
- Lessor is able to obtain a higher salvage value
- Piecemeal financing
- Convenient
- Avoid some risk of obsolescence
- Smoother earnings and EPS
- Lessor can maintain equipment more efficiently
- Liquidity in the case of sale and leaseback
- For small or marginally profitable firms, leases may be the only source of financing available.
- Leasing may provide divisional/plant managers some flexibility in acquiring assets.

2.1.3 Lawrence(2003) explain disadvantages to leasing[6]

- More expensive for profitable firms
- Salvage value goes to lessor
- Difficult to get approval for modifications on leased real estate
- May not be cancelled without penalty

2.2 Types of leases

Lawrence (2003) explain types of leases through several different forms, the three most important of which are: (1) sales- and- leaseback arrangements, (2) operating leases, and (3) financial leases.

Sales-and-leaseback arrangement, a firm that owns land, buildings, or equipment sells the property to a financial institution and simultaneously executes an agreement to lease the property back for a specified period under specific terms. The financial institution could be an insurance company, a commercial bank, a specialized leasing company, or an individual investor. The sale-and-leaseback plan is an alternative to a mortgage.

Operating leases, sometimes called service leases, provide for both financing and maintenance. IBM is one of the pioneers of the operating lease contract. Computers and office copying machines, together with automobiles and trucks, are the primary types of equipment involved in operating leases.

Finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset. Moreover, title may or may not eventually be transferred (IAS 17, 3). Financial leases are differentiated from operating leases in that they (1) do not provide for maintenance service, (2) are not cancelable, and (3) are fully amortized (i.e. the lessor receives rental payments equal to the full price of the leased equipment plus a return on investment).

2.3 Financial Statement Effects

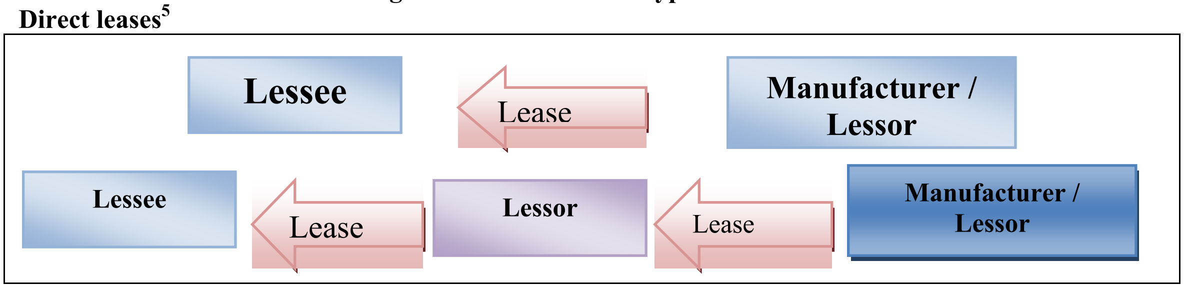
Lease payments are shown as operating expenses on a firm's income statement, but under certain conditions, neither the leased assets nor the liabilities under the lease contract appear on the firm's balance sheet. For this reason, leasing is often called off balance sheet financing which permits a firm to obtain more financial leverage if it leases than if it uses straight debt. This was cited as a major reason for leasing. Today, however, taxes are the primary reason for the growth of financial leasing. Leasing permits the tax shelters [7] (depreciation expenses and the investment tax credit) to be transferred from the user of an asset to the supplier of capital, and if these parties are in different tax brackets, both can benefit from the lease arrangement.

2.2.1 Financial leases (Lawrence ,2003)
Type of Financial Leases

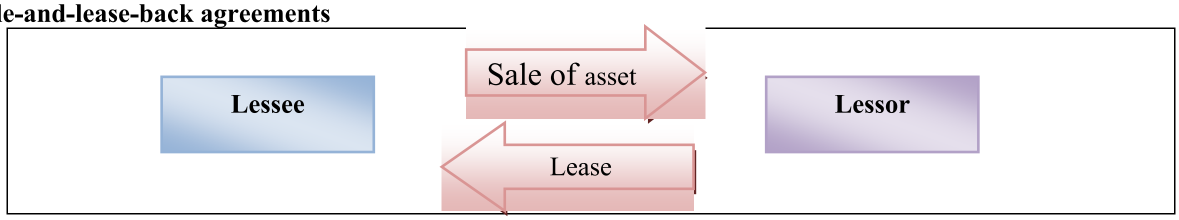
- Direct leases
- Sale-and-lease-back agreements
- Leveraged leases

Figure 1 shows that the Type of Financial Leases

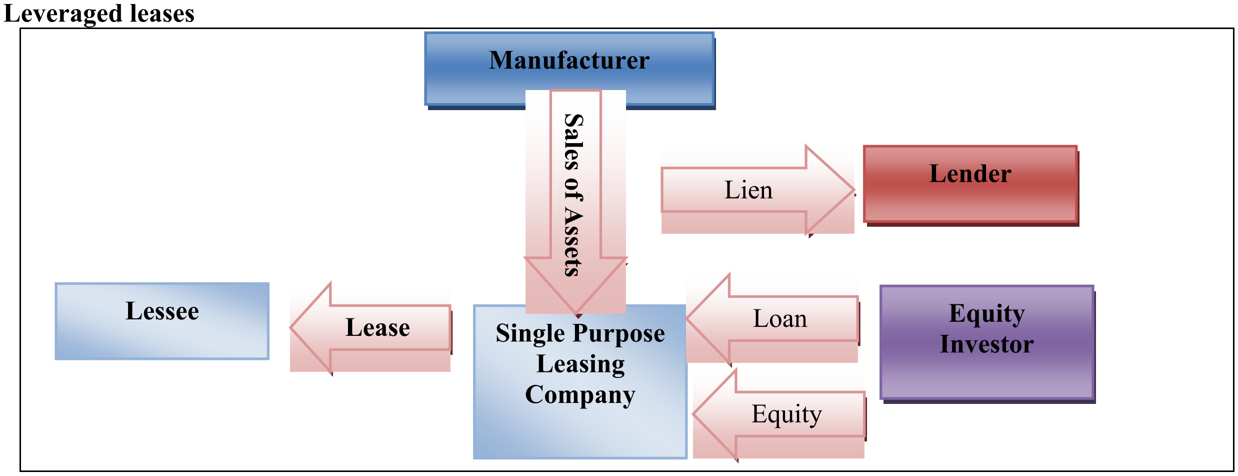
Direct leases[5]



Sale-and-lease-back agreements



Leveraged leases



3. The Role of Financial Leasing in Developing Countries

The financial leasing industry can play a very important role in developing financial markets and in providing finance to enterprises, especially small-scale-ones that face problems obtaining credit from banks. Financial leasing companies have a dual role, as on one side they complement the banking sector with increasing the range of products and services but on the other side they compete with the banking sector, forcing it to be more efficient and responsive to the needs of their customers. Leasing of plant and equipment has been extensively used in many countries as a means of expanding enterprises' access to credit, including term finance[5].

Advantages of leasing in emerging markets lie in its separation of ownership from economic use. For the lessor, ownership provides stronger security. In countries where collateral laws are not well developed or enforced by courts, secured lending of the type offered by banks can involve considerable collateral risk. Leasing offers the advantage of simpler procedures for repossession, because ownership of the asset already lies with the lessor. Other advantages to the lessee lie in allowing SMEs to have access to capital for investment. In addition, leasing enables the lessee to leverage off the purchasing strength of specialized lessor companies.

Basically, without a leasing industry, the sources of financing for small-scale enterprises, without assets to pledge as collateral, are funds from friends and relatives, suppliers' credit, moneylenders, and internal funds. However, for larger enterprises with adequate collateral, they would be a bank loan, suppliers' credit, capital markets, and internal funds. With a financial leasing, small and large enterprises would seek leasing for equipment purchase as their financing options in addition to the other alternatives. Leasing is perceived a substitute for debt for firms that are "too risky or are unable to access conventional debt markets".

Financial leasing could play an important role in enhancing financial intermediation, induces competition in the financial sector, and hence promote investment and economic growth. Gains acquired by the lessee include:

(i) less strict requirements for historical balance sheets, giving newly established and small-scale firms access to finance;

(ii) little cash required as leasing can finance a higher percentage of the capital cost of equipments than bank borrowing;

(iii) lower transaction costs despite the relatively high spreads of leasing:

(iv) Provision of medium- and long-term financing for the purchase of equipments; and

(v) Tax incentives as lessees can offset their full lease payments against income before tax, compared to just interest on bank loans. In addition, lessors can pass on tax benefits associated with their depreciation to lessees via reduced financing costs. Financial leasing could be a less risky transaction. Being able to retain ownership of the leased asset, the lessor is more secure in case of failure of repayment, especially if the repossession procedure is simple.

The specialized nature of leasing companies, combined with their scale, can also lead to a higher level of efficiency. They can offer efficiencies in dealing with government bureaucracies to negotiate and secure investment incentives, import licenses, and other investment related government benefits. A strong leasing market can also benefit financial sector development more generally by broadening the financial markets. In early stages of development, it is typical for leasing companies to raise their funding from wholesale sources such as banks, insurance companies, and pension funds. They can issue paper directly in the securities market. Once they have a sufficient credit history, they also can benefit the equity markets by going public.

4. Egypt Financial Leasing Market Evaluation

In September 2005, the **International Finance Corporation (IFC)**, a member of the World Bank Group, established the Egypt Leasing Development Project as one initiative under a regional program implemented by the IFC's Private Enterprise Partnership – Middle East and North Africa (MENA) called (**PEP-MENA**[6]), to assist in the development of leasing markets across the MENA region (IFC **2006**). The report published by IFC has valuable information used in this paper for giving a comprehensive overview about the leasing in Egypt.

The number of companies registered[7] with the General Authority for Investment and Free Zones are 267 Leasing Company until June 2009. The total investment according to their contracts are 11.989 Billion and the total volume of funding for these contracts is approximately 27.9 billion pounds until the end of June 2009. The first half of 2009 has recorded total number of leasing contracts are around 661 contract and funding volume of about 1.28 billion pounds. Leasing products exist in Egypt since May 1995 and has been created by the Law 95. New law No.95 which has just been amended on 10th of May 2001 and now authorizes companies to finance vehicles for transportation of passengers like all types of bus or personal car. The rest of the law has not been modified and can be summarized by the three following figures:

1) Financial Leasing Companies:
   Financial Leasing companies are considered as commercial entities as they have been regrouped in an informal Association.
2) Leasing operations accounting:
   Operations are not submitted to the International Accounting Standard
   Operations do not appear in the financial statements of the lessee, neither assets nor liabilities.
   Rentals are considered as expenses and are fully deductible from the taxable profit
3) The leasing operations:
   The leasing company (the lessor) buys the property chosen by the end user (the lessee).

- The lessor rents the property to the lessee during a certain period, in general between 1 to 5 years (up till 7 years for real estate leasing)
- The lessee pays rentals as agreed in the leasing contract (monthly, quarterly, half-yearly...)
- The rentals can be fixed or variable
- The rentals can be in EGP or foreign currencies
- At the end of the contract the lessee can buy the equipment for the residual value mentioned in the contract (ranging 1 EGP up till 10 % of the initial amount

Table (3) Show Equipment Types as % of Portfolio 2009

No.	Equipment Types	No. of Contract	%
	Medical Equipment	50	3
	Heavy equipment	84	4
	Trucks &Vans	171	9
	Buses	205	11
	Cars	208	11
	Real Estate	348	18
	Industrial	866	45

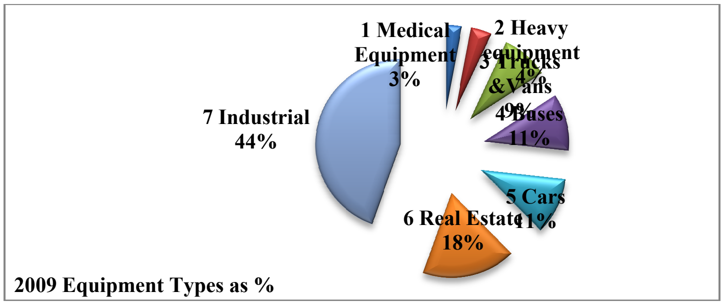


Figure 1 shows that the Equipment Types

5-Research Methodology

The methodology adopted in this research includes critical and comparative analyses. The critical analysis reviews the theoretical and empirical literature related to financial leasing in emerging markets, focusing on industrial companies. The research will review and assess the effectiveness of the macroeconomic, legal, and institutional framework, in addition to the existing incentive systems. Moreover, a comparative analysis will be conducted at the cross country level, taking into account the variations in the stages of development in terms of legislation and approaches in meeting the requirements of leasing. This will help in identifying policy recommendations on how to develop the financial leasing decision in industrial companies.

The sample selected for interview was the financial managers, or their representatives, in the industrial companies under study listed in Egypt.

5.1 Problem definition

Financial Leasing plays an influential role in the economies of many developing countries where it contributes in development of economic growth through the provision of necessary liquidity to finance the purchase of equipment and devices. It was anticipated Law of the financial lease No. 95 of 1995 that this activity is growing rapidly as one of the most important means of financing for being an effective means of providing finance for projects of small and medium-sized enterprises. But these hopes did not materialize and the shrinking role of financial leasing in the financial services sector to provide a limited number of financial products only, with little penetration hardly noticeable, to the industrial sector of small and medium-sized enterprises.

5.2 Research Objective

The objective of the study is to provide a comprehensive overview of the state of the leasing market in Egypt for further development and improvement of such market. Thus, considerable attention is paid to the analysis of the regulatory and tax, legal, and marketing framework related to leasing activities. In order to promote the impact of different variables on the use of financial leasing, mainly; regulatory and tax, legal, and marketing.

5.3 Research Question

Although the financial leasing industry has been stagnant during the last few years, it is expected to progress, partially as a result of the general reluctance of the banks to extend loans, especially to small and medium firms, pushing customers to look for alternative means of financing. In general, due to various reasons, the financial leasing sector in Egypt is in development phase.

So the most important questions are:-

- Is leasing the ideal alternative for companies that have exhausted their energies in the traditional borrowing and for small and medium-sized enterprises and successful institutions that need to purchase fixed assets to be able expand with its activities?
- Does lease payment (instalments & interests) affect the tax paid by the lessee & lessor?
- Does the regulation, tax, legal and marketing factors influence the decision to go to financial leasing?

5.4 Hypothesis

To examine the effect of regulatory and tax issues, legal, and marketing on the use of financial leasing, the following null hypothesis is proposed:

H0: There is no significant relationship between the financial leasing and independent variables (tax and accounting issues, legislations, and marketing)

In order to make our hypotheses more concrete, we specify and estimate an empirical model linking tax and accounting issues, legislations, marketing, and the use of financial leasing. The models to be estimated are the following equations ordinary least-squares (OLS) multiple linear regression:

$$LEAS = \alpha_0 + \beta_1 TAC + \beta_2 LEG + \beta_3 MAR + \varepsilon$$

Where: for firm i at time t, α is the constant term, β is a factor of regression slope, LEAS, TAC, LEG, and MAR are factors of financial leasing, regulatory and tax, legal, marketing, respectively.

5.5 Method of the survey

The researcher analysis is comprehensive for the companies that use the financial leasing through questionnaire and interviews with the financial managers to discuss the research problem.

5.6 Empirical study

The framework of applied research has been adopted on the following:

– The actual accounting data contained in the annual financial reports under consideration.
– Time limit of search only in achieving its objectives and to test assumptions imposed by the mainland and within the limits of the data for a time period of seven years starting from 2002, and ending in 2008 was chosen as that period of time based on market conditions, it included a rise in the cases of Egypt and then declines relative stability.
– Application was on a sample of companies leasing within the Arab Republic of Egypt due to the possibility of the availability of information used in the study.

6-Results61 Results of Questionnaire

1- It is clear that reliability and validity coefficient are reasonable for all variables. The questionnaire included four main variables, the reliability coefficient ranged from 0.731 for marketing to 0.908 for legislations; while the validity coefficient ranged from 0.855 to 0.953 respectably (the value of validity coefficient is the square root of the reliability coefficient).
2- The correlation coefficients report indicated that there is a strong positive correlation between (financial leasing) and explanatory variable (tax and accounting issues) where the value of the correlation coefficient is (.716), it is significance at the significance level of 1%.
   Generally, there is a proportional relationship between the dependent variable and the independent variables, and significance at significance level 1%.
3- It is clear significant regression model (financial leasing) on the tax and accounting issues as the f value (111.362) and it is significant at a significance level of 1% as the value of (Sig= 0.000) is less than 1% from the significant level, a significant regression coefficient and Constant show through T test and the value of p-value as it is significant at the significant level 1, the determination coefficient is (0.512), which means that Tax and accounting issues explain 51.2% of the changes that occur in the dependent variable.
4- It is clear significant regression model (financial leasing) on legislations as the f value (34.746) and it is significant at a significance level of 1% as the value of (Sig= 0.000) is less than 1% from the significant level, a significant regression coefficient and Constant show through T test and the value of p-value as it is significant at the significant level 1, the determination coefficient is (0.247), which means that Legislations explain 24.7% of the changes that occur in the dependent variable.
5- It is clear significant regression model (financial leasing) on marketing as the f value (15.225) and it is significant at a significance level of 1% as the value of (Sig= 0.000) is less than 1% from the significant level, a significant regression coefficient and Constant show through T test and the value of p-value as it is significant at the significant level 1, the determination coefficient is (0.126), which means that marketing explain 12.6% of the changes that occur in the dependent variable.
6- It is clear significant multivariate regression model (financial leasing) on the tax and accounting issues as the f value (37.339) and it is significant at a significance level of 1% as the value of (Sig= 0.000) is less than 1% from the significant level, a significant regression coefficient of tax and accounting issues and constant show through T test and the value of p-value as it is significant at the significant level 1, the determination coefficient is (0.519), which means that the independent variables explain 51.9% of the changes that occur in the dependent variable.

From the above the hypotheses in incorrect and we accept the alternative hypothesis:

'There is significant relationship between dependent variable (financial leasing) and independent variables (tax and accounting issues, legislations, and marketing) '

6.2 Results of Empirical study

1. It is clear a higher average ROA in the company Misr Cement / Qena, where was 18.27 while the average of the nine companies during the study period, 10.57, and the average ROE in the company Aracemco / Arab Ceramic reaching 26.40 while the general average of 16.68, and to test the difference between the average financial variables were tested using analysis of variance, , there is no difference between the companies to each other. This may be due to the beginning of the use of financial leasing companies, where there are companies' uses financial leasing for a long time and there are companies that use financial leasing short time ago.
2. Ii is clear from higher average ROA the companies which uses financial leasing than companies which not uses financial leasing , As the average of companies using financial leasing (10.57), while average companies that do not use the financial leasing (0.265), To test the difference between the average financial variables were used to test t, it is clear significant difference between the average of some financial indicators such as: ROA , ROE, EPS, Net Sales, Total Current Assets, NPAT.
3. The results test difference between companies that do not use financial leasing shown significant difference between the average of some financial indicators such as: Current Ratio, Total Current Assets, Total Liabilities, Paid Capital, Total Stockholder, Total Investment and Cash at End.

'There is significant relationship between dependent variable (financial leasing) and independent variables (tax and accounting issues, legislations, and marketing) '

7-Recommendations

To improve the environment financial leasing in Egypt , it is important to:

1. Increase knowledge about role financial leasing among companies stakeholder. In order to enhance the role of financial leasing companies that require find supportive regulatory environment and a strong system for determine clear property rights and repossession of assets in case of default.

2. Strengthen the legal framework governing financial leasing operations.
3. There is a good potential for the involvement of the financial leasing companies in providing their services to Small and Medium Enterprises (SME) sector in Egypt. Still, there are some companies, which are worried about the high risk, that can be involved in SME financing which may result in high pricing strategies or need for initial deposits.
4. Although the Egyptian law provides incentives for financial leasing companies to operate in the Egyptian market, there are still some deficiencies-which are mostly related to default as per the interviewees-in need to be revisited. Moreover, since the only type of leasing, which practice is allowed in the Egyptian leasing market is financial lease, it would be, therefore, beneficial to assess the possibility of introducing new types of leasing activities.

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