Leasing as a Practical Instrument for Financial Design in Russia

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Abstract

The solution to the urgent problem of financing a business, at first glance, is to attract a bank loan. However, at present, the receipt of borrowed funds from banks by companies in Russia is limited by a number of reasonable reasons: the distrust of banks in businesses due to their nontransparency, instability of the proceeds, lack of collateral. As a result, all this leads to higher interest rates. In this light, the use of leasing acquires additional benefits, among its main advantages. The paper explores relevant scientific discussions regarding the use of leasing as an instrument for financing fixed assets modernization projects in Russia. The authors investigated the problem of assessing the effective implementation of the project for the modernization of fixed assets using leasing instruments. The classification of existing methods for assessing the effectiveness of leasing transactions is developed. The main advantages of leasing are determined. The factors affecting the efficiency of projects on modernization of fixed assets at an enterprise using leasing instruments are identified. A methodology for assessing a leasing transaction based on economic indicator of added value, and an author's scheme for the use of leasing in financial design are proposed. The purpose of the study is to identify key features of leasing as a financial instrument in Russia.

Keywords: Leasing, Modernization of fixed assets, Enterprise, Financial design, Assessment of a leasing transaction, WACC, Weighted Average Cost of Capital

1 Introduction

The problem of relevant use of leasing in Russian companies is justified, first of all, by its effectiveness, remains acute and requires a comprehensive review. In developing methods for determining the effectiveness of leasing transactions, it is important to understand the goals of the parties interacting in the process of concluding a contract. For a lessor, this is, first of all, a type of entrepreneurial activity, and for a lessee, this is a capital-saving form of attracting investments. In the current economic realities, the feasibility and necessity of leasing activities, like any other economic activity, must ultimately be justified on the basis of one of the most important categories - the effectiveness of its implementation. In the study of the scientific literature it was revealed that there are a number of foreign and domestic procedures for evaluation of the effectiveness level for leasing schemes, including for assessment of the effective use of leasing in comparison with other financial instruments. Based on the analysis of published leasing valuation techniques, two groups can be distinguished. The first group of economists assess efficiency on the basis of methods for calculating leasing payments based on determining the costs of a leasing company. For example, the techniques presented by Ladnova E.S., Kasimov A.V., and others (1) Another group of economists compares leasing with alternative financing methods (in particular, with lending) to analyse the effectiveness of leasing transactions. For example, the methods of Ivashkin V.A., and Gazman V.D. (2). In turn, leasing can be compared with alternative investment methods in accordance by direct comparison, by calculating the adjusted current value, by calculating the net present value of the lease at the adjusted discount rate. Some methods based on the lessor’s costing suggest the use of correction factors, and others – by discounting.

The purpose of this paper is to identify the key features of leasing as a financial instrument in Russia.

2 Methods

When conducting the research of leasing as a toolkit, statistical methods, methods of strategic management, economic analysis of organizations, as well as general scientific methods such as analysis and synthesis, a systematic approach to studying the external and internal environment of an organization, socio-economic phenomena and processes were used.
Table 1: Methods for assessing the effectiveness of leasing transactions

<table>
<thead>
<tr>
<th>Methodology</th>
<th>Authors / Representatives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Methods based on a comparison of leasing and credit.</td>
<td>I.B. Kiselev, V.A. Shtavrin, V. Maslenikov</td>
</tr>
<tr>
<td>Methods that determine the effectiveness of leasing on the basis of discounting cash flows.</td>
<td>V.D. Gazman, I.P. Kamenev</td>
</tr>
<tr>
<td>Methods based on a comparison of leasing and various purchase options.</td>
<td>I. I. Lukasevich, N.A. Grabar</td>
</tr>
<tr>
<td>Methods that determine the effectiveness of leasing, regardless of other sources of financing</td>
<td>A. Kadushkin and N. Mikhailova, A.V. Kasimov, I.A. Form</td>
</tr>
<tr>
<td>Methods described in foreign literature</td>
<td>The methodology of the non-profit fund for enterprise restructuring and the development of financial institutions.</td>
</tr>
<tr>
<td>Methodology used by leasing participants in the US market (8)</td>
<td>S. Myers, D. Dill, and A. Batista, “Equivalent Loan Method.” E. Reed, R. Cotter, E. Gill, R. Smith in the book “Commercial Banks” proposed a model that is separately applied to the lessor and lessee.</td>
</tr>
</tbody>
</table>

3 Results and Discussion

As a result of the study with the use of data on the implementation of projects for the modernization of fixed assets belonging to enterprises in Russia using leasing instruments, a classification of existing methods for assessing the effectiveness of leasing transactions is compiled (Table 1). Thus, to date, there is no clearly applicable methodology for assessing the effectiveness of leasing projects. Including, at the moment, there are no effectiveness analysis techniques focused on accounting for the effect of leasing on company value. The main advantages of leasing are determined. Firstly, an entrepreneur can start their own business with only a fraction (about one third of the funds) needed to purchase premises and equipment, and secondly, not money is provided, control of which is not always possible, but directly the means of production necessary to update and expand the production apparatus. Also, not all companies can implement any projects at their own expense (3). Therefore, companies evaluate in detail the advantages and disadvantages of various types of investments. Credit and leasing have much in common; however, it is necessary to conduct a comparative analysis to highlight significant features.

Credit has its own distinctive features, which are set out in its definition. Today, the Central Bank of the Russian Federation pays special attention to regulating the activities of credit organizations, regulating it with strict instructions. Before comparing the loan and leasing directly, it is necessary first to mention what credit and leasing are, and secondly, what are their main features.

So, S.S. Artemyeva gives the following definition of loan: “A loan is an economic category expressing the relationship that develops between a lender and a borrower regarding the transfer of funds for temporary use with an obligation to repay within a certain period of time” (4).

According to the Civil Code of the Russian Federation, a loan is understood as an agreement on the basis of which a bank or other credit institution (lender) is obliged to provide funds (credit) to the borrower in the amount and on the terms stipulated by the agreement, and the borrower undertakes to return the received amount and pay interest on it (5).

The lending market in Russia has come a long way in its development. Today it is considered absolutely normal: to go to a bank and, if necessary, take a loan. As history shows, at the stage of its development, interest on loans reached 210% per annum (at such a rate the Central Bank of the Russian Federation issued loans to commercial banks from October 15, 1993 - April 28, 1994) and were issued at extremely disadvantageous conditions, in addition to a large interest percentage (6). This was largely due to an imperfect credit system, as well as the instability of the economic and political situation in the country.

Due to the fact that the loan is repaid from the net profit of an enterprise, a significant number of them go to various abuses in order to reduce the amount of profit in order to avoid progressive taxes. Sometimes some banks cooperate with companies that violate tax laws (7). When issuing a loan, a credit institution attaches particular importance to the liquidity of property acting as collateral. A bank may refuse to give a loan to enterprises that implement projects equal to or greater than the liquid assets value on the balance sheet of the enterprise. The reason for the refusal to grant a loan to the enterprises implementing investment projects may be the presence of the outstanding loan. Since an increase in the share of borrowed funds, on the one hand, indicates an increase in the financial instability of the enterprise and an increase in its financial risks, and on the other hand, the factor of the successful functioning of the enterprise indicates the trust of creditors and ensures an increase in the profitability of own funds.

Due to the formation of additional assets, an enterprise using borrowed capital has a higher financial potential for its development and the possibility of increasing financial profitability. However, as the share of borrowed funds in the total amount of capital used increases, it generates financial risk and the threat of bankruptcy (8, 17, 18, 19).

In contrast to loan, there is a very effective alternative to acquiring fixed assets by an enterprise - long-term (financial) lease or leasing. Unlike ordinary leases, financial leases (leasing) are a form of borrowed financing in which loans are provided not with cash, but with property.

A methodology for assessing a leasing transaction based on an indicator of economic value added has been developed. The cost of capital concept is one of the key in financial management. There is a priority for the economic interests of business owners, which, in turn, has led to a change in the
goal-setting process in elaborating a development strategy for a company. The new process is aimed at maximizing the corporate value and wealth of business owners, as opposed to the traditional process of setting goals, focused on maximizing profits (9, 20, 21).

The development of a new approach to strategic goal setting has led to the formation at the end of the last century of the concept VBM (Value-Based Management). According to G.I. Khotinsky, the emergence of the VBM-concept was the result of the strengthening the strategic emphasis in corporate management, for which current profit is not so much important as the profit of future periods and the source of its generation. Thus, the approach underlying this concept orients the company towards an increase in its value (10). In the 80s - 90s, a number of value added management systems appeared in the modern management of organizations.

The main ones include EVA (Economic Value Added), MVA (Market Value Added management), SVA (Shareholder Value Added - increase of equity capital), CVA (Cash Value Added - cash income management, CFROI (Cash Flow Return on Investment - adjusted cash inflows and outflows), and others. Of all the existing indicators designed to assess the value creation process, economic value added (EVA) is one of the most common. In our opinion, it is also suitable for evaluating leasing transactions. According to the authors, a significant advantage of economic added value is that in its calculation, it takes into account the cost of equity of the company and the costs associated with borrowing funds.

The main idea of economic added value is as follows: investor actions should bring returns that would compensate for the risk he/she has taken reflected in the cost of capital employed. The traditional approach to the calculation of economic value added is expressed in formula 1.

\[
EVA = NOPAT - WACC \times CE [\%]
\]

(1)

Where NOPAT (Net Operating Profit after Tax) is the post-tax operating profit before deducting accrued interest on loans and borrowings received. When calculating it, an account is made of all incomes and expenses of the company included in the income statement, including income tax. To determine NOPAT to the net profit of the reporting period, it is necessary to add interest to payment;

CE (Capital Employed) - invested capital;

WACC (Weighted Average Cost of Capital) in %, per year.

In its pure form, the economic value added concept is rather complicated in its application due to the need to make a large number of adjustments. And accordingly, the development of the most acceptable way to determine the economic added value for Russian companies using leasing is one of the current tasks of the development of economic science in our country.

To build an effective methodology of financial design based on an indicator of economic added value, it is necessary to develop a methodology for determining this indicator for a leasing company. In general terms, the methodology for assessing a leasing transaction based on an indicator of economic added value should include the following sections:

1. Methodology for determining WACC for a leasing company.
2. The procedure for determining the price of equity.
3. The procedure for determining the price of borrowed capital.
4. Methodology for calculating NOPAT as to the leasing company.
5. Calculation of invested capital of a leasing company.
6. The procedure for assessing the indicator of economic value added.

Figure 1: The use of leasing in financial design

4 Summary

Analysing and comparing the methods of domestic and foreign scientists, we can draw the following conclusions:

1. Foreign methods are based for the most part on calculating the cost of leasing and comparing the results with alternative options for financing the project. Domestic methods consider leasing exclusively as a form of lease.

2. Assessing the effectiveness of leasing is an important step in choosing a method of financing a project; however, in most domestic methods, the economic effect of leasing operations is not evaluated, and part of the methods is focused exclusively on the interests of a lessor.

3. Often in domestic methods there is no justification for the selection of criteria. Moreover, the criteria must satisfy three basic rules: to be objective, adequate and neutral.

4. Most foreign methods are based not on considering leasing as a form of rental, but on calculating the cost of leasing for the lessor and lessee and on comparing various financing options.

5. Most existing methods are based on comparing leasing with loan. However, the lessee often does not have a choice between credit and leasing (especially for small businesses), but only between the most acceptable leasing conditions.

6. The methods proposed by modern science for the most part do not provide for a clear division of efficiency into two areas: from the position of investor and from the position of a business owner (11, 12, 22). From the investor's point of view, the analysis is carried out in the conditions of uncertain investment in various options of financial assets; as a result, the most profitable project is selected. From the perspective of a business owner, the analysis is carried out in certain conditions with specific objectives of the project.

7. The analysis of the published methods for assessing the effectiveness of leasing showed the absence of a unified
methodological framework for calculations, generally accepted methods for determining economic efficiency. So, the approach based on taking into account the interests of a leasing company is mainly used in the basis of published methodological developments, which limits the range of issues to be resolved. In addition, the ambiguity of the calculation results when using various methods of assessing the effectiveness of leasing makes it difficult for the lessee to make a final decision. Finally, a high degree of uncertainty in the assessment of leasing is inherent in techniques that offer an assessment of effectiveness without taking into account the influence of changes in external factors.

5 Conclusions

Today, for the full functioning of an enterprise, own funds are not enough, since the debt repayment periods, as a rule, differ from the receipt of funds from sales, there is also an untimely payment and force majeure circumstances are not excluded. In such situations, the company is forced to turn to external sources of financing to obtain funds, and therefore is forced to choose one or another side of borrowing on the side (12, 13). So, for example, the management of some enterprises that do not want to give control (even partially) to an outside investor or its representatives, thus exclude the attraction of an external source of financing (14, 15, 16). For these reasons, in recent years, leasing has become increasingly popular and widespread, which, due to its inherent capabilities, can become a motive for the technical re-equipment of enterprises, the attractiveness of benefits will contribute to the further development of leasing.

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References