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LEASING

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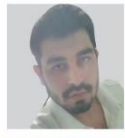
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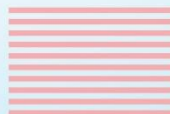
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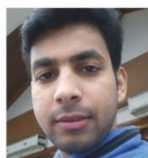
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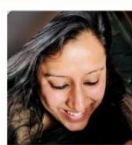
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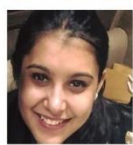
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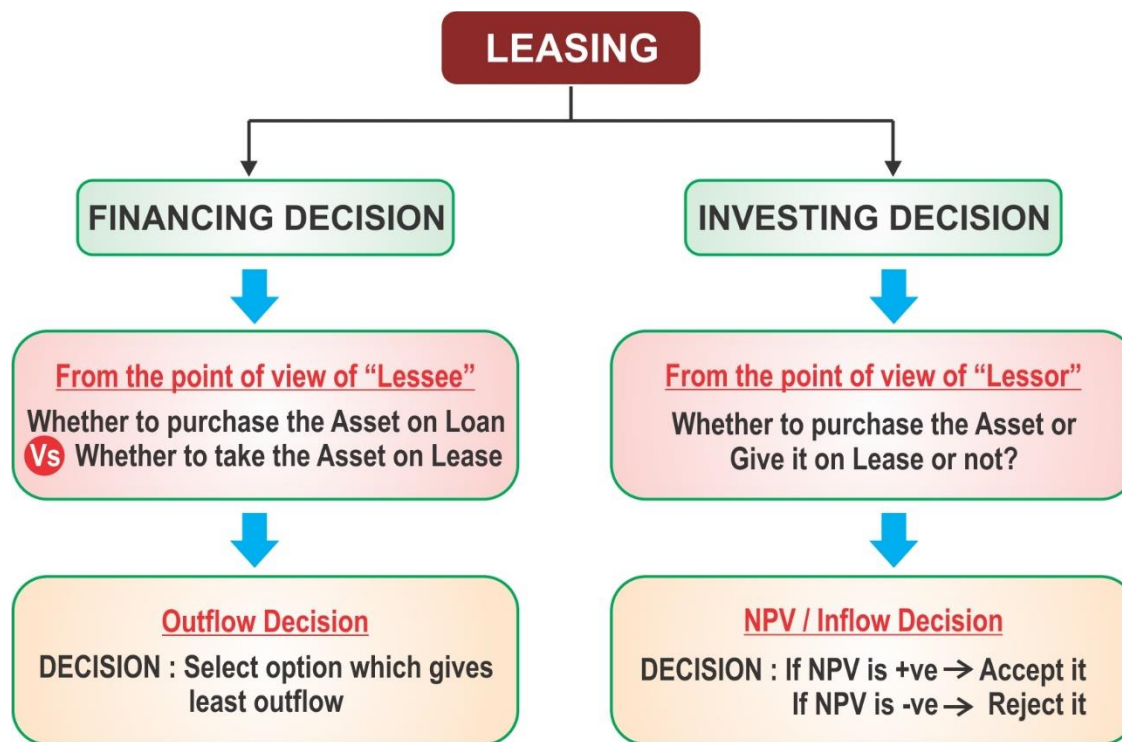
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LEASING

LOS 1 : Introduction



The Future of Finance starts with you

- Leasing is an important source of medium-term financing or leasing is the process of financing the cost of an asset.
- It is an arrangement under which an asset is financed and owned by one party but possessed and used by the other.

Parties to the lease agreement:-

1. LESSOR:

The OWNER of the asset is known as lessor-who gives assets on lease.

2. LESSEE:

The USER of the asset is known as lessee-who takes asset on lease.

- The lease agreement details out the specified period and timing of the sequential payments to be made by the lessee to the lessor as consideration for the use of the asset. It also incorporates repayment schedule.

LOS 2: Evaluation from the Point-of-view of Lessee/ Lease or Borrow & Buy Decision(A Financing Decision)

Loan Option	Lease Option
Outflows	Outflows

Interest Net of Tax	Lease Rentals Net of Tax
Principal Repayment	Repair & Maintenance Net of Tax
Expense Net of Tax	
Repair & Maintenance Net of Tax	
Inflows:	Inflows:
Tax Saving on Depreciation	Nil
Salvage value adjusted for Tax	
Calculation of Discount Rate	Calculation of Discount Rate
Kd = Interest Net of Tax →	Kd
	Leasing is an alternative of Loan Option
Ke →	Ke
Ko →	Ko
Present Value of outflow under Loan option	Present Value of outflow under Lease option
Decision: Select the option which gives the least outflow.	

Adjustment No. 1**Common items under lease option and loan option can be ignored.****Exception to this rule:**

1. Timing Difference.
2. If discount rate is different in both options.

Note :

Repair and Maintenance Expenses are always borne by the user of the Asset unless otherwise specifically stated.

Insurance expenses are always borne by the owner of the Asset unless otherwise specifically stated.

Adjustment No. 2**Loan / Principal Repayment**

1. **Bullet Payment:** Principal will be repaid in one shot at the end of Loan term, in this case interest is calculated for each year.
2. **Principal amount of loan repayment:** Interest is calculated on Balance amount.
3. **Equated Annual Installments:** It includes Interest and Principal both.

Adjustment No. 3 : Equated Annual Installment (EAI)**(When installment is paid at the end of each year)****Step1: Equated annual loan repayment inclusive of interest (paid at the end of each year)**

$$EAI = \frac{\text{Amount of loan}}{PVA(r\%, n \text{ years})}$$

Where,
 $r\%$ = rate of interest before Tax (Charged by bank)
 n = Period of Loan

Step 2: Calculate Principal Repayment amount and interest amount from the total equated Annual Installment

Step 3: Calculate Interest Net of Tax.

When installment is paid from beginning of each year/ annuity due

$$EAI = \frac{\text{Amount of Loan}}{1 + PVAf(r\% (n-1)\text{years})}$$

❖ If silent, we will assume those rentals are paid at the end of each year.

LOS 3: Evaluation from the point of view of Lessor (Investment Decision)

Decision: “Whether to purchase asset and give asset on lease rent or Not”

Step 1: Calculate all cash inflows and all cash outflows of lessor. TABLE

Inflows of Lessor:	Out Flows for Lessor:
(i) Lease Rent received net of Tax. (ii) Tax Savings on Depreciation. (iii) Salvage Value adjusted for Tax.	Cost of Asset Purchased

Step 2: Compute a suitable Discount Rate.

K_0 = Cost of Capital

Or

$$K_0 = WACC = K_e W_e + K_d W_d + K_r W_r + K_p W_p$$

Step 3: Compute NPV (Net Present Value)

Decision: If NPV is Positive, lessor should lease the asset.

LOS 4: Treatment of Depreciation

- Depreciation is always charged by the owner of the Asset.
- In case of Loan Option, depreciation is charged by borrower.
- Depreciation is a non-cash item, it should not be considered while calculating cash flows.
- Tax savings on depreciation should be taken as cash inflows.

$$\text{Tax Saving on Depreciation} = \text{Depreciation Amount} \times \text{Tax Rate}$$

Methods of Depreciation:

1. Straight- line Depreciation Method:

Straight-line depreciation allocates an equal amount of depreciation each year over the asset's useful life.

$$\text{Depreciation p.a.} = \frac{\text{Original Cost} - \text{Salvage Value/Residual Value}}{\text{Life of the asset}}$$

Note:

If question is silent, always use straight-line method of depreciation.

2. Written-down value Depreciation Method:-

$$\text{WDV Depreciation} = [\text{Cost} - \text{Accumulated Depreciation}] \times \% \text{ of Depreciation}$$

Note:

If Rate of Depreciation is given use WDV Method

- ❖ We recognize more depreciation expense in early years of the asset's life and less depreciation expense in the later years of life.

3. Sum of Years Digit Method of Depreciation:-**Example:**

Cost of Asset = 100
Life = 5 Years
Salvage Value = 10
Calculate Depreciation.

Solution:

Amount to be depreciated = $100 - 10 \rightarrow 90$

Life = 5 years

Sum = $1+2+3+4+5=15$

Years	Depreciation
1	$90 \times 5 / 15 = 30$
2	$90 \times 4 / 15 = 24$
3	$90 \times 3 / 15 = 18$
4	$90 \times 2 / 15 = 12$
5	$90 \times 1 / 15 = 6$

LOS 5: Treatment of Salvage Value Adjusted for tax – (WDV Depreciation)**1. In Case of Profit**

$$= \text{Salvage Value} - \text{Tax Paid on Profit on Sale}$$

2. In Case of Loss

$$= \text{Salvage Value} + \text{Tax Saved on Loss on Sale}$$

Example A (In case of Profit):

Cost of Asset = 1,00,000
WDV Dep. = 10%
Life = 5 Years
Tax@ = 50%
Salvage Value = 70,000
Calculate Cash inflows & outflows for each year.

Solution:

Year	Cash flows
0	(1,00,000)
1	+ 5000

2	+ 4500
3	+ 4050
4	+ 3645
5	+ 3281 + (70,000 – 5476) = 67,805

1. Calculation of Depreciation:

Year	Opening Balance	WDV@10%	Closing Balance
1	100000	10000	90000
2	90000	9000	81000
3	81000	8100	72900
4	72900	7290	65610
5	65610	6561	59049

2. Calculation of Profit & Loss on Sale of Asset:

Original Cost	1,00,000
Less: Depreciation till date	<u>40,951</u>
WDV	59,049
Less: Salvage Value	<u>70,000</u>
Profit on sale	10,951

Tax Payment on Profit on Sale of Asset @ 50% 5,476
 Calculation of Salvage value Adjusted for tax = 70000-5476=64524

Example B (In case of Loss):**If Salvage Value is 35,000****Solution:**

Year	Cash Flows
0	(100000)
1	+5000
2	+4500
3	+4050
4	+3645
5	+3280.50 + (35000 + 12024.50) = 50305

3. Calculation of Profit & Loss on Sale of Asset:

Original Cost	1,00,000
Less: Depreciation till date	<u>40,951</u>
WDV	59,049
Less: Salvage Value	<u>35,000</u>
Loss on sale	24,049
Tax Saving on Loss on Sale of Asset @ 50%	12,024.50

LOS 6 : Treatment of Salvage Value Adjusted for tax – (SLM Depreciation)**Example:**

Cost of Asset 1,00,000
 SLM Depreciation
 Life 5 Years
 Tax @ 50%
 Salvage Value 20,000
 Calculate Cash inflows & outflows for each year.

Solution:

Year	Cash flows
0	(1,00,000)
1	+ 8000
2	+ 8000
3	+ 8000
4	+ 8000
5	+ 8000 + (20,000 ± 0) = 28,000

Working Note**1. Calculation of Depreciation:**

$$\text{Depreciation p.a} = \frac{1,00,000 - 20,000}{5} = 16,000 \text{ p.a}$$

2. Calculation of Profit & Loss on Sale of Asset:

Original Cost	1,00,000
Less: Depreciation till date	<u>80,000</u>
WDV	20,000
Less: Salvage Value	<u>20,000</u>
Profit on sale	0

Note:

When SLM method is used, Salvage Value should not be adjusted for tax purpose, we only considered SV as inflow unless there is a adjustment related to SV.

Confusion regarding SV

1. If question states that Profit/Loss on sale of assets should be ignored then no need to adjust SV for Tax purpose.
2. Use words like "Net SV" then no need to adjust SV for Tax purpose.
3. If SV is not given in the question then do not assume SV = 0, accordingly no adjustment of SV.

LOS 7: Treatment of Tax

- Cash inflows & Cash outflows should be taken Net of Tax provided cash inflows & outflows are part of the profit & loss account (Tax Saving or Tax Paid only on revenue items not on Capital items).
- Tax savings should be taken as cash inflows like tax savings on depreciation, tax savings due to loss on sale of asset.
- **Treatment of Tax when Cash inflow & Cash outflow arises from the Beginning of each year.**

Example:

Training expense incurred at the beginning of the Year 1 or in Year 0 ₹10, 000. Tax Rate@40%. Calculate Inflow & outflow for each year.

Solution:**Alternative 1 (Adjust Tax in year 0 itself):**

Year	Cash Flow
0	- 10,000 + 4,000 = (-) 6,000
1	Nil

Alternative 2: (Preferred by CA Institute) (Adjust Tax at year end 1):

Year	Cash Flow
0	-10,000
1	+ 4,000

Note:

There will be difference in answer under both alternatives.

LOS 8: Break-even lease rentals

Break-even lease rentals are those rentals at which:

$$\text{PV of outflow under Loan Option} = \text{PV of outflow under Lease Option}$$

LOS 9: IRR Technique / Implied Interest Cost of Lease for Lessor

- When discount rate is missing in the question, we use IRR technique.
- IRR is the Discount at which NPV is Zero.
- IRR is the discount rate at which PV of inflows = PV of Outflows

@NPV +ve

@NPV -ve

$$\text{IRR} = \text{Lower Rate} + \left[\frac{\text{Lower rate NPV}}{\text{Lower Rate NPV} - \text{Higher rate NPV}} \right] \times \text{Difference in Rate [HR - LR]}$$

Break Even Lease Rentals (From the point of view of LESSOR)**PV of Inflow = PV of Output**

PV of Lease Rentals Net of Tax

(+)

PV of Tax Savings on Depreciation = Cost of Asset

(+)

PV of SV Adjusted for Tax

(-)

PV of Expense Net of Tax

LOS 10 : Concept of Block of Assets

- Block of Assets means a group of assets falling within a particular class of assets.

- **No depreciation** shall be charged in the year in which asset is sold.
- Tax Benefit/Loss on Short Term Capital Loss/Gain shall be calculated on **previous year WDV**.

LOS 11: Different Plans under lease Rentals

Different plans are offered by lessor to lessee. Some of these are follows:

1. Equal Annual Lease Plans

In this plan, equal amount of lease rentals are paid every year.

2. Stepped-up lease plan

Under this plan lease rentals are increased by a particular percentage every year.

3. Deferred Payment Plan

Under this, lease rentals are deferred for some year (i.e. not paid for few years) and after that it will be paid according to the terms of the contract.

4. Ballooned Payment plan

Under this plan, low amount lease rentals are paid for few years

At the end of the lease term, a huge amount is paid which is known as **Ballooned Payment**.

LOS 12: Net Advantage of Leasing (NAL)

- NAL is the Net Advantage/ Net Benefit of Leasing over & above the loan/ purchase option.

$$\text{NAL} = \text{PV of Outflow under Loan Option} \\ (-) \\ \text{PV of Outflow under Lease Option}$$

- If NAL is positive → lease should be preferred, otherwise purchase (loan option) should be preferred.

LOS 13 : Treatment of Subsidy for charging Depreciation.

Alternative 1 (Preferred by CA Institute)

Claim Depreciation on the full cost of asset.

Alternative 2

Claim Depreciation on Net Amount of Asset

LOS 14: Evaluation of quotation from two or more Lessor

- When Quotations are received from two or more lessor, lessee should select the quotation which gives least outflows.
- When life of two proposals/quotes are not same, we will take decision based on equated annual annuity(EAA)

$$EAA = \frac{\text{PV of Outflow or PV of Inflow or NPV}}{\text{PVAF @ } r\%, n \text{ years}}$$

LOS 15: Calculation of Cost of Asset/ Amount of Loan**Example:**

Equate Annual Installment = ₹ 2,65,000

Life 5 years, Interest Rate = 14%.

Payment starts from the beginning of each year.

Calculate Cost of Asset?

Solution:

$$2,65,000 = \frac{\text{Cost of Asset}}{1 + \text{PVAF}(14\% (5-1)\text{years})}$$

$$\text{Cost of Asset} = 2,65,000 \times 3.9137 = 10,37,130$$

LOS 16: Sales & Lease back Agreement

- If you own an asset, you can sell it to a leasing company and take the asset back for use under a leasing arrangement. This is referred to as "Sales & Lease Back"
- The main advantage is that it releases cash from the sale of asset that can be put to alternate use without giving up the benefits that flow from the existing asset.

LOS 17: Confusing regarding Discount Rate**Lessee & Borrower**

K_d = Interest (1-Tax), even if cost of capital is separately given in the question.

Lessor

K_0 = Cost of Capital / Discount Rate / Desire Rate of Return / Target rate of return

Note:

K_0 , K_d , discount rate & Desire rate of return given in the question are always Net of Tax.

Exception to these rules:

- If discount rate is separately given in the question.

E.g 1 : Borrow Vs. Lease

~~$$\begin{aligned} K_d &= 12\% \\ K_0 &= 15\% \end{aligned}$$~~

Discount Rate @ 18%

- If PVF table is given in the question for single discount rate.

E.g 2 : Borrow Vs. Lease

~~$$\begin{aligned} K_d &= 12\% \\ K_0 &= 15\% \end{aligned}$$~~

PVF Table @ 18%



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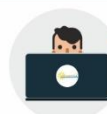
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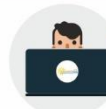
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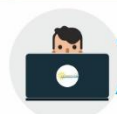
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