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FINAL CA
MAY '19
REVISION NOTES
Strategic Financial Management

Leasing

LEASING DECISIONS & APV

Q.1. Your company is considering to acquire an additional computer to supplement its time share computer services to its clients. It has two options :

(i) To purchase the computer for ₹ 22 lakhs.

(ii) To lease the computer for three years from a leasing company for ₹ 5 lakhs as annual lease rent plus 10% of gross time - share service revenue. The agreement also requires an additional payment of ₹ 6 lakhs at the end of the third year. Lease rents are payable at the year - end, and the computer reverts to the lessor after the contract period.

The company estimates that the computer under review will be worth ₹10 lakhs at the end of third year.

Forecast Revenues are :

Year	1	2	3
Amount (₹ in lakhs)	22.5	25	27.5

Annual operating costs excluding depreciation / lease rent of computer are estimated at ₹ 9 lakhs with an additional ₹ 1 lakh for start-up and training costs at the beginning of the first year. These costs are to be borne by the lessee. Your company will borrow at 16% interest to finance the acquisition of the computer. Repayments are to be made according to the following schedule :

Year end	1	2	3
Principal (₹ '000)	500	850	850
Interest (₹ '000)	352	272	136

The company uses straight line method (SLM) to depreciate its assets and pays 50% tax on its income. The management approaches you to advice, which alternative would be recommended and why?

Note : The PV factor at 8% and 16% rates of discount are :

Year end	1	2	3
8%	0.926	0.857	0.794
16%	0.862	0.743	0.641

Q.2. Welsh Limited is faced with a decision to purchase or acquire on lease a mini car. The cost of the mini car is ₹ 1,26,965. It has a life of 5 years. The mini car can be obtained on lease by paying equal lease rentals annually. The leasing company desires a return of 10% on the gross value of the asset. Welsh Limited can also obtain 100% finance from its regular banking channel. The rate of interest will be 15% p.a. and the loan will be paid in five annual equal installments, inclusive of interest. The effective tax rate of the company is 40%. For the purpose of taxation it is to be assumed that the asset will be written off over a period of 5 years on a straight line basis.

(a) Advise Welsh Limited about the method of acquiring the car.

(b) What should be the annual lease rental to be charged by the leasing company to match the loan option?

For your exercise use the following discount factors :

	Years				
Discount Rate	**1**	**2**	**3**	**4**	**5**
10%	0.91	0.83	0.75	0.68	0.62
15%	0.87	0.76	0.66	0.57	0.49
9%	0.92	0.84	0.77	0.71	0.65

Q.3. Kuber Leasing Ltd. Is in the process of making out a proposal to lease certain equipment to a user – manufacturer. The cost of the equipment is expected to be ₹ 10 lakhs and the primary period of lease is to be 10 years. Kuber Ltd. gives you the following additional information :

- SLM over 10 years period is acceptable under the Income – tax Act.
- The current effective tax rate is 40% and is expected to lower to 30% from the beginning of the 6th year of lease.
- Cut off rate is 10%.
- Lessees need to pay 1% of the value of the asset as lease management and processing fee.
- Annual lease rentals are to be collected at the beginning of the year.

Compute annual lease rent.

Q.4. (a) The pre – tax expected rate of return for the Hypothetical Industries Ltd. (HIL) is 24 per cent for a five year non – cancellable lease. The annual lease rental would be stepped at 10 per cent over the period. Compute the lease rental per ₹ 1,000.

(b) Assume that the lease rentals are deferred for the first two years. Compute the lease rentals per ₹ 1,000.

(c) The lease rentals will be stepped up by 25 per cent and then by 40 per cent and subsequently stepped down in the reverse order in the fifty year. Compute the lease rental per ₹ 1,000.

Q.5. GMBH Ltd. is in software development business. It has recently been awarded a contract from an Asian country for computerization of its all offices and branches spread across the country. This will necessitate acquisition of a super computer at a total cost of ₹10 crores. The expected life of computer is 5 years. The scrap value is estimated at ₹5 crore. However, this value could even be much lower depending upon the developments taken place in the field of computer technology.

A leasing company has offered a lease contract will total lease of ₹1.5 crore per annum for 5 years payable in advance will all maintenance costs being borne by lesee.

The other option available is to purchase the computer by taking loan from the bank with variable interest payment payable semi – annually in arrears at a margin of 1% per annum above MIBOR. The MIBOR forecast to be at a flat rate of 2.4% for each 6 month period, for the duration of loan.

Tax rate applicable to corporation is 30%. For taxation purpose, depreciation on computer is allowed at 20% as per WDV method, with a delay of 1 year between the tax depreciation allowance arising and deduction from tax paid.

You are required to calculate :

(a) Compound annualized post tax cost of debt.

(b) NPV of lease payment Vs. purchase decisions at discount rate of 4% and 5%.

(c) The break – even post – tax cost of debt at which corporation will be indifferent between leasing and purchasing the computer.

(d) Which option should be opted for?