

MAFA : CA FINAL

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CA Final (2nd Group Pending)

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Introduction

It is an extension of capital budgeting problem

Procedure Find the CFAT, for every year
 Apply the discounting rate
 And form the decision
 CFAT, may be Cash Inflow / Outflow

Decision making Whether to purchase asset, by borrowing loan, or
 Whether to go for lease rental scheme

Definition

Lease It may be defined as an Agreement,
 Between 2 parties, wherein
 One party gets the right of using the asset of another party
 For payment / Series of payment

Lessor Owner of the Asset, who allows the right to use

Lessee The party who enjoys, the right to use the asset

Treatment of Depreciation & Salvage Value

As per AS - 19 In case of Finance Lease
 Lessee can claim depreciation

As per Income Tax Lessor can Claim Depreciation

Application We go as per Income tax Act

Notes Salvage value is attributable to lessor
 Lessee has to pay lease rental
 Lessor has to receive lease rental
 Lease rental would be cash inflow for lessor
 Lease rental would be cash outflow for lessee

Evaluation of lease

Point of view, of Lessee point of view
 Lessor point of view

Lessee, Point of view

Decision to be made Whether to go for lease, or
 Whether to go for purchase, by borrowing loan

Determination of CFAT, in case of Borrow of funds **[Direct Method]**

	<u>MULTIPLY by</u>
Repayment of loan	Nil
Interest paid on loan	$(1-t)$
Depreciation	(t)
Salvage Value	Nil

Determination of CFAT, in case of Lease

Lease rental	
Savings in tax	$(\text{rental} \cdot t)$

Note :	<i>Be careful while calculating the CFAT, when the loan / lease has to be paid in the beginning of the year, and not at the end of the year</i>
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In such case,	Regarding borrowing option, the interest paid will be one year less
	Regarding lease Eventhough the lease is paid in the beginning
	That is, in the year 0, the tax effect will be in the year 1,

Determination of Discounting Factor

Discount rate is given	Same has to be considered
Discount rate is not given	Cost of capital rate is to be considered
Discount rate is not given Cost of capital is not given	Discounting rate = Borrowing rate $(1 - t)$

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Instalment amount is not given

But clue is given with respect to
Number of years of payment,
Borrowed amount,
Borrowing Rate
Also, that the Installment of all years to be equal

Procedure, for finding Installment

Find the EAI
Calculate the Interest, for the year 1,
Deduct from the EAI the interest
Which will give us Principal paid in the year 1
Which also results in the computation of outstanding principal amount
By following above process, we can find the interest for every year

Computation of EAI

IN CASE OF YEAR END INSTALLMENTS

$$EAI = \frac{\text{Amount of Borrowing}}{\text{Sum of DF from year 1 to year n}}$$

IN CASE OF BEGINNING YEAR INSTALLMENTS

$$EAI = \frac{\text{Amount of Borrowing}}{\text{Sum of DF from year 0 to year n-1}}$$

Whereas, n = Life of the borrowing
 DF = Rate of Borrowing (No, after tax borrowing)
Discounting factor = Rate of borrowing (Before tax)

Lease Rental is not given, : computation of BELR

BELR Break Even Lease Rental

BELR : Meaning It is the Lease Rental for which,
Borrowing Option & Lease Option would be equally
Attractive

That means to say,

$$PV \text{ of CFAT (Lease option) } = PV \text{ of CFAT (Borrowing option) }$$

Procedure

Assume that BELR = Rs, 'x' pa
So Annual Rental after tax = 'x' (1 - t)
Sum of DF from year 1 to n = X.xxxxxx
So PV of Lease Rental = 'x' (1 - t) = X.XXXXXX
OR
You can find the BELR, for every year

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Ballong Lease

Meaning	It is a type of lease, where the lease rental for every year goes on increasing. It is the concept, which is included in finding the BELR In such case, we have to follow the below procedure Assume the lease rental as 'x' for year 1 Assuming 10% increase in Lease Rental every year The lease rental for year 2 will be '1.1x' In the same way the lease rental goes on increasing
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Lessor, Point of view

Evaluation of only	Lease Proposal
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Determination of CFAT, under Lease Option

[Direct Method]

	<u>MULTIPLY by</u>
Lease Rental	Nil
Tax paid, on rental	t
Depreciation	(t)
Salvage Value	Nil

Lease Rental is not given, : computation of BELR

BELR	Break Even Lease Rental
BELR : Meaning	It is the Lease Rental for which, the Cash outflow in year 0, should be equal That means to say, BELR year end $PV \text{ of CFAT (Lease option) } = \text{Cash outflow as equipment cost}$ BELR beginning year $PV \text{ of CFAT (Lease option) } = 0$ because the year 0 cash flow is included in PV of CFAT Procedure Assume BELR = 'x' pa Then compute CFAT as usual

BIG NOTE : **Be care full, when the lease rental is to be received in the beginning of the year**



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