

MAFA : CA FINAL

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Disclaimer

Every effort is taken to avoid errors and omissions.

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Introduction

It is a 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 depreciaiton
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As per Income Tax	Lessor can Claim Depreciation
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<u>Application</u>	We go as per Income tax Act
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<u>Notes</u>	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
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Evaluation of lease

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

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

IN CASE OF BEGINNING YEAR INSTALLMENTS

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

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,

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

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 of CFAT (Lease option) = Cash outflow as equipment cost
BELR beginning year	PV 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
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BIG NOTE : **Be care full, when the lease rental is to be received in the beginning of the year**