

How to Perform a Lease vs. Buy Equipment Analysis A Step by Step Guide

By BizMove Management Training Institute

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1. Introduction

Businesses have difficulty raising capital - that's no secret. This difficulty (among other reasons) has caused many to look at leasing as an alternative financing arrangement for acquiring the use of assets. All types of equipment leasing-from motor vehicles to computers, from manufacturing machinery to office furniture-have become more and more attractive.

This guide describes various aspects of the lease/buy decision. It lists advantages and disadvantages of leasing and provides a format for comparing costs of the options.

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2. What Is a Lease?

A lease is a long term agreement to rent equipment, land, buildings, or any other asset. In return for most-but not all-of the benefits of ownership, the user (lessee) makes periodic payments to the owner of the asset (lessor). The lease payment covers the original cost of the equipment or other asset and provides the lessor a profit.

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3. Types of Leases

There are three major kinds of leases: the financial lease, the operating lease, and the sale and leaseback.

Financial leases are most common by far. A financial lease is usually written for a term not to exceed the economic life of the equipment. You will find that a financial lease usually provides that:

Periodic payments be made,

Ownership of the equipment reverts to the lessor at the end of the lease term,

The lease is noncancellable and the lessee has a legal obligation to continue payments to the end of the term, and

The lessee agrees to maintain the equipment.

The operating lease, or "maintenance lease," can usually be canceled under conditions spelled out in the lease agreement. Maintenance of the asset is usually the responsibility of the owner (lessor). Computer equipment is often leased under this kind of lease.

The sale and leaseback is similar to the financial lease. The owner of an asset sells it to another party and simultaneously leases it back to use it for a specified term. This arrangement lets you free the money tied up in an asset for use elsewhere. You'll find that buildings are often leased this way.

You may also hear leases described as net leases or Kross leases. Under a net lease the lessee is responsible for expenses such as those for maintenance, taxes, and insurance. The lessor pays these expenses under a gross lease. Financial leases are usually net leases.

Finally, you might run across the term full payout lease. Under a full payout lease the lessor recovers the original cost of the asset during the term of the lease.

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4. Kinds of Lessors

As the use of leasing has increased as a method for businesses to acquire the use of equipment and other assets, the number of companies in the leasing business has increased dramatically.

Commercial banks, insurance companies, and finance companies do most of the leasing. Many of these organizations have formed subsidiaries primarily concerned with equipment leasing. These subsidiaries are usually capable of making lease arrangements for almost anything.

In addition to financial organizations, there are companies which specialize in leasing. Some are engaged in general leasing, dealing with just about any kind of equipment. Others specialize in particular equipment, such as trucks or computers, for example.

Equipment manufacturers are also occasionally in the leasing business. Of course, they usually lease only the equipment they manufacture.

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5. Advantages of Leasing

The obvious advantage to leasing is acquiring the use of an asset without making a large initial cash outlay. Compared to a loan arrangement to purchase the same equipment, a lease usually

requires no down payment, while a loan often requires 25 percent down;

Requires no restriction on a company's financial operations, while loans often do;

Spreads payments over a longer period (which means they'll be lower) than loans permit; and

Provides protections against the risk of equipment obsolescence, since the lessee can get rid of the equipment at the end of the lease.

There may also tax benefits in leasing. Lease payments are deductible as operating expenses if the arrangement is a true lease. Ownership, however, usually has greater tax advantages through depreciation. Naturally, you need to have enough income and resulting tax liability to take advantage of those two benefits.

Leasing has the further advantage that the leasing firm has acquired considerable knowledge about the kinds of equipment it leases. Thus, it can provide expert technical advice based on experience with the leased equipment.

Finally, there is one further advantage of leasing that you probably hope won't ever be of use to you. In the event of bankruptcy, claims of the lessor to the assets of a firm are more restricted than those of general creditors.

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6. Disadvantages of Leasing

In the first place, leasing usually costs more because you lose certain tax advantages that go with ownership of an asset. Leasing may not, however, cost more if you couldn't take advantage of those benefits because you don't have enough tax liability for them to come into play.

Obviously, you also lose the economic value of the asset at the end of the lease term, since you don't own the asset. Lessees have been known to grossly underestimate the salvage value of an asset. If they had known this value from the outset, they might have decided to buy instead of lease.

Further, you must never forget that a lease is a long-term legal obligation. Usually you can't cancel a lease agreement. So, if you were to end an operation that used leased equipment, you might find you'd still have to pay as much as if you had used the equipment for the full term of the lease.

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7. Accounting Treatment of Leases

Historically, financial leases were "off the balance sheet" financing. That is, lease obligations often were not recorded directly on the balance sheet, but listed in footnotes, instead. Not explicitly accounting for leases frequently resulted in a failure to state operational assets and liabilities fairly.

In 1977 the Financial Accounting Standards Board (FASB), the rule-making body of the accounting profession, required that capital leases be recorded on the balance sheet as

both an asset and a liability. This was in recognition of the long-term nature of a lease obligation.

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8. Cost Analysis of Lease v. Loan/Purchase

You can analyze the costs of the lease versus purchase problem through discounted cash flow analysis. This analysis compares the cost of each alternative by considering: the timing of the payments, tax benefits, the interest rate on a loan, the lease rate, and other financial arrangements.

To make the analysis you must first make certain assumptions about the economic life of the equipment, salvage value, and depreciation.

A straight cash purchase using a firm's existing funds will almost always be more expensive than the lease or loan/buy options because of the loss of use of the funds. Besides, most small firms don't have the large amounts of cash needed for major capital asset acquisitions in the first place.

To evaluate a lease you must first find the net cash outlay (not cash flow) in each year of the lease term. You find these amounts by subtracting the tax savings from the lease payment. This calculation gives you the net cash outlay for each year of the leases.

Each year's net cash outlay must next be discounted to take into account the time value of money. This discounting gives you the present value of each of the amounts.

The present value of an amount of money is the sum you would have to invest today at a stated rate of interest to have that amount of money at a specified future date. Say someone offered to give you \$100 five years from now. How much could you take today and be as well off?

Common sense tells you you could take less than \$100, because you'd have the use of the money for the five year period. Naturally, how much less you could take depends on the interest rate you thought you could get if you invested the lesser amount. For example, to have \$100 five years from now at six percent compounded annually, you'd have to invest \$74.70 today. At 10 percent, you could take \$62.10 now and have the \$100 at the end of five years.

Fortunately there are tables which provide the discount factors for present value calculations. There are also relatively inexpensive special purpose pocket calculators programmed to make these calculations.

Why bother with making these present value calculation? Well, you've got to make them to compare the actual cash flows over the time periods. You simply can't realistically compare methods of financing without taking into account the time value of money. It may seem confusing and complex at first, but if you work through an example, you'll begin to see that the technique isn't difficult-just sophisticated.

Evaluation of the borrow/buy option is a little more complicated because of the tax benefits that go with ownership, loan interest deductions, and depreciation.

As noted earlier, the salvage value is one of the advantages of ownership. It must be considered in making the comparison. Naturally, it's possible that salvage costs for real asset could be very high or be next to nothing. Salvage value assumptions need to be made carefully.

Thus, while this sort of analysis is useful, you can't make a lease/buy decision solely on cost analysis figures. The advantages and disadvantages discussed earlier, while tough to qualify, may outweigh differences in cost-especially if costs are reasonably close.

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9. Look Before You Lease

A lease agreement is a legal document. It carries a long term obligation. You must be thoroughly informed of just what you're committing yourself to. Find out the lessor's financial condition and reputation. Be reasonably sure that the lease arrangements are the best you can get, that the equipment is what you need, and that the term is what you want. Remember, once the agreement is struck, it's just about impossible to change it.

The lease document will spell out the precise provisions of the agreement. Agreements may differ, but the major items will include:

The specific nature of the financing agreement,

Payment amount,

Term of agreement,

Disposition of the asset at the end of the term,

Schedule of the value of the equipment for insurance and settlement purposes in case of damage or destruction,

Who is responsible for maintenance and taxes,

Renewal options,

Cancellation penalties, and

Special provisions.

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Bonus Guide

10. How to Manage a Business Effectively

Manage a business effectively, manage staff effectively, is the key to the establishment and growth of the business. The key to successful management is to examine the marketplace environment and create employment and profit opportunities that provide the potential growth and financial viability of the business. Despite the importance of management, this area is often misunderstood and poorly implemented, primarily because people focus on the output rather than the process of management.

Toward the end of the 1980s, business managers became absorbed in improving product quality, sometimes ignoring their role vis-a-vis personnel. The focus was on reducing costs and increasing output, while ignoring the long-term benefits of motivating personnel. This shortsighted view tended to increase profits in the short term, but created a dysfunctional long-term business environment.

Simultaneously with the increase in concern about quality, entrepreneurship attracted the attention of business. A sudden wave of successful entrepreneurs seemed to render earlier management concepts obsolete. The popular press focused on the new cult heroes Steve Jobs and Steve Wozniack (creators and developers of the Apple Computer) while ignoring the marketing and organizing talents of Mike Markula, the executive responsible for Apple's business plan. The story of two guys selling their Volkswagen bus to build the first Apple computer was more romantic than that of the organizational genius that enabled Apple to develop, market and ship its products while rapidly becoming a major corporation.

In large businesses, effective manage business skills requires planning. Planning is essential for developing a firm's potential. However, many small businesses do not recognize the need for long-range plans, because the small number of people involved in operating the business implies equal responsibility in the planning and decision-making processes. Nevertheless, the need for planning is as important in a small business as it is in a large one.

This guide focuses on the importance of good management practices. Specifically, it addresses the responsibilities of managing the external and internal environments.

MANAGING THE EXTERNAL ENVIRONMENT

Three decades ago, Alvin Toffler suggested that the vision of the citizen in the tight grip of an omnipotent bureaucracy would be replaced by an organizational structure of ad-hocracy. The traditional business organization implied a social contract between employees and employers. By adhering to a fixed set of obligations and sharply defined roles and responsibilities, employees received a predefined set of rewards.

The organizational structure that Toffler predicted in 1970 became the norm 20 years later, and with it came changed concepts of authority. As organizations became more transitory, the authority of the organization and firm was replaced by the authority of the individual manager. This entrepreneurial management model is now being replicated

throughout society. As a result, the individual business owner must internalize ever increasing organizational functions.

Another change in today's business environment is dealing with government agencies. Their effect on the conduct of business most recently appears to have increased. As industries fail to achieve high levels of ethical behavior or individual businesses exhibit specific lapses, the government rushes in to fill the breach with its regulations.

MANAGING THE INTERNAL ENVIRONMENT

HUMAN RESOURCE ISSUES

Ensuring Open Communications

Effective communications play an integral role in managing and operating any successful business. With open communications changes and their effects on the organization are quickly shared. Your firm then has the time and skills needed to respond to changes and take advantage of evolving opportunities.

The following checklist addressing how you would respond to an employee's suggestion provides an assessment of the communication process in your business. Place a check next to the statements that are commonly heard in your business.

Statement

Face facts it's unrealistic.

Who else has done it?

It's not your problem.

Fill out form XX/xx revised.

It won't work.

Bring it to the committee.

We don't have the time.

We tried it before and it failed.

You think what? You're joking!

Everybody knows that that's foolish.

We can't afford to think about it.

Don't you have better things to do?

Are you some kind of a radical?

We're too small/big for that.

Impossible; our main product line would be obsolete.

The boss would never consider it.

It's contrary to company policy.

Carefully consider any statements that you have checked. This may indicate that management is inflexible and unresponsive to employee suggestions. Management that is unable to respond immediately to changes in the market signals an inflexible unstable firm. In the rapidly changing business environment such management can mean eventual failure for your business. If you haven't developed such a checklist do so. It will help you determine if and where adjustments are needed in your management staff.

Balancing Schedules Stress and Personnel

Without organization and good management the compressed time schedules associated with modern business can cause stress and make extraordinary demands on people. An effective management structure can reduce stress and channel the productive capacity of employees into business growth and profits.

Setting Duties Tasks and Responsibilities

An organization is characterized by the nature and determination of employees' duties tasks and responsibilities. While many organizations use different methods for determining these it is essential that they be clearly defined.

The core of any organization is its people and their functions. Duties tasks and responsibilities often evolve in an ad hoc manner. A typical firm starts with a few people often one performing all duties. As the firm grows others are hired to fill specific roles often on a functional basis. Roles that were handled by consultants and specialists outside the firm now are handled internally. As new needs emerge new roles are developed.

Just as an emerging business develops an accounting system it should also develop a human resource system. For instance the following employee information should be available and checked for accuracy at least once each year.

- Name
- Address
- Nationality (immigration status)
- Marital status and dependents
- Hire date
- Company job history:
- Title and code

- Performance
- Location
- Salary rate and history
- Education including degrees
- Specialty training
- Transcripts as appropriate
- Pre-employment work experience:
- Key responsibilities and levels
- Professional licenses or certificates
- Professional publication and speaking engagements
- Teaching experience
- Language abilities:
- Reading
- Writing
- Speaking
- Leadership evidence:
- Company
- Civic
- Other
- Relocation preferences and limitations
- Travel experience and preferences
- Career goals

Review your personnel files periodically to ensure that the information is correct and current. Implement a system that will make updating personnel files a fairly simple routine yet confidential process.

Business Team

The apex of an effective organization lies in developing the business team. Such a team involves delegating authority and increasing productivity. Assess the effectiveness of your business team with the following checklist:

The leader of the team is respected by the members.

The abilities of all team members are respected.

A team spirit is evident through activities.

Individual members compensate for weaknesses in each other.

Jokes are not disparaging.

A genuine feeling of being part of the best is exuded.

The work area is self-delineated and reflects a spirit.

Mistakes result in corrective action not retribution.

Each member understands the importance of his or her contribution.

The team can explore new areas of activity.

Security of employment is evident.

Controlling Conflict

Another key to successful management lies in controlling conflict. Conflict cannot be eliminated from either the business or the interpersonal activities of the enterprise. A measure of the organization's success is the degree to which conflict can be exposed and the energies associated with it channeled to develop the firm. Although establishing policies and procedures represents the tangible aspect of organization and management the mechanisms to tolerate and embody challenges to the established operation serve as the real essence of a firm that will survive and prosper.

Structural Issues

Organization

The effectiveness of a particular organizational form depends on a variety of internal and external events for example:

Competitors (number or activity)

Technology (internal or external)

Regulatory environment

Customer characteristics

Supplier characteristics

Economic environment

Key employees

Growth

Strategy (including new products and markets)

Even though you may discover that certain events are affecting your business be careful not to change the organizational structure of your firm without discussing it with your management team. Employees generally can accomplish goals despite organizational structures imposed by management. Because restructuring involves spending a lot of time learning new rules implementing a new organizational structure is costly.

Structure

The essence of a successful organization can be more simply summarized than implemented. The following checklist can help you determine measures to ensure your management structure is adequate. Check the entries that apply to your firm and also find out what measures your company needs to take to improve its management structure.

Key market and customers are understood.

Technology is mastered.

Key objectives are articulated and shared.

Major functions are identified and staffed.

A hierarchy of relationships is established.

A business team is in place and functioning.

Measurable results are well above industry standards.

Employees are the best source of new hires.

Policy and Procedural Issues

Authority

The central element of organizational management is authority. Through authority your firm develops the structure necessary to achieve its objectives.

A. L. Stinchcombe summarized the role of authority succinctly when he stated any administrative system that decides on the use of resources is also a system of authority directing the activities of people.

The authority that once was conferred by either owning a small business or having a position in the bureaucracy of a larger firm has been replaced by technical competence (including that of forming and running the business). Forces external to your business may emphasize the elements of granted versus earned authority. Once the owner-manager controlled the entire business but suppliers customers unions and the

government have severely limited the ability of the business owner-manager to take independent action.

A primary component of authority is the exercise of control within the organization. A thorough system of controls ensures the firm's operation and provides a mechanism for imposing authority. Internal controls include the provision that authority be delegated and circumscribed; examples of these provisions follow. Place a check by the provisions that apply to your firm. Consider implementing controls over areas that you have not checked.

Approval for disbursements of cash and regular accounting.

Reconciliation of bank statements.

Periodic count and reconciliation of inventory records.

Approval of pricing policies and exemptions.

Approval of credit policies and exemptions.

Review of expense and commission accounts.

Approval of purchasing and receiving policies.

Review of payments to vendors and employees.

Approval of signature authorities for payments.

Review of policies.

Delegation is a key to the effective exercise of authority in your business. By delegating limited authority to accomplish specific tasks the talents of employees in the organization can be used to upgrade the skills and experience of the manager. The following checklist enables you to determine if you are taking advantage of opportunities to delegate authority.

Is your time consumed by daily chores?

Do you have time for the following:

- Training and development of subordinates?
- Planning?
- Coordinating and controlling work of subordinates?
- Visiting customers and subordinates regularly?
- Remaining involved in new product development?
- Visiting branch locations regularly?

- Attending business meetings outside your business?

- Participating in civic affairs?

Is no one on your staff as good as you are?

To effectively delegate responsibility and authority in your organization you must:

Accept the power of delegation.

Know the capabilities of subordinates.

Ensure that specific training is available.

Select specific responsibilities to be delegated.

Clearly define the extent and limits of delegation.

Match each with necessary authority.

Provide periodic monitoring and interest.

Restrain the impulse to insist on how to do something.

Remember there are many ways to accomplish a specific objective.

Assess results and provide appropriate feedback.

Praise and criticize.

The skills and abilities of each level of authority can be increased by effectively delegating authority throughout any organization.

Operating Reports

Operating reports form the organizational basis of your business. Such reports mirror the organization its structure and function. They define key relationships between employees and can either minimize or increase organizational stress.

For many businesses the following reports form the basis for analyzing the specific areas of a business (the frequency of each report depends on the nature size and organization of your business). Check the reports your firm currently generates.

Consider creating reporting systems where they are lacking.

Case reports (daily, weekly, monthly)

New orders and backlog (weekly, monthly)

Shipments/sales (weekly, monthly)

Employment (monthly)

Inventory out of stock (weekly, monthly)

Product quality (weekly, monthly)

Accounts receivable aging accounts (monthly)

Weekly overdue accounts

Returns and allowances (monthly)

Production (weekly, monthly)

Reporting must be kept current to allow for timely identification and correction of problems before serious damage to the organization occurs.

Too much reporting as well as inappropriate reporting can be as destructive as too little reporting. For instance the CEO of a major industrial firm who receives daily production and inventory reports by model can lose his or her ability to maintain an overall perspective. Thus operating managers must attempt to identify and solve local problems and take advantage of local opportunities within their own authority. Inappropriate reporting compromises management's ability to leverage individual skills and abilities.

Operating reports not only provide essential data that enable management to accomplish its objectives they also focus staff's attention on the organization's goals. If reporting is not taken seriously employees may deal with customers suppliers and each other in a similarly trivial manner.

To avoid inappropriate reporting review reporting policies annually to ensure that reports are appropriate and contain the information needed to make sound management decisions.

Conclusion

Successful management is founded on the mastery of a myriad of details. While management schools teach the importance of focusing attention on major issues affecting the business practical managers realize the major issues are the variety of small aspects that form the business. In an increasingly structured society inattention to even one minor detail can result in significant disruption of the business or even its failure.

Checklist For An Effective Organization

The following checklist will help you identify and determine the effectiveness of the management and organizational structure of the firm. If you answer yes to most of the following questions you are effectively managing your firm. A no answer indicates that you need to focus on this management issue.

yes/no

Are responsibilities clear and matched by authority?

Is your business structure clear yet flexible?

Are communications focused on finding solutions rather than placing blame?

Do people have the information and resources necessary to do an excellent job?

Do you and your employees care about the business?

Does staff come in early and stay late on their own initiative?

Are mechanisms for conflict resolution working?

Is disorder minimized and channeled?

Can people joke with and about each other and you?

Does a corporate plan spell out the firm's vision?

Do employees pitch in unmasked during a crisis?

Do customers and suppliers prefer to do business with you?

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