Small Business: Lease or Purchase?

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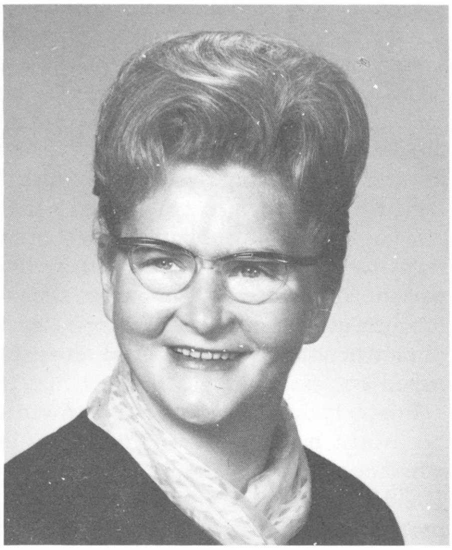

Small Business

LEASE OR PURCHASE?

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The decision to purchase or lease a piece of equipment is based on many considerations — some strictly financial, some tax-oriented, some related to over-all economic conditions.

The Effect on the Financial Statements and Cash Flow

Often a purchase requires a substantial down payment which could create a problem at times. On the other hand, a lease agreement does not normally require a large cash outlay up front. In the long run, of course, the ultimate cash requirements will be rather close, but the timing can be very important.

A purchase creates an immediate liability in the amount of the balance of the price of the equipment after the down payment. At least a portion of this liability is reflected in current liabilities, while the asset is shown in the Property and Equipment section of the balance sheet — not a current asset. Moreover, cash has been reduced by the amount of the down payment, and the current-asset/current-liability ratio is adversely affected. Even if circumstances require that a lease be capitalized and the commitment be shown as a liability, a relatively small amount would be a current liability.

Many items of office equipment are available on a lease basis only — or at least they were. Until recently, a Xerox copier could not be purchased, and the lease was for short durations, even though businesses renewed their leases year after year. There was never a question that each lease payment was a current period expense, the equipment was never owned and thus would not be shown as a capital asset, and no liability accrued — ever.

Tax Considerations

These are, of course, closely related to financial aspects, since a current tax deduction helps the cash position of a business. On the other hand, a 10% Investment Credit on equipment purchased or leased on a long-term basis (assuming a pass-through by the lessor), along with deductions for depreciation and interest, reduces the tax liability of the business and improves the cash position at least as much.

However, the trade-off of current deductions for lease payments as opposed to Investment Credit may not be an important consideration when assets with a relatively short life are involved. Automobiles and trucks are a good example. In the following comparison of lease costs and purchase, a hypothetical car is used that can be purchased for $4,500.00 to be financed over a 36-month period. The example used in this case assumed Columbus, Ohio delivery and residence for purposes of figuring license plates, freight and sales tax. Generally, what is true for Ohio is true for most of the country. The figures could change, but the comparison would remain similar. A more expensive or a less expensive car would reflect similar differences. Naturally, charges vary from one leasing company to another, but competition serves to keep the differences fairly low.

BUYING:

$4,500.00	Purchase price
180.00	4% sales tax
7.50	Filing fee
$4,687.50	
987.50	Down payment
$3,700.00	Amount to be financed
721.50	Finance Charge (6.5% add-on interest — equal to 12.27 annual percentage rate)
$4,421.50	Total to be paid in 36 monthly installments
122.81	Monthly payment
.92	License plates (per month for 36 months)
$123.73	Total monthly cost

LEASING:

The same car leased over a period of 36 months with a predicted resale value of

$1,250.00	can be leased for —
$103.13	Monthly lease payment (including finance charge and license plates)
4.13	4% Use (Sales) tax
$107.26	Total monthly payment

Assuming that it is desirable to purchase the car at the end of the lease period, the total costs compare as follows:

BUYING		LEASING	
$123.73	Monthly payment	$107.26	Monthly payment
× 36	Number of payments	× 36	Number of payments
$4,454.28	Total payments	$3,861.36	Total Payments
987.50	Down payment	1,250.00	Option to buy
$5,441.78	Total cost	$5,111.36	Total cost of lease and purchase

The cash requirements by year are shown below:

	BUYING		LEASING
First year — 12 payments	$1,484.76		$1,287.12
Down payment	987.50		
last month's lease			107.26
	$2,472.26		$1,394.38
Second year — 12 payments	1,484.76		1,287.12
Third year — 12 payments	1,484.76		
— 11 payments		$1,179.86	
Option price		1,250.00	2,429.86
	$5,441.78		$5,111.36

The tax deduction situation compares as follows:

	BUYING				LEASING
	Tax & License	Interest (Rule of 78)	Depreciation $1,250 Salv. S/L 3 years	Total	Lease payments
First year	$198.50	396.50	1,083.34	1,678.34	1,287.12
Second year	11.00	240.50	1,083.33	1,334.83	1,287.12
Third year	11.00	84.50	1,083.33	1,178.83	1,287.12
Three-year totals	$220.50	721.50	3,250.00	4,192.00	3,861.36

In addition, the purchase would yield an Investment Credit of $150.00 in the first year.

Notes:

A 6.5% yearly add-on interest rate is competitive for individual purchasers. Corporations may be subject to higher rates.

The lease rate is that of an Ohio corporation, which is very strong in the field of leasing cars to professionals, assuming 15,000 driving miles per year for a closed-end lease.

Add-on interest rates would not generally be used for purchases that are financed longer than 3 years. A bank loan at simple interest or other borrowing at straight rates will prove a lot less costly. And, of course, there are those businesses that are able to purchase equipment out of funds generated in the ordinary course of business.

Over-all Economic Conditions

The final ingredient in any decision to buy or lease is related to today's fast developing technology and the general state of the economy.

Even though in many cases leasing may be more costly than buying, the possibilities of obsolescence must be given due weight. At the end of the initial lease period, the equipment may not be truly obsolete, but there may be other machines available that would be capable of increasing the efficiency and productivity of the business to the point where it may be very valuable to be able to switch. Where the equipment was purchased, the trade-in value of the old equipment may be unattractive, especially where the newly developed machinery is offered by a competitor.

Finally, these are inflationary times, and the dollars paid out 3-10 years hence are "cheaper" than today's dollars. The business will have an opportunity to use this cash by turning over inventory, taking advantage of cash discounts, or saving interest by reducing short-term borrowing.

Of course, leasing obligations will affect repayment ability — which is a very important criteria used by bankers and other financial institutions in making new loans. But it will not make inroads into an established line of credit.

In conclusion, it is obvious that there is no ready answer to the question of whether a business should buy or lease. The decision will be influenced by giving properly weighted considerations to the cash flow position, tax problems and the technological pace of the particular business and equipment under consideration.

And Now a Brief Message

(Continued from page 13)

made on the basis of the station's standing in the community and the percentage of total national dollars expected to be spent in the market as well as the prestige of the network affiliation. For instance, in a certain market CBS may get 40% of the national orders, and NBC and ABC might get 30% each. Expenses to be considered are anticipated costs of market surveys, talent fees, extensive outdoor billboard and bus advertising campaigns and promotions, in addition to all the usual items on business budgets, like wages and supplies. It might be necessary to make a decision whether to budget for a new film processor and raw film stock or whether to acquire minicameras where the film shot may be used immediately, obviating the need for the film processing equipment and the photo lab technician.

To make a meaningful contribution to the success of the local station the business manager must have up-to-date knowledge of all local and federal regulations affecting the broadcast industry, must feel the pulse of both the local and the national economy in order to guide collections and personnel practices, and make proper decisions on forecasts. Finally, the business manager must be able to apply generally accepted accounting principles.

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