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*Is it better to buy or lease the equipment needed in business? The answer will depend on a number of related factors, each of which can vary with the individual company. Here's a guide—the eight criteria used in one company—*

## **A LEASE-OR-PURCHASE DECISION MODEL FOR THE XYZ CORPORATION**

*by Jack R. Charrin*

*Continental Oil Company*

**W**HENEVER the managers of a business decide to acquire new equipment, they must decide whether it is better to buy the equipment or to lease it from a leasing company. The decision is a choice among financing methods since equipment is seldom purchased outright out of working capital.

Leasing, in general, has both advantages and disadvantages as compared to older and more conventional methods of financing equipment acquisitions such as bank loans. These pros and cons have been widely discussed.

Unfortunately, such discussions are applicable to specific corporate decisions only in a general way. Even for a particular company, it is impossible to state flatly that leasing is to be preferred to borrowing—or vice versa. Each acquisition must be considered on its own merits, in the light of criteria pertinent at that time, every time the need for decision arises.

This article presents—in the form of an actual case study—a demonstration of the type of analysis that is required. It evaluates leasing versus purchasing on the basis of eight criteria deemed significant to

the particular company being analyzed: the effect of each alternative on its working capital position, balance sheet, income statement, bank credit, debt restrictions, tax liability, equipment profitability, and costs.

The model used for the study was an actual company, and all data, including the data furnished for the lease-purchase comparison, were actual data.

A similar analysis could be prepared for any lease-or-purchase decision. The data would vary among companies, and so might the choice of some of the criteria and/or the



**Financial Statement Summary**

(in thousands of \$)

NAME	ADDRESS						FISCAL YEAR ENDS
XYZ CORPORATION	HOUSTON, TEXAS						12/31
STATEMENT SUMMARY							
Date of Statement:	12/31/61	12/31/62	12/31/63	12/31/64	12/31/65	12/31/66	
Uncertified - Certified:	Certified	Certified	Certified	Certified	Certified	Certified	
Current Assets	\$4,267.2	\$4,967.4	\$5,194.0	\$4,825.4	\$5,781.1	\$4,824.4	
Current Liabilities	2,312.6	2,936.5	2,876.8	3,298.6	4,739.1	4,564.1	
Working Capital	1,954.6	2,032.9	2,317.2	1,526.8	1,042.0	260.3	
Current Ratio	1.8	1.7	1.8	1.5	1.2	1.1	
Non Current Assets	3,657.4	3,540.3	3,327.1	4,488.6	5,375.7	5,362.7	
Non Current Liabilities	-0-	-0-	-0-	-0-	-0-	-0-	
Total Debt	2,312.6	2,936.5	2,876.8	3,298.6	4,739.1	4,564.1	
Deferred Income	5,612.0	5,573.2	5,644.3	6,015.4	6,417.7	5,623.0	
Total Worth	-	-	-	-	-	-	
Contingent Liabilities							
OPERATING SUMMARY							
Period covering data below	12 months	12 months	12 months	12 months	12 months	12 months	
Revenues							
Net Sales for above period	\$11,183.4	\$11,278.8	\$11,264.9	\$11,755.3	\$12,503.7	\$12,534.7	
Net Profit Before Depreciation & Tax	1,783.2	1,248.5	1,459.2	1,648.3	1,443.7	636.1	
Depreciation	(1,215.6)	(1,348.4)	(1,254.4)	(1,068.9)	(1,214.1)	(1,190.7)	
Tax	( 199.9)	<sup>4)</sup> 61.2	( 133.7)	( 197.9)	( 122.9)	( 135.7)	
Net Profit (Loss)	367.7	( 38.7)	71.1	381.5	106.7	( 690.3)	
Dividends Paid or Withdrawals	-	-	-	-	-	-	
Adjustments	-	-	-	<sup>3)</sup> (10.4)	<sup>2)</sup> 295.5	<sup>1)</sup> ( 104.4)	
Net to Surplus for Period	367.7	-	71.1	371.1	402.3	-	
ANALYZED BY (Initials & Date)							
EXPLANATIONS:							
1) Deferred Tax Accounting on Inter-Company profit							
2) Non-recurring income							
3) Foreign Exchange loss							
4) Refund							
Source: XYZ CORPORATION Financial Statements 1961-1966							



TABLE II

## Lease-Versus-Purchase Working Capital Gain

Year	1 Purchase Net Cash Out	2 Lease Net Cash Out	3 Freed Working Capital Plus Cumulative Earnings	4 10% Return on Column 3 Totals	5 Tax at 50% of Column 4	6 Cumulative Lease Gain (3 + 5)	7 10% Present Value Factor	8 Present Value of Cash Inflows
1	\$191,915	\$ 64,512	\$127,403	\$ 12,740	\$ 6,370	\$133,773	.909	\$121,600
2	183,750	64,512	119,238 133,773					
			253,011	25,301	12,650	265,661	.826	219,436
3	191,917	64,512	127,405 265,661					
			393,066	39,307	19,654	412,720	.751	309,953
4	( 49,584)	64,512	( 49,584) 412,720					
			363,136	36,314	18,157	381,293	.683	260,423
5	( 49,584)	64,512	( 49,584) 381,293					
			331,709	33,171	16,586	348,295	.621	216,291
6	( 49,584)	64,512	( 49,584) 348,295					
			298,711	29,871	14,936	313,647	.564	176,897
	\$418,830	\$387,072	\$298,711	\$176,704	\$88,353	\$313,647		\$176,897

## Explanations:

Column 6. XYZ will gain \$313,647 in working capital at end of lease period.

Column 7. Present value factor is XYZ's investment opportunity rate.

Column 8. Present value worth of working capital gain is \$176,897.

Sources: See Table VI

weight attached to each of them. The method presented here, however, is believed to be generally applicable.

**The problem**

XYZ Corporation faces a lease-or-purchase financing decision within the next three months. The decision to acquire the new equipment has been made. Competition and expanding geographical operations make the acquisition necessary. XYZ Corporation desires to analyze the present situation in light of the corporate needs over

the next three- to five-year period.

The financing decision involves \$700,000 worth of income-producing capital equipment. Two alternatives are possible. XYZ Corporation can either purchase the equipment through a three-year bank loan or lease it for six years from a leasing company.

**Definitions**

The terms used in the study are defined as follows:

*Financial lease*—A contract under which the lessee agrees to make a series of payments to the lessor which, in total, exceed the purchase price of the asset acquired.<sup>1</sup>

*Operating lease*—All other leasing contracts, and those typically cancellable by the lessee upon giving due notice of cancellation to the lessor.<sup>2</sup>

*Lessee*—The renter of the equipment, i.e., XYZ Corporation.

*Lessor*—The organization that holds title to the leased equipment and that invoices the user (lessee) for the rental.<sup>3</sup>

*Income-producing equipment*—Equipment that produces a product or renders a service which provides revenue to the owner or user.

*Equipment*—In this case it is specialized oil-well-servicing equipment. There are seven units costing \$100,000 each, for a total cost of \$700,000.

*Present Value*—The maximum amount a firm could pay for the opportunity of making the investment without being financially worse off,<sup>4</sup> or, the value today of money due at a future time.

Eight criteria have been selected



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<sup>1</sup> R. F. Vancil, "Lease or Borrow—New Method of Analysis," *Harvard Business Review*, September-October, 1961.

<sup>2</sup> *Ibid.*

<sup>3</sup> F. K. Griesinger, "Pros and Cons of Leasing Equipment," *Harvard Business Review*, January-February, 1954.

<sup>4</sup> R. W. Johnson, *Financial Management*, Allyn and Bacon, Inc., Boston, 1965, p. 189.

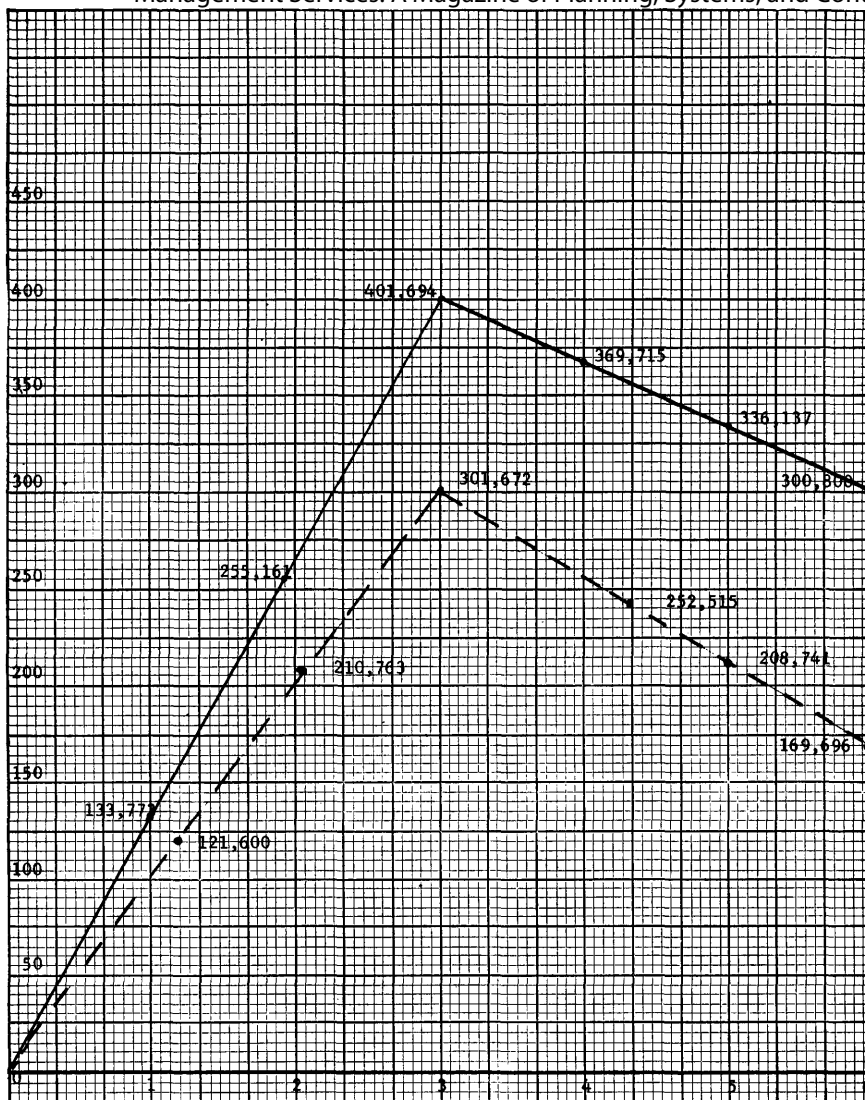
Table II on page 21 compares the effects of purchase and lease on working capital for XYZ Corporation. By leasing the equipment, the company gains \$313,647 in working capital at the end of the six-year period. A present value factor is applied to the cumulative lease gain in Table II, Column 6, relating these figures to the present worth of future dollars.

The figure at the left shows the working capital advantage of leasing before and after application of the present value factor. There is a rapid rise in the first three years followed by a decline in the last three years. This is primarily the result of higher purchase payments over a relatively short term compared to the lease rentals. The fact that lease rentals are fully deductible and purchase payments are not contributes to the rapid working capital gain. The decline results from the depreciation charge in the last three years. Lease rentals continue while purchase payments stop. This causes the lease gain in working capital to decline.

The net effect, however, is a freeing of additional working capital over the six-year period. Working capital means just that; it must be kept working to justify the additional leasing cost. It is assumed that the company will invest the additional working capital in profitable projects returning a minimum 10 per cent before taxes. This return is measured by dividing net profit after taxes and depreciation by working capital. Table I provided the two figures for the years 1961 through 1966.

**Balance sheet effects**

The appropriate treatment of leases on the balance sheet has been debated by financial institutions that seek credit information and accountants who prepare financial statements. C. R. Reed summarizes the results as follows: "Despite sincere attempts to achieve uniformity by accountants,



**Working Capital Movement Over Six-Year Period**  
 (Based on Data from Columns 6 and 8, Table II)

as pertinent. These criteria are generally applicable to any lease-or-purchase decision. However, modifications would have to be made to adapt the model to individual needs. For example, the method of depreciation may vary, the interest rate may change, and the lease rate may fluctuate. However, the approach described here can be adapted to adjust to these changing factors.

**Working capital**

Maintaining adequate working capital is important to most companies. Working capital is defined as the funds available after meeting all current obligations (liabilities) during the course of a year.

XYZ Corporation shows a need for working capital, as indicated from the analysis in Table I on page 20. Working capital has decreased from \$2,317,200 in 1963 to \$260,300 in 1966. Working capital provides funds for investment projects important to the company. XYZ Corporation has an active research program, which requires large sums each year.

Leasing has the advantage of providing increased working capital, especially in the first few years. This additional working capital may be invested in profitable projects. The lease provides this working capital advantage because the rentals are fully deductible as expenses while purchase payments are not. Tax deductions on a pur-



Charrin: Lease-or-Purchase Decision Model for the XYZ Corporation  
Table III

FINANCIAL STATEMENT ANALYSIS

5-553A

NAME	(In thousands of \$)						FISCAL YEAR ENDS
XYZ CORPORATION	Houston, Texas						12/31
Date of Statement:	12/31/61	12/31/62	12/31/63	12/31/64	12/31/65	12/31/66	
Uncertified - Certified:	Cert.	Cert.	Cert.	Cert.	Cert.	Uncert.	
Cash on Hand and in Bank	\$ 366.9	\$ 428.1	\$ 675.8	\$ 459.9	\$ 432.5	\$ 310.2	
Notes Receivable							
Accounts Receivable	2,402.8	2,628.6	2,597.4	2,145.0	2,086.0	2,246.1	
Reserve for Credit Losses (Red)							
Inventory	1,396.3	1,639.6	1,695.2	1,860.5	1,906.5	1,862.3	
Other Receivables	101.2	273.1	225.6	360.0	702.0	405.8	
Contract Receivables	-	-	-	-	654.1		
Cash Sur. Value Life Ins.							
<b>TOTAL CURRENT ASSETS</b>	<b>\$4,267.1</b>	<b>\$4,969.4</b>	<b>\$5,194.0</b>	<b>\$4,825.4</b>	<b>\$5,781.1</b>	<b>\$4,824.4</b>	
Land and Buildings and ))							
Machinery & Equipment, Furniture & Fixtures )	\$8,144.4	\$8,807.1	\$9,072.9	\$10,633.4	\$12,156.4	\$12,469.8	
Reserve for Depreciation (Red)	(4,643.7)	(5,428.3)	(5,949.1)	(6,494.1)	(7,200.6)	(7,289.4)	
Deferred and Prepaid Expenses							
Due from Officers & Employees							
Reserve & Holdback with Finance Co.							
<b>TOTAL ASSETS</b>	<b>\$7,924.6</b>	<b>\$8,509.7</b>	<b>\$8,521.1</b>	<b>\$9,314.0</b>	<b>\$11,156.8</b>	<b>\$10,187.1</b>	
Notes Payable to Bank (Secured)	-	-	-	-	-	267.6	
Notes Payable to Bank (Unsecured)							
Notes Payable, Merchandise							
Notes Payable - Others	700.0	1,405.0	1,405.0	1,850.0	3,000.0	2,720.0	
Accounts Payable Trade	651.1	437.1	507.2	516.6	789.8	502.5	
Due to Officers & Employees							
Accrued Expenses	492.6	529.6	533.8	463.3	548.3	515.8	
Taxes Due & Reserve for Taxes	131.6	33.6	99.2	161.1	69.1	27.5	
Accounts Payable - Other	230.7	422.4	220.5	101.1	-	305.7	
Minority Interest in							
Subsidiaries	106.6	108.8	111.1	156.0	158.8	165.2	
Deferred Taxes				50.5	173.1	59.8	
<b>TOTAL CURRENT LIABILITIES</b>	<b>\$2,312.6</b>	<b>\$2,936.5</b>	<b>\$2,876.8</b>	<b>\$3,298.6</b>	<b>\$4,739.1</b>	<b>\$4,564.1</b>	
Real Estate Mortgages - When Due?							
Deferred Income							
Capital Stock - Preferred	560.0	560.0	560.0	560.0	560.0	560.0	
Capital Stock - Common	500.0	500.0	500.0	500.0	500.0	500.0	
Individual or Partnership Investment							
Eamed Surplus	4,552.0	4,513.2	4,584.3	4,955.4	5,357.7	4,563.0	
Capital Surplus							
Treasury Stock (Red)							
Intangibles (Red)							
<b>TOTAL LIABILITIES &amp; WORTH</b>	<b>\$7,924.6</b>	<b>\$8,509.7</b>	<b>\$8,521.1</b>	<b>\$9,314.0</b>	<b>\$11,156.8</b>	<b>\$10,187.1</b>	
Explanations:	Source: XYZ Corporation Financial Statements 1961 through 1966						



bankers, and others, with capitalization of the leased asset at one extreme, complete omission of it at the other, and footnotes of various kinds somewhere in between.”<sup>5</sup>

This article does not attempt to offer a solution to that problem. Under XYZ's present method of treatment of lease obligations, the company's balance sheet will reflect a more favorable debt to equity ratio if it chooses to lease. XYZ's 1966 year-end balance sheet, for example (shown in Table III on page 23), would reflect the results shown in Table IV at the left before and after \$700,000 equipment financing.

The lease does not affect the company's balance sheet. The balance sheet would contain a footnote describing the lease obligation. The company's debt to equity ratio remains at .8:1 when leasing while the ratio changes to almost 1:1 when purchasing. A creditor may or may not take

**TABLE IV**  
Effect of Financing on Balance Sheet

Before and After Lease (no change):			
Current Assets	\$ 4,824,400	Debt	\$ 4,564,100
Fixed Assets	5,362,700	Equity	5,623,000
<b>Total Assets</b>	<b>\$10,187,100</b>	<b>Total</b>	<b>\$10,187,100</b>
After Purchase:			
Current Assets	\$ 4,824,400	Debt	\$ 5,264,100
Fixed Assets	\$ 6,062,700	Equity	5,623,000
<b>Total Assets</b>	<b>\$10,887,100</b>	<b>Total</b>	<b>\$10,887,100</b>

**TABLE V**  
Comparison of Deductible Expenses

Deductible Expenses	Year 1-2	Year 3-6
Interest	\$ 81,667	\$ 16,333
Depreciation	198,334	396,668
<b>Totals</b>	<b>\$280,001</b>	<b>\$413,001</b>

**LEASE**

Rentals	\$258,048	\$516,096
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<sup>5</sup> C. R. Reed, "Leasing and Its Effect on Financial Statements," *Bulletin of the Robert Morris Associates*, April, 1966.

**TABLE VI**  
Lease-or-Purchase Comparative Analysis  
EQUIPMENT COST—\$700,000

Year	PURCHASE						LEASE				
	1	2	3	4	5	6	7	8	9	10	11
	Principal Payments	Interest	Gross Depreciation	Investment Credit	Tax Saving 50% of (2 + 3)	Net Cash Out [(1 + 2) - (4 + 5)]	Cumulative Cash Out	Rentals	Tax Saving 50% of Rentals	Net Cash Out (8-9)	Cumulative Cash Out
1	233,333	49,000	99,167	16,334	74,084	191,915	191,915	129,024	64,512	64,512	64,512
2	233,333	32,667	99,167	16,333	65,917	183,750	375,665	129,024	64,512	64,512	129,024
3	233,334	16,333	99,167		57,750	191,917	567,582	129,024	64,512	64,512	193,536
4			99,167		49,584	( 49,584)	517,998	129,024	64,512	64,512	258,048
5			99,167		49,584	( 49,584)	468,414	129,024	64,512	64,512	322,560
6			99,167		49,584	( 49,584)	418,830	129,024	64,512	64,512	397,072
	700,000	98,000	595,002	32,667	346,503	418,830	418,830	774,144	387,072	387,072	387,072

Explanations:

Column 2. Interest for each year is due annually on remaining loan balance at 7% per year.

Column 3. Six-year straight line depreciation is used. Salvage value is 15% or \$105,000.

Column 4. Two-thirds of \$700,000 at 7% spread equally over two years

Column 5. 50% of interest and depreciation will be recovered through tax deduction. 50% rate taken as average corporate tax rate.

Column 6. To Table II, Column 1

Column 10. To Table II, Column 2

Bank Rate is an effective rate of 7%.

Lease company rate is \$15.36 per \$1,000 per month or \$129,024 per year, for six years, all inclusive charge. Factors such as equipment residual value, money cost, depreciation method, lease term, and investment credit are used in a formula to return a minimum 2% on average earning asset.

Rates used are estimated and are subject to change under various economic conditions.

Sources: Bank X, XYZ Corporation, and ABC Leasing Company.



the lease obligation into account. At first glance the balance sheet presents a more favorable debt to equity ratio. However, it should be recognized that this particular advantage may be temporary and somewhat misleading. The company may or may not want to capitalize a lease obligation.

### *Income statement effects*

The company should consider the effect of both leasing and purchasing on the income statement. If the lease period is too short, operating expenses will be overstated; if it is too long, they will be understated. In this particular case, the lease period corresponds to the depreciable life of the equipment; therefore, the operating expenses are neither overstated nor understated. However, because deductible expenses under leasing will be less than deductible expenses under purchasing during the first two years of the six-year period, the before-tax earnings will be less under the purchase than under the lease. During the remaining four-year period, deductible expenses will be greater and before-tax earnings will be less under the lease than under the purchase. Table V on page 24 illustrates these points. (The figures are taken from Table VI, which appears on page 24.)

During the first two years, earnings will be \$21,953 less under the purchase. During the next four years, earnings will be \$103,095 less under the lease. The six-year period will result in \$81,142 less earnings under the lease.

### *Bank credit line*

XYZ Corporation can use the lease as a credit expansion tool. Through leasing rather than purchasing, the company keeps its present bank credit line free for possible future loans. A \$700,000 loan would seriously draw down any available credit line.

Therefore, leasing the equipment, by maintaining the company's borrowing capacity with the

TABLE VII

## XYZ Corporation's Economic Justification for Capital Expenditure

Estimated Equipment Cost		\$700,000	
<u>Annual Sales:</u>			
2—Offshore logging units		\$240,000	
5—Land logging units		<u>900,000</u>	
	Total Annual Sales		\$1,140,000
<u>Annual Operating Cost:</u>			
2—Offshore logging units		\$210,000	
5—Land logging units		<u>690,000</u>	
	Total Operating Cost		\$ 900,000
Gross Operating Profit			\$ 240,000
Selling and Administrative Expense			<u>15,000</u>
Annual Profit before Taxes			\$ 225,000
Estimated Taxes 40%			<u>90,000</u>
Annual Profit after Taxes			\$ 135,000
Annual Depreciation			<u>116,000</u>
Annual Payout Amount—Cash Flow			\$ 251,000
Payout Period from Approximately 1/1/67			2.9 years
Return on Investment			19%

Source: XYZ Corporation

bank, would have a beneficial effect on its credit line.

### *Debt restrictions*

A company may be prevented from assuming additional long-term debt by loan covenants. Leasing under the conditions of this case would not place restrictions on the company's need to assume additional debt. Based on the past history and overall financial condition of XYZ Corporation, the terms of the lease would allow management to exercise its own judgment in assumption of additional debt.

Under its present debt structure, however, XYZ is restricted from taking on additional debt. There are no restrictions against leasing equipment. Therefore, leasing offers a flexible means of financing the equipment.

To the extent that lease rentals are fully tax-deductible as operating expenses while only depreciation and interest are deductible under the purchase method, leasing offers an advantage. From Table VI, Columns 5 and 9, a comparison of tax savings between leasing and purchasing indicates that leasing saves \$40,569. This saving results because the amount of the rentals is

higher than the total of depreciation plus interest. If the six-year lease period were shorter than the depreciable life of the equipment, a faster equipment write-off would be possible, which would defer taxes. But in this particular case, both the lease period and depreciable life are the same; therefore, that possible tax advantage does not exist.

### *Equipment profitability*

As is shown in Table VII on this page, the equipment will net \$135,000 annual profit after taxes. A return of 19 per cent on investment is projected. The figures are based on the historical earning capacity of the equipment.

Whether the company leases or purchases the equipment, the net profit of \$135,000 will be earned, assuming that the current economic situation continues for the foreseeable future. Therefore, the company must decide whether the equipment creates profits because of its ownership or because of its use. If the company decides that profits lie in use, the lease should be considered a possible alternative to the more traditional purchase. The relatively high rate of



return of \$135,000 net after taxes compared to the \$64,512 net after tax rental indicates that leasing would offer an attractive financing alternative.

### Cost

In any lease-versus-purchase comparison, the area of cost is an important consideration. As a general statement, it can be said that leasing is more expensive than purchasing when all factors are considered. However, in spite of leasing's higher dollar cost, the profits generated on freed working capital often outweigh the additional cost.

From Table VI, Column 8, XYZ Corporation would pay \$74,144 in finance charges through leasing. Added to this figure is the estimated equipment residual value which XYZ gives up. The residual value of the type of equipment involved is difficult to estimate because of its specialized nature and limited marketability. However, an approximate value at the end of the six-year lease would be 20 per cent, or \$140,000. The total dollar leasing cost is estimated at \$214,144 ( $\$140,000 + \$74,144$ ), compared to \$98,000 in interest charges for purchasing (Table VI, Column 2). However, this \$116,144 higher leasing cost difference is offset by the earnings on freed working capital totaling \$176,704 (Table II, Column 4). While the figures are estimates, they are realistic enough to support the comparative analysis.

### Conclusions

These significant conclusions for XYZ can be drawn from this analysis:

1. The lease provides working capital advantages for XYZ Corporation.
2. XYZ Corporation can use the additional working capital for profitable alternative investments.
3. The lease cash flow is superior to the purchase cash flow.
4. The actual financing cost of the lease is higher than the cost of

bank financing, but profits on the freed capital offset the higher cost.

5. The income statement leasing effects are unfavorable from an earnings standpoint, but the balance sheet leasing effects are favorable.

6. Debt restrictions, tax advantages, bank credit line effects, and equipment profitability criteria are important considerations.

It is recommended, therefore, that XYZ Corporation should consider leasing as a method of financing the \$700,000 equipment cost.

The evidence in this case indicates that leasing the equipment from a leasing company offers definite advantages over financing the purchase of the equipment through a bank loan. This is not necessarily the case for other companies or for other decisions of XYZ. It must be emphasized that these findings are based on evidence collected under particular business conditions and analyzed from a particular company's financial data. While the company is similar to many others, certain peculiarities and variables exist for each company. For example, the interest or leasing rate, i.e., money cost, varies according to the economic conditions and credit standing of the borrower. However, the approach of this study can be adopted to take these variables into account.

The decision model presented in this article and the eight criteria on which it is based should contribute toward a better understanding and awareness of the factors involved in a lease-or-purchase decision. The model attempts to present significant criteria in an easy-to-apply approach. XYZ Corporation provided an actual situation to which the decision model could be applied. The model can be adapted to meet an individual company's needs. It must be re-emphasized that any company considering a lease-or-purchase decision must analyze its individual needs in light of the criteria presented. No generalization can be made as to whether lease or purchase is a better financing method.

*As a general statement, it can be said that leasing is more expensive than purchasing when all factors are considered. However, in spite of leasing's higher dollar cost, the profits generated on freed working capital often outweigh the additional cost. Thus, in the case of the XYZ company, which could use additional working capital for profitable investments, leasing was recommended.*