LEASE-PURCHASE DECISION

STANDARD

The decision to lease or purchase should be considered on a case-by case evaluation of comparative costs and other factors.[1] Procurement should conduct a cost/ benefit analysis to determine the appropriate contracting method.

Definition

Lease-Purchase Decision is a decision based on the results of a cost/benefit analysis of the costs to own, costs to lease, and the advantages and disadvantages of any relevant qualitative factors. (ISM, 2000). [2]

Element 1.1: Factors to Be Considered

A cost-benefit analysis can take several forms, however, procurement (together with finance and other stakeholders if appropriate) should consider all of the elements involved in the life cycle of the equipment, including asset management and disposal issues. When making a decision to lease or purchase, procurement should consider comparative costs and other factors that, at a minimum, include:[3]

- Estimated time period the equipment is to be used and the frequency of use within that period
- Financial and operating advantages of alternative types and makes of equipment
- Cumulative rental payments for the estimated period of use
- Net purchase price
- Transportation and installation costs
- Maintenance and other service costs
- Availability of funds and cost of capital
- Potential obsolescence of the equipment because of technological improvements

The following additional factors should be considered, as appropriate, depending on the type, cost, complexity, and estimated period of use of the equipment:

- Availability of purchase options
- Potential utilization of the equipment by others after its initial useful purpose has ended
- Trade-in or salvage value at the end of the lease term
- Imputed interest
- Availability and cost of a servicing capability, especially for highly complex equipment; e.g., can the equipment be serviced by internal staff or other sources if it is purchased?

LEASE-PURCHASE DECISION *(Cont'd)*

Element 1.2: Comparing Contracting Options

There are several options that may be considered when making a lease-purchase decision. The cost-benefit analysis will help to identify and quantify the available contracting options. Those options generally include:

- Purchasing - may be the preferred option if:
  1. The equipment is to be used for longer than three years
  2. The agency does not have staff and systems to track assets and manage the lease with each supplier.
  3. Funding is uncertain so that the full term of the lease cannot be met
- Lease-purchasing – may be the preferred option if:
  1. The monetary value of the equipment is substantial and its useful life is longer than three years
  2. The flexibility of spreading out payments would be beneficial
- Leasing – may be the preferred option if:
  1. Replacement according to industry life cycles is needed[4]
  2. There is a business need for rapid technological change
  3. Agencies are undergoing downsizing or reorganizing
  4. There is a business need for quick adoption of new technologies
  5. The flexibility of spreading out payments and using operating funds (rather than capital funds) would be beneficial[5]

Element 1.3: Calculations

Present Value[6] – When comparing leasing and purchasing alternatives, the future monetary value you would expend in a lease or lease-purchase contract must be converted to its value in present monetary value in order to compare the real costs of each option. Calculating Present Value can be used as an intermediate step to calculating Net Present Value (NPV).[7]

Net Present Value[8] – When comparing cost of leasing and purchasing alternatives, it may be necessary to calculate the total costs and benefits over the entire life of a project. Net present value analysis involves four basic steps.

- The first step is to forecast the benefits and costs in each year
- The second step is to determine a discount rate
- The third step is to use a formula to calculate the net present value
- The final step is to compare the net present values of the alternatives

Analysts should follow five general rules when forecasting costs and benefits:

- Forecast benefits and costs in today's monetary value amount
- Do not include sunk costs
- Include opportunity costs
- Use expected value to estimate uncertain benefits and costs
- Omit non-monetary costs and benefits

Costs and Benefits to Quantify[9]

Purchasing	Lease-Purchasing	Leasing
■ Equipment Price ■ Residual value of equipment ■ Maintenance Costs ■ Staff Costs* ■ Procurement Costs** ■ Disposal Costs	■ Equipment Price ■ Residual value of equipment ■ Maintenance Costs ■ Staff Costs* ■ Procurement Costs** ■ Disposal Costs	■ Equipment Price ■ N/A equipment is returned at end of lease ■ Maintenance Costs ■ Staff Costs* ■ Procurement Costs** ■ Disposal Costs

* Staff costs include time spent on installation, maintenance, moves/adds/ changes, de-installation, and disposal. Costs will vary depending on who is responsible for maintenance in leasing contracts.
** Procurement costs include procurement staff time spent on processing purchase orders, tracking leased equipment, dealing with surplus equipment, etc.

Note: *In the analysis, it is important to use Present Value calculations to equalize price comparisons. Use the present value formula as a guide. Make sure that the time frames considered for all three options are the same.*

Element 1.4: Choosing a Vendor

Selecting the right vendor is an important step in any procurement, however, it becomes even more important when using a lease contract. Because leasing companies range from equipment producers to third parties, it is important that both sides understand each other and are committed to the project. At a minimum, the following should be considered when choosing a vendor:

- Financing options offered by the vendor
- The type of equipment that is being offered
- The services (e.g. maintenance, troubleshooting) offered by the vendor[10]
- The needs of the organization or end users
- Use of a Request for Information (RFI) or Request for Proposal (RFP)[11]

Element 1.5: Negotiating the Contract[12]

The negotiation process provides an opportunity to develop the specific details of the leasing agreement and to select the best vendor. The following should be considered:

- Develop a cross-functional team that includes: end-users, legal, finance, purchasing groups, and any other areas that can lend their expertise, or may be affected by the procurement method
- Select specific members of the cross-functional team to be responsible for direct negotiations with the vendor
- Ensure that all viewpoints from the cross-functional team are represented and considered in the proposal review process
- Ensure that the length of the lease corresponds with the necessary life cycle of the equipment and with the industry standard for life cycles
- Examine alternative contract scenarios and calculate cost impacts
- Ensure that accounting issues have been resolved for the type of lease contract that is being used

Element 1.5: Negotiating the Contract[12] *(cont'd)*

- Cover issues such as early termination or contract extension with all vendors
- Ensure that obligations are understood during the lease period (i.e. achieving residual value at the end of the lease period)
- Decide what types of flexibility the end user may need within the contract (e.g. equipment changes, options for increasing/ decreasing service levels) then negotiate for the most important items
- Ask vendors to provide a copy of the lease agreement and review terms and conditions carefully

Element 1.6: Managing a Lease Contract[13]

A lease contract must be closely managed during the course of the contract. Failure to implement appropriate controls and oversight will result in unnecessary charges and weaken the effectiveness of the lease contract. The following should be considered when managing a lease contract:

- Assignment of regular staff to manage the lease contract through the term of the lease
- Track the life cycle of the equipment along with the financial plan for making lease payments. This allows staff to ensure the terms of the lease are being enforced, and enables them to track the utility of the lease contract and the ability of the vendor to meet business needs
- Develop a method to effectively track leased equipment to avoid additional charges when returning equipment. Develop a method to effectively track problems with the equipment. Early identification of potential problems reduces the risk of increased vendor charges
- Be able to measure the performance capabilities of the leased equipment and to identify cost savings, improved efficiency, and other results due to the leasing strategy
- Make sure that the lease does not automatically renew, and that the leasing company does not expect certain notification requirements about ending the leasing contract
- Prepare for the end-of-lease by having procedures in place to manage the transition of equipment, whether it is new equipment from the same vendor, or if an entirely different vendor or procurement method is chosen

Principles and Practices of Public Procurement

Background

As responsible stewards of public funds it is up to procurement to conduct proper analysis when making any purchasing decisions. One such decision, where proper analysis is required, is the lease-purchase decision. The lease-purchase decision may be necessary when considering the purchase of equipment or to support decisions to initiate, renew, or expand existing contracts that would result in a series of measurable benefits or costs extending for three or more years into the future.[14] In some public sector departments or organizations the budgets might be fixed annually, therefore the cost analysis of a lease-purchase analysis might be secondary to functionality and/or services provided in a lease versus purchase decision.

The way that individual procurements are conducted reflects how an organization understands its needs and its current environment. The advantages and disadvantages of certain procurements should be weighed according to the situation, then a cost-benefit analysis should be conducted to assist with the final determination of value. If done properly and in the right situation, leasing can be cost-effective and efficient. If done poorly or without due consideration, leasing will be more expensive and harder to manage than an outright purchase or a lease-purchase procurement.

1 Federal Acquisition Regulations (FAR).. (2012). Subpart 7.401: Acquisition considerations. Retrieved from https://www.acquisition.gov/far/html/Subpart%207_4.html.
2 National Institute of Governmental Purchasing, Inc. (NIGP). (2012).Public procurement dictionary of terms. Herndon, VA:NIGP. Lease or Buy Decision. Available from: www.nigp.org.
3 Op. Cit.
4 In order to obtain the most cost-effective lease, the lease term should align as closely as possible with the equipment's recommended industry life cycle.
5 Government policy can often dictate when a leasing option is preferred (i.e. Public Funding Initiatives (PFI) to build new hospitals and schools have been prevalent in the UK and encouraged by the UK Government over recent years).
6 Texas Department of Information Resources. (1998). Lease v. purchase: Guidelines for lease vs. purchase of information technologies. Austin, TX: DIR.
7 Note: Methods for calculating the more advantageous method of purchase will vary by type of procurement. The most simple situation would involve calculating Present Value, while more complex situations may require multiple calculations (e.g. Net Present Value), to arrive at a decision. Please consult with your local government accounting/ finance professionals to decide which formulas are acceptable when calculating your specific scenario.
8 The Government Finance Officers Association (GFOA) offers comprehensive guidance on calculating NPV. For more information see: Michel, G. (2001). Net present value analysis: A primer for finance officers. Government Finance Review, February (2001), 28-31.
9 Op. Cit.
10 By negotiating a lease contract that includes services, an agency can avoid contracting with a separate vendor for maintenance, thus avoiding the cost of managing multiple vendor contracts. If internal staff was previously responsible for maintenance, staff maintenance costs can be saved, and personnel can be freed for more complex, strategic work (Texas DIR, 1998).
11 An RFI can be less explicit than an RFP, but should still contain sufficient information so that responses address requirements accurately. The RFP should include all expectations and relevant information about the needs of the agency. This is the best and often the only opportunity for vendors to demonstrate their understanding of the needs and their ability to meet the needs in a cost-effective manner. Define the requirements and expectations. Weights may need to be established in order to identify the most critical needs, but requirements should be listed so that an effective comparison can be made between proposals (Texas DIR, 1998).
12 Texas Department of Information Resources. (1998). Lease v. purchase: Guidelines for lease vs. purchase of information technologies. Austin, TX: DIR.
13 Op. Cit.
14 Office of Management and Budget (OMB). (2012). Circular A 94 revised. Retrieved from http://www.whitehouse.gov/omb/circulars_a094

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