

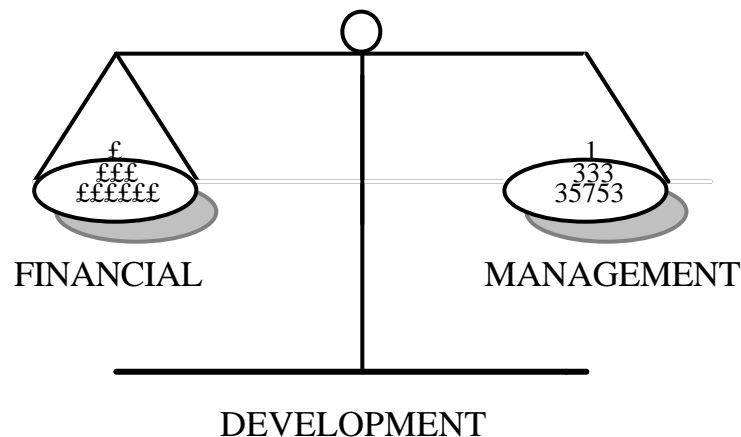
FINANCIAL MANAGEMENT DEVELOPMENT

Financial Accounting

Common Problem Areas

NO 145

ACCOUNTING FOR LEASING - APPLICATION



ONE OF A SERIES OF GUIDES FOR
FINANCIAL MANAGEMENT DEVELOPMENT

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This is one of a series of documents produced by David A Palmer as a guide for managers on specific financial topics to assist informed discussion. Readers should take appropriate advice before acting upon any of the issues raised.

ACCOUNTING FOR LEASING - APPLICATION

This note sets out the method of accounting for finance leases in the books of the lessee and the lessor in accordance with the guidelines set out in SSAP 21.

THE LEASE

Lessee Ltd takes a 5 year lease on a piece of plant with a market price of £100,000. It agrees to pay 5 annual amounts of £25,000 starting on 1 January Year 1. The asset will last 5 years.

Prior to SSAP the company would have shown a rental figure of £25,000 in the Profit and Loss Account and nothing in the Balance Sheet. Under SSAP 21 it will show the following:

Profit and Loss:

Depreciation	20,000
Finance Interest	9,442

Balance Sheet

Fixed Asset	100,000
Depreciation	20,000
	80,000

Short term creditors	(25,000)
Long term creditors	(59,442)

THE LESSEE

If the company started off with a single balance sheet of £100,000 cash and £100,000 shareholders funds at the end of Year 1 it would have a Balance Sheet as follows:-

	Opening £	End of Year 1 £	NOT £
Fixed Assets	-	100,000	-
Depreciation	-	20,000	-
Net Book Value	-	80,000	-
Cash	100,000	75,000	75,000
Short Term Creditors	-	(25,000)	-
Long Term Creditors	-	(59,442)	-
	100,000	70,558	75,000
	=====	=====	=====

How are the finance changes (interest) and balance figures calculated?

By calculating the Rate of Interest Implicit in the Lease.

This is the Internal Rate of Return (IRR) of the lease payments, also known as the Annual Percentage Rate (APR). For this lease it is approximately 12.59%.

Capital Value	100,000
First Rental	(25,000)
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Effective Capital Borrowed	75,000
Interest at 12.59% for Year 1	9,442
Balance Owing end of Year 1	84,442
Second Rental	(25,000)
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Balance Owing start of Year 2	59,442
Interest at 12.59% for Year 2	7,483
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Balance Owing end of Year 2	66,925
Third Rental	(25,000)
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Balance Owing start of Year 3	41,925
Interest at 12.59% for Year 3	5,279
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Balance Owing end of Year 3	47,204
Fourth Rental	(25,000)
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Balance Owing at Start of Year 4	22,204
Interest at 12.59% for year 4	2,796
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Balance Owing end of Year 4	25,000
Fifth Rental	25,000
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BALANCE	NIL

THE LESSOR

The Lessor will show income as follows:

Year 1	9,442
Year 2	7,483
Year 3	5,279
Year 4	2,796
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	25,000

This is called the investment period method.

The Lessor's balance sheet at the end of Year 1 will show:

Lease Rentals Receivable	100,000
Less Unearned charges	15,558
	84,442
	84,442

In practice many leasing companies calculate an after tax rate of return which will yield a different profit release. Some also allocate start up overheads to the first year to increase the profit take to cover them.

Some - particularly those where leasing is not a major part of their business e.g. vendor finance companies - use the rule of 78 or sum of the digits method.

SUM OF THE DIGITS (RULE OF 78)

This is a crude method of allocating interest earned.

The lease effectively lasts 4 years. Allocating digits to each year in reverse order gives

Year 1	4
Year 2	3
Year 3	2
Year 4	1
Total digits	10

Total profit in the Lease £25,000 Allocated on the SODIT Basis:

Year 1	4/10	10,000
Year 2	3/10	7,500
Year 3	2/10	5,000
Year 4	1/10	2,500
		25,000

As an approximation to the Investment Period Method the Rule of 78 (so called because the numbers 1 to 12 add up to 78) is a reasonable allocation method.

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David is an experienced financial professional who has devoted his skills to management training in practical understanding and utilisation of financial information. A Graduate, Chartered Accountant, and Associate of the Institute of Taxation, he is also a Member of the Chartered Institute of Personnel and Development.

He has worked as a Financial Controller and Company Secretary in the Finance Industry and as a Director of Finance and Administration in the Computer Services industry. Since 1990 he has conducted management development programmes for over thirty major organisations including Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, The Post Office, Rothmans and Zeneca. International training experience includes work in Denmark, Kenya and the Czech Republic for Unilever, in Dubai for Al Atheer, in Holland and the U.S. for Avecia and Zeneca and in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. A key output from the training is demonstrable use of the knowledge and skills acquired to enhance corporate profitability. In addition he has run courses in acquisition evaluation (The Economist, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). He has also developed material for delivery by in house personnel (Royal Mail, Lloyds Bowmaker and Conoco) and computer based training packages (The Post Office, Unilever and BP).

He is a prolific writer of case studies, role plays and course material, he has also published articles on the financial justification of training, financial evaluation of IT investment proposals, the use of Activity Based Costing and Customer Profitability statements, commercial considerations for consultants and the need for taxation awareness training for general managers.

He is married with one grown up daughter and his outside interests include being The Treasurer of the Hospice of St. Francis (Berkhamsted), and a member of the Catholic Alpha Training Team (Promoting the Alpha course on Basic Christianity). He was a Governor of Luton University for nine years and a school Governor for four years.

This series of papers is designed to help managers by providing a basic understanding of key financial concepts to assist them in their work. It is provided at no cost since this knowledge is a Gift from God and thus to be shared (Matthew 10:8).