

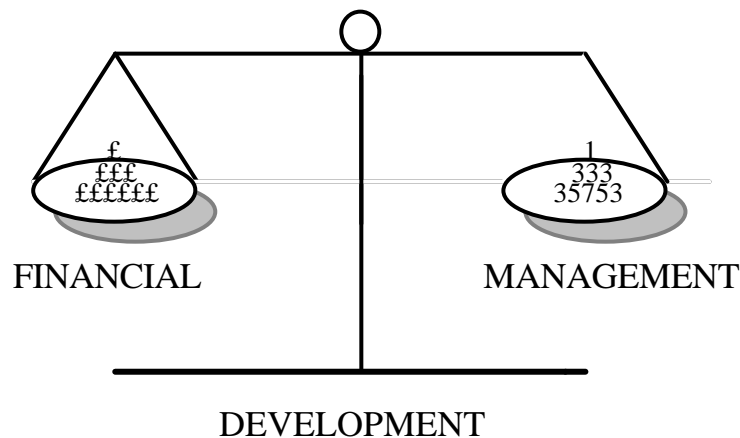
FINANCIAL MANAGEMENT DEVELOPMENT

Financial Accounting

Common Problem Areas

NO 144

ACCOUNTING FOR LEASING - THEORY



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 - THEORY

INTRODUCTION

This note only sets out the basic rules for the treatment of asset financing for both the lessee (the user of the asset) and the lessor (the provider of the finance). It explains why it is necessary to have rules and the impact of the Statement of Standard Accounting Practice for Leases and Hire Purchase Contracts (SSAP 21). It is a simplified document to illustrate principles - not a basis for legal argument. In cases of doubt reference should be made to SSAP 21 itself and to related documents such as the Financial Reporting Standard on Reporting the Substance of Transactions (FRS 5).

WHY HAVE A STANDARD?

In simple terms a standard was needed because too many companies were failing to disclose their liabilities for long term leases. They were acquiring assets on finance terms i.e. paying for the assets over a period, but not showing either the asset or the liability in the balance sheet. A simple example will illustrate the problem.

You want to live in a house. You can rent one for £1,000 per month. Buy one for £80,000 cash borrowed on overdraft at 12% or buy one on a repayment mortgage of £700 per month for 20 years.

Consider the three different Profit and Loss Accounts and Balance Sheets at the end of Year 1.

Profit and Loss Account

	Rent £	Buy £	Mortgage £
Rent	12,000	-	-
Interest	-	9,600	-
Mortgage Interest*	-	-	4,400

Balance Sheet

House	-	80,000	80,000
Overdraft	-	(80,000)	-
Mortgage	-	-	(76,000)
	-----	-----	-----
	-	-	4,000
	=====	=====	=====

* The example assumes interest and capital are repaid evenly over the mortgage which is not normally how it is calculated.

Many companies considered that they would have a better chance of borrowing money if they did not show any borrowing on their balance sheets so they always treated leased assets like the rental figure in the above example. This was fine for short term hire but during the 1970's there were considerable tax advantages in leasing rather than buying and thus many leases were taken out for long terms effectively purchasing the asset on finance. In order to avoid the disclosure of their borrowing they omitted both the asset and the liability from the Balance Sheets. In 1984 SSAP 21 was issued to provide guidance on how both Lessees and Lessors should account for Leasing.

LEASING AND HIRE PURCHASE

Leasing and hire purchase contracts are both means by which companies finance the right to use or the purchase of fixed assets.

In a lease there is usually no provision in a lease contract for legal title to the leased asset to pass to the lessee during the term of a lease. In contrast, under a hire purchase contract the hirer may acquire legal title by exercising an option to purchase the asset upon fulfilment of certain conditions (normally the payment of an agreed number of instalments).

Hire Purchase

Normally a company which acquires an asset under a hire purchase agreement capitalises the asset in its balance sheet, even though technically it does not own the asset until the completion of the hire purchase agreement.

The asset held under a hire purchase agreement is depreciated over its useful life. The amounts due, net of any interest of future periods, are shown under current and long term liabilities.

The interest element of the payments is charged to the profit and loss account over the life of the agreement.

Leases

The old method of accounting for leases by lessees was to charge the lease rental to the profit and loss account for the year.

In many cases the accounting treatment used did not fairly reflect the substance of the transaction involved. It is a generally accepted accounting principle that accounts should reflect the commercial substance of transactions and not merely their legal form.

SSAP 21

SSAP21 split leases into two types:

Finance Leases; and
Operating Leases.

It defined a Finance Lease as:

“**A Finance lease** is a lease that transfers substantially all the risks and rewards of ownership of an asset to the lessee. It should be presumed that such a transfer of risks and rewards occurs if at the inception of a lease the present value of the minimum lease payments, including any initial payment, amounts to substantially all (normal 90 per cent or more) of the fair value of the leased asset. The present value should be calculated by using the rate of interest implicit in the lease or, if this is not practical, a commercial rate of interest.”

An Operating lease is any lease other than a finance lease.

Thus the accounting treatment of a finance lease is similar in substance to the ownership of an asset, financed by a loan repayable by instalments over the period of the lease. The lessee would normally have sole use of the asset and would be responsible for its maintenance, repair and insurance even though legal title to the asset remains with the lessor.

Since leasing an asset under a finance lease is similar to ownership, SSAP 21 requires that finance leases are capitalised in the lessee's balance sheet by reflecting the “ownership” of the asset on one side of the balance sheet, financed by the outstanding lease commitments on the other. The profit and loss account is charged with depreciation on the asset and an amount representing the finance charges inherent in the lease payments.

In order to conform to the standard the lessee has to capitalise the asset and its fair market value and depreciate it. Any lease payments in excess of the fair market value are to be shown as charges in the profit and loss account i.e. the cost of the finance.

In a similar way the lessor should show the rentals receivable as an asset and release income from the lease to the profit and loss account on some reasonable basis.

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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).