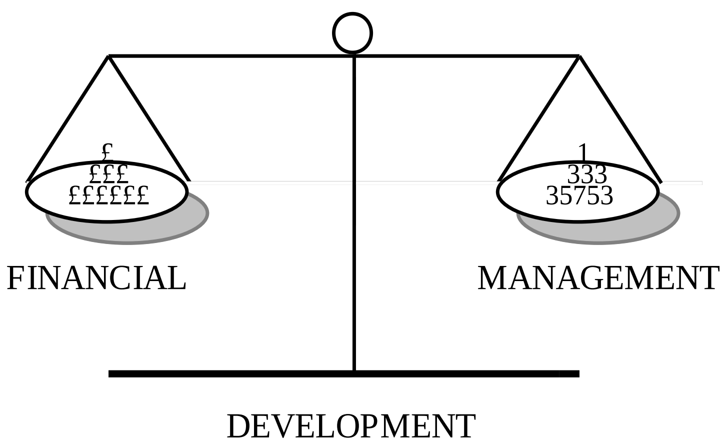
FINANCIAL MANAGEMENT DEVELOPMENT

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 International Accounting Standard (IAS 17) and 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.

<u>Profit and Loss Account</u>

	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 in the UK 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.

<u>SSAP 21</u>

SSAP21 split leases into two types:

Finance Leases; and Operating Leases.

It defined a Finance Lease as:

"**<u>A Finance lease</u>** 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."

<u>An Operating lease</u> 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.

NOTE
Financial rocket scientists are constantly inventing "legal" ways of circumventing the rules and the rule makers are constantly playing catch up to invent rules to constrain them. Unfortunately the main culprit - the UK Government - is not subject to sensible (accruals accounting) rules so Private Finance Initiatives, the Student Loan system and the like continue to distort the National Accounts by ignoring liabilities. For legislators it is a case of "do as I say, not as I do"!

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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 and has been an Ordained as a Deacon in the Catholic Church.

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 forty major organisations including Arla Foods, Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, Royal Mail, Unilever and Zeneca. He also runs programmes for the Leadership Foundation and the management teams at a number of Universities. International training experience includes work in Belgium and Holland for CSC, in Denmark, Kenya and the Czech Republic for Unilever, in Holland and the US for Zeneca, in Dubai for Al Atheer, in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. In addition he has run courses in acquisition evaluation (The Economist, Eversheds, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). All training is specifically tailored to the needs of the organisation with the emphasis on practical applications to enhance profitability and cashflow. He has developed material for delivery by in-house personnel (Royal Mail, Lloyds Bowmaker and Conoco), computer based training packages (The Post Office, Unilever and BP), and post course reinforcement self-study workbooks (CSC and Zeneca). He has also produced a training video on Cashflow Management.

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, the need for taxation awareness training for general managers, evangelisation and Christian business ethics.

Many of his generic documents are freely available on his website:
FinancialManagementDevelopment.com including papers on Charity Management.

In addition to his Diaconal work in the Church, he has held a number of voluntary positions including University, College and School Governor, Hospice Treasurer and Trustee of various charitable institutions. He continues to provide ad hoc commercial advice to several other charitable organisations. He has been married for over 35 years and has one daughter and three granddaughters.

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).

