Evaluating leasing

Working out whether to lease, and then deciding on which type of lease to choose needs careful consideration. Costas Thoupos of bfinance explains.

At a time when companies are loathe to tie-up capital in fixed assets and banks are increasingly reluctant to extend their loan portfolios, the attractions of acquiring assets via means other than outright purchase are being re-examined by many a treasurer. A wide range of assets are commonly financed via leasing arrangements. However, there are a large number of variables that contribute to the final list of pros and cons that the treasurer must evaluate when deciding whether to lease rather than buy (and if so by which method). The tax cashflow implications are amongst the most significant, and thus are explained in as much detail as room allows in this introduction to asset finance.

Primary products

Hire purchase (HP) – Sometimes known as lease purchase and defined in SSAP21 as "a hire agreement with an option to purchase". This is the simplest form of asset finance; it is not tax based and merely offers the lessee cashflow benefit with ultimate ownership. The option to purchase is usually a nominal amount (say £30) and so the Inland Revenue (IR) take the view that title will pass to the lessee at the end of the agreement and therefore allow the lessee to claim the associated capital allowances.

Finance lease (FL) – SSAP 21 defines a FL as a lease that transfers substantially all of the risk and reward of ownership to the lessee. 'Substantially' is measured by the present value test that requires that the present value of total rentals payable under a FL be greater than or equal to 90% of the fair value of the asset. As such, a FL may be described as an asset finance facility that allows the lessee the use but not the ownership where the full capital cost of the asset is amortised by way of the lease rentals. In view of the fact that title never passes to the lessee, fiscal rights rest with the lessor who will claim capital allowances and reflect this in the lease rentals.

Operating lease (OL) – This is defined by SSAP 21 as a lease other than a finance lease, ie the lessor must amortise less than 90% of the fair value of the asset for the lease to be an OL. This means that the lessor must take a minimum 10% residual risk in the asset. OLs are therefore said to offer the lowest pre-tax rentals of any finance scheme and provide off balance sheet funding. SSAP 21 allows a lease to be treated as an OL and accounted for off balance sheet, due to the fact that the lessee is merely using the asset, with the lessor taking substantially all of the risk and reward of ownership. As with an FL, fiscal rights rest with the lessor.

Note that the present value test is overridden by FRS 5 if the substance of a transaction does not reflect its form, eg where a lessor is said to be taking a minimum 10% residual risk in the asset, but has taken an indemnity from the lessee against any loss on disposal of the asset.

Contract hire/contract purchase – These are lease/HP agreements with maintenance often used for the finance of vehicles. Contract hire agreements may be on or off balance sheet, depending upon the residual risk taken by the lessor.

VAT treatment

HP – Such agreements are regarded by the IR as 'a supply of goods' and although VAT is charged on the supply of the goods, the finance element (the rentals) is VAT exempt. However, the lessor must account for the full amount of VAT relating to the supply of goods at the outset, which is a burden immediately passed to the lessee who will pay the associated VAT upfront. This will have an impact on the cashflow of the lessee, who in a best case scenario will have to fund the VAT until its next VAT quarter end, with the worst case scenario, being that of the non-VAT registered lessee, with no means of recovery.

Features & benefits

	HP	FL	OL	Bank debt
100% finance available	Y	Y	N	Y
Maintenance	Contract Purchase	Contract Hire		N
Title remains with	Lessor	Lessor	Lessor	Lessee
Option to purchase	Y	N	Y (at fair market value)	N/a
WDA remain with	Lessee	Lessor	Lessor	Lessee
Flexible term	Y	Y	Y	Y
Interest options	Fixed/Variable			
Euro option	Y	Y	N**	Y
Rentals tax deductable	Int only	Y subject to SP3*	Y	Int only
Additional security required	N	N	N	Maybe
Refinance possible	Y	Y @ lower of FMV & NBV	Y	Y
Balance sheet treatment	On	On	Off	On
Extendible	Y	Y	Y	N**
Asset/ disposal risk rests with	Lessee	Lessee	Lessor	Lessee
Financial covenants	N	Sometimes, if big ticket	N	Y**

*Inland Revenue Statement of Practice 3/91 ** Usually but not always

FL/OL – A lease is a rental agreement and is regarded by the IR as 'a supply of service'. The lessor will usually be able to recover VAT on the cost of the service provided to the lessee, including the VAT on the asset acquisition. As such, the lessor will normally finance the gross value of an asset (including VAT, which it can reclaim), and calculate rentals based on the net of vat cost. It will then charge VAT on rentals over the term of the agreement. This is beneficial to both non-VAT registered

and registered lessees, since the former can spread the VAT burden over the term of the agreement and the latter does not have cashflow drain until VAT is recovered.

Choosing your provider

Choosing the right provider is easier said than done. Treasurers may be tempted to go straight to the leasing arm of their relationship bank(s), but this is no guarantee of the best deal. Key factors to consider include:

- **Track record/reputation** – Long established, well backed lessors will offer a lessee comfort and security.
- **Specialists** – The leasing industry contains many specialists able to cater for a great variety of funding needs.
- **Support** – An inexperienced lessee may opt for a lessor who offers a high level of support as opposed to the cheapest. This type of lessor may or may not be the cheapest, but takes the view that 'it's a long race' and if they offer lessees a high level of support they will inevitably win a tender and will be more likely to retain client loyalty.
- **Documentation** – This is an area fraught with danger for a lessee and as such it is vital to seek a provider with simple, plain English documentation. For example, lessors may include an all-consuming one-way tax clause allowing them uncapped rental increases to reflect fiscal changes.
- **Relationship bank pressure** – Relationship banks will often put pressure upon their clients to use their leasing subsidiaries. However it is important for a lessee to also seek alternative quotes to ensure that it is getting a market product and rate from its provider.
- **Tenders**. A tender will help obtain a market product rate, but whom should be invited? Different lessors will have different agendas, which may vary at different times of the year. For example, a lessor with a high level of exposure to a specific sector, may be less competitive than another with adequate headroom. A subsidiary of a clearing bank may be constrainted by its parent, who wants to exit a specific product. Others may be near their year end and below target and having their equivalent of the January sales.

Negotiation

Information required by the lessor will depend upon the credit worthiness of the lessee, but may include: term sheet (vital to avoid lessors quoting on disparate terms) the last three years' accounts; projected cashflows (demonstrating ongoing serviceability); and full asset specification and supplier details.

Most asset finance arrangements will exclude financial covenants, therefore once entered into the lessee will be allowed 'quiet enjoyment'. But with OLs, it is important to negotiate mutually acceptable return conditions. Failure to do so could prove very costly at the end of the primary period.

Conclusion

Changes to the tax treatment of finance leases introduced in the 1997 Finance Act had a significant negative impact on the use of this method of finance for certain types of asset, and fiscal and regulatory developments, eg from ASB, retain the ability to tip the delicate balance described above. Watch this space! ■

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Tax and accounting implications

These are best explained with the aid of a simple example, which examines first the balance sheet then the profit and loss (P&L) treatment of each financing option. Plant costing £300,000 is acquired on the 1 Jan 2000 with 100% finance. The debt is financed over three years (in line with the asset's useful economic life) and will be accounted for as follows:

Balance sheet treatment

HP/FL/Bank debt – balance sheet extract as at:

		31/12/00	31/12/01	31/12/02
Fixed assets				
Plant & Machinery	Cost	£300,000	£300,000	£300,000
	Acc depn	£100,000	£200,000	£300,000
	NBV	£200,000	£100,000	£0
Current liabilities				
HP/ FL/ bank debt		£100,000	£100,000	£100,000
Long-term liabilities				
HP/ FL/ bank debt		£200,000	£100,000	£0

Note. OL is off balance sheet, therefore, would have no impact on assets or liabilities. It is merely shown as a contingent liability in the notes to the accounts.

P&L Treatment

HP/Bank debt – P&L account extract as at:

	31/12/00	31/12/01	31/12/02
Depreciation	£100,000	£100,000	£100,000
Interest payable	£15000	£15,000	£15,000
Profit before tax	£500,000	£300,000	£100,000
Tax (see below)	(£157,500)	(103,125)	(£9,375)
PAT (Profit after tax)	**£342,500**	**£196,875**	**£90,625**
Tax computation			
PBT	£500,000	£300,000	£100,000
Plus depreciation	£100,000	£100,000	£100,000
Less WDA (@25% pa)	(£75,000)	(£56,250)	(168,750)
Taxable profit	£525,000	£343,750	31,250
Tax (@30%)	(£157,500)	(103,125)	(£9,375)

NOTE. The writing down allowances (WDA) reflect the life of the asset and the fact that the lessee made a short life election (SLE). An SLE allows a lessee to depool the asset and claim immediate tax relief on the balance of unrelieved allowances outstanding at disposal. If an SLE were not made, the asset would have been included in the general asset pool and allowances would continue to be claimed at 25% pa based on the tax written down value of the asset.

FL – P&L account extract as at:

	31/12/00	31/12/01	31/12/02
Depreciation	£100,000	£100,000	£100,000
Finance charge	£17,000	£17,000	£17,000
PBT	£498,000	£298,000	£98,000
Tax (@30%)	(£149,400)	(£89,400)	(£29,400)
PAT	**£348,600**	**£208,600**	**£68,600**

Note. The above has been calculated in line with SP3/91, which requires that lease rentals be split into finance charge (interest etc) and capital, with the finance charge split over the period of the lease and the capital element split over the useful economic life of the asset (ie capital element = depreciation). In this instance, the period of the lease and the useful economic life of the asset are the same therefore the depreciation and the capital charge are also the same example. However, consider the same example, but an asset with a useful economic life of five years. Here, the lessee would still pay £117k, but would only be able to set off interest of £17k pa & depreciation of £60k pa which would result in a higher corporate tax charge during years one, two and three.

OL – P&L account extract as at:

	31/12/00	31/12/01	31/12/02
OL rental	£120,000	£120,000	£120,000
PBT	£495,000	£295,000	£95,000
Tax (@ 30%)	(£148,500)	(£88,500)	(£28,500)
PAT	**£346,500**	**£206,500**	**£66,500**

Note. A true OL is off balance sheet because the lessor retains substantially all the risk and reward of ownership. In view of this, it is treated like any other rental agreement and included in the P&L as a general expense.