

Finance Leases

What is a Finance Lease?

A finance lease is a funding structure for an asset in which the lease transfers substantially all the risks and rewards of ownership to the lessee. It usually involves payment to the lessor the full cost of the asset together with a return on the finance provided by the lessor.

Finance leases are commonly found in the financing of specific assets for a business, such as a machine for production.

If you believe the lease is more in the way of an operating lease please refer to the **Operating Lease User Guide**.

If you are unsure as to what lease type you are considering you are strongly recommended to consult your advisor.

What is the significance of a Lease Type?

The accounting for a finance lease is different from that of an operating lease.

For a finance lease, the capital value of the lease is treated as a fixed asset. The liability to pay the lessor is shown as a creditor. The financing (interest) is charged to the Profit and Loss account on a regular basis.

It can be complex and you are advised to agree with your accountant the accounting entries.

For operating leases no fixed asset or creditor accounting is required. The rentals under an operating lease should be charged on a straight line basis over the lease term, even if actual payments are made on a different basis.

Initiating Finance Lease Accounting

It is usual for some basic preparatory work to be undertaken to understand the elements that will represent the finance lease; the following example is used to demonstrate a process and accounting to be used in the system.

An asset is leased under the following terms:

Cost of Leased Asset	£20,000
Lease Term	5 years
Rental quarterly in advance	£1,220
Residual Value	£0.0

Using these figures it is possible to calculate the interest rate implicit in the lease; the interest rate that amortises these amounts is 2.2% compounded on a quarterly basis. From this the relevant figures for the whole of the lease can be prepared.

Please take appropriate advice if this unclear or you are unsure as to how to compute the interest rate, bearing in mind that the specific circumstances of the lease must be understood and taken into account.

The amounts owed to the Lessor and the interest charges are as follows.

	Obligation at Period start	Rental Paid	Obligation during Period	Interest at 2.20%	Obligation at end of period
	£	£	£	£	£
Quarter 1	20000	(1220)	18780	413	19193
Quarter 2	19193	(1220)	17973	395	18369
Quarter 3	18369	(1220)	17149	377	17526
Quarter 4	17526	(1220)	16306	359	16665
Quarter 1	16665	(1220)	15445	340	15784
Quarter 2	15784	(1220)	14564	320	14885
Quarter 3	14885	(1220)	13665	301	13965
Quarter 4	13965	(1220)	12745	280	13026
Quarter 1	13026	(1220)	11806	260	12066
Quarter 2	12066	(1220)	10846	239	11084
Quarter 3	11084	(1220)	9864	217	10081
Quarter 4	10081	(1220)	8861	195	9056
Quarter 1	9056	(1220)	7836	172	8008
Quarter 2	8008	(1220)	6788	149	6938
Quarter 3	6938	(1220)	5718	126	5844
Quarter 4	5844	(1220)	4624	102	4725
Quarter 1	4725	(1220)	3505	77	3582
Quarter 2	3582	(1220)	2362	52	2414
Quarter 3	2414	(1220)	1193	26	1220
Quarter 4	1220	(1220)	0	0	0
		(24400)		4400	

These items will be accounted for as liabilities and as interest charged to the profit and loss account in the appropriate period. This is described below.

Equally in this example the lease term of five years is assumed to be the useful life of the asset and there is no residual value the depreciation (which will be calculated automatically by the asset register) is straight line at £4000 per year (£1000 per quarter)

	Asset at Cost	Depreciation Charge	Cumulative Depreciation	Net Book Value
	£	£	£	£
Quarter 1	20000	(1000)	(1000)	19000
Quarter 2	20000	(1000)	(2000)	18000
Quarter 3	20000	(1000)	(3000)	17000
Quarter 4	20000	(1000)	(4000)	16000
Quarter 1	20000	(1000)	(5000)	15000
Quarter 2	20000	(1000)	(6000)	14000
Quarter 3	20000	(1000)	(7000)	13000
Quarter 4	20000	(1000)	(8000)	12000
Quarter 1	20000	(1000)	(9000)	11000
Quarter 2	20000	(1000)	(10000)	10000
Quarter 3	20000	(1000)	(11000)	9000
Quarter 4	20000	(1000)	(12000)	8000
Quarter 1	20000	(1000)	(13000)	7000
Quarter 2	20000	(1000)	(14000)	6000
Quarter 3	20000	(1000)	(15000)	5000
Quarter 4	20000	(1000)	(16000)	4000
Quarter 1	20000	(1000)	(17000)	3000
Quarter 2	20000	(1000)	(18000)	2000
Quarter 3	20000	(1000)	(19000)	1000
Quarter 4	20000	(1000)	(20000)	0

Setting up a Finance Lease in summary

- ◆ Enter the leased Asset in the Asset Register
- ◆ Create the initial Obligation (Liability) to the Lessor
- ◆ Set up a Memorised transaction for the periodic payment to the Lessor
- ◆ Create a journal template for the interest charge
- ◆ Post the interest as scheduled
- ◆ Regularly review and reconcile the relevant accounts

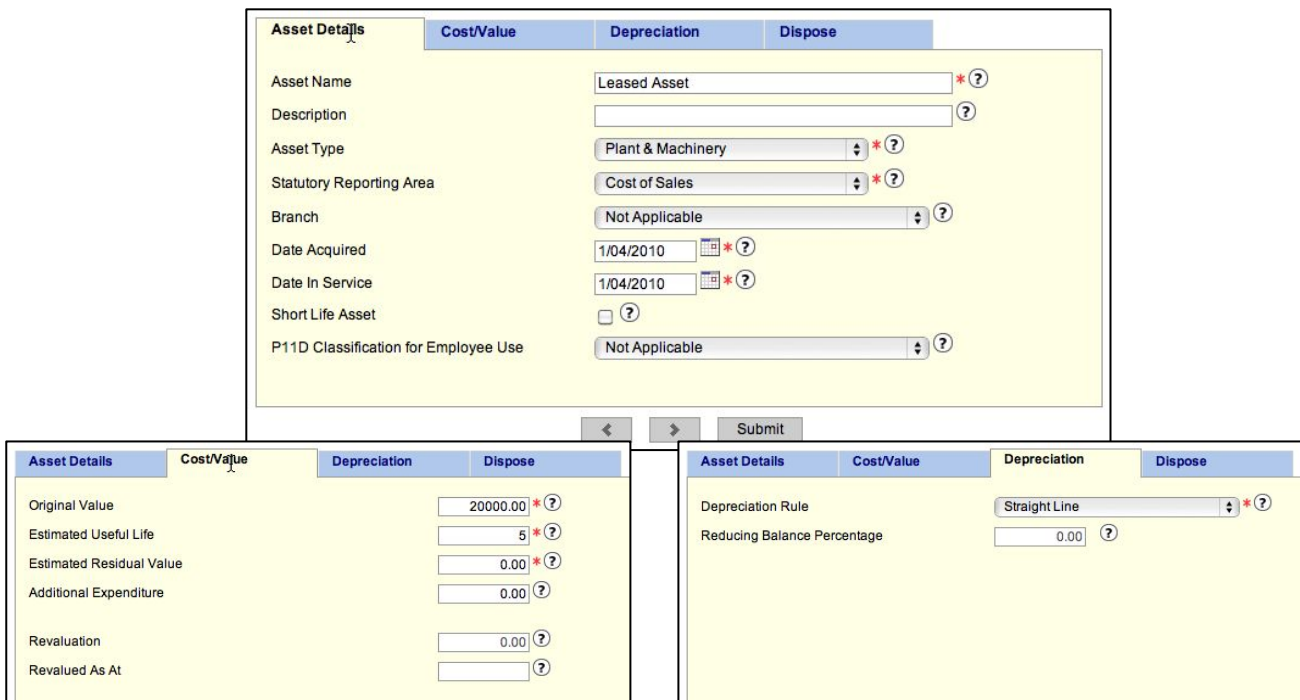
Adding the Lease Asset to the Asset Ledger

In the first instance this is the same process as for a normal an asset (More information is available from the **Using the Fixed Asset Register** user guide)

The asset register is accessed via the **ADD-INS** menu

ADD-INS → ASSET REGISTER → ADD ASSET

Enter the relevant information and **SUBMIT** to create the asset in the register and allow automatic posting of the depreciation charge.



Asset Details	Cost/Value	Depreciation	Dispose
Asset Name		Leased Asset	
Description			
Asset Type		Plant & Machinery	
Statutory Reporting Area		Cost of Sales	
Branch		Not Applicable	
Date Acquired		1/04/2010	
Date In Service		1/04/2010	
Short Life Asset		<input type="checkbox"/>	
P11D Classification for Employee Use		Not Applicable	

Asset Details	Cost/Value	Depreciation	Dispose
Original Value	20000.00		
Estimated Useful Life	5		
Estimated Residual Value	0.00		
Additional Expenditure	0.00		
Revaluation	0.00		
Revalued As At			

Asset Details	Cost/Value	Depreciation	Dispose
Depreciation Rule		Straight Line	
Reducing Balance Percentage		0.00	

Create the initial Obligation to the Lessor

The asset register entry creates a liability in the **Asset Additions** accounts pending a payment transaction; in the case of a finance lease asset, however, the liability is moved to either an Obligations under Finance Lease or Obligations under Hire Purchase account as appropriate. Use an Asset Journal to do this

ADD-INS → ASSET LEDGER → ASSET JOURNAL ENTRY

Note that if the correct obligation account is not visible use the **Add from Standard Accounts** process under the **Accounts** menu.

Journal **Analysis**

Relates To: Select... Reference: ?
Date: 1/04/2010 *
Asset Name: Leased Asset
Non-VAT VAT Input (eg Expense) VAT Output (eg Income) ?
Memo: Asset Financing Company Ltd





(A)dd Item (U)ndo Item (S)ave Item (R)eset Submit

Account: Obligations Under Finance Leases Debit: 0.00 Credit: 20000.00 VAT Rate: Select... VAT Amount: 0.00 Memo:

#	Account	Debit	Credit	VAT Rate Memo	VAT Amount Memo	Memo
1	Asset Additions	20000.00			0.00	
2	Obligations Under Finance Leases		20000.00		0.00	
3						
4						
5						
6						
7						
8						
		20000.00	20000.00		0.00	

This journal has now recorded the initial obligation to the Lessor, you can view this

ACCOUNTS → CURRENT LIABILITIES

	Income Tax Payable	Liability - Current	0.00	
	Obligations Under Finance Leases	Liability - Current	20,000.00	

Create a memorised Transaction for the periodic payment to the Lessor

Use an appropriate payment method such as Bill, Cheque or Electronic Payment. In this case we will use an electronic payment.

ACTIVITIES → RECORD ELECTRONIC PAYMENT

Electronic Payment **Analysis** **Memorise**

Type: Direct Debit * ? Refund/Credit? ? Reference: ?
A/C: LTT Current * ? Date: 01/04/2010 *
Payee: UK Supplier 2 * ? Tax Point: 01/04/2010 *
1433.50 * ?
Memo: First Lease Payment Purchase File Ref. 0 ?

(A)dd Item (U)ndo Item (S)ave Item (R)eset (C)alc Submit Delete Cancel

Account: Select... Net Amount: * VAT Rate: * VAT Amount: * Memo: Customer: Not Applicable

#	Account	Net Amount	VAT Rate	VAT Amount	Memo	Customer
1	Obligations Under Finance Leases	1220.00	17.5%	213.50		
2						
3						
4						
5						
6						
7						
8						
		1220.00		213.50		

Locate the Journal again (from the **LISTS** menu) and memorise it but do not auto schedule it. The template will then be available for the next occasion via the **LISTS** menu.

LISTS → **MEMORISED TRANSACTIONS** → **USE**

And simply edit the amount as appropriate.

Review

It is recommended that a regular review of the balances on the appropriate accounts is undertaken.

For instance, in this example, the balance on the Obligations account at the 30th June 2010 should be £19193 as per the schedule above.

ACCOUNTS → CURRENT LIABILITIES

View	Obligations Under Finance Leases	Liability - Current	19,193.00	Edit +
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Clicking the **VIEW** displays the details for inspection or edit if necessary.

From 01/03/2010	To 21/04/2010	Go			
Liability - Current Obligations Under Finance Leases					
Date	Reference	Name	Increase	Decrease	Balance
Type	Account	Memo	Balance B/F: 0.00		
01/04/2010			20,000.00	0.00	20,000.00
Edit Del	Journal Entry	Asset Additions			
		Asset Financing Company Ltd			
01/04/2010			0.00	1,220.00	18,780.00
Edit Del	Direct Debit	LTT Current			
		First Lease Payment			
30/06/2010			413.00	0.00	19,193.00
Edit Del	Lease Asset				
	Journal Entry	Interest Paid			