

# SSAP

Statement of standard accounting practice No. 21.

# 21

August 1984

## Accounting for leases and hire purchase contracts



## FOREWORD

Over the past few years, leasing has grown in importance such that it is now a major source of finance for industry in the UK. In consequence, the question of how to account for various types of lease has itself become important. SSAP 21 distinguishes finance leases from operating leases and sets out standard practice for each. It codifies accepted practice for some aspects of lease accounting and introduces a requirement for lessees to capitalise material finance leases – which a significant number of companies are doing already.

Why is a capitalisation requirement necessary? When a company is leasing a substantial amount of assets instead of buying them, the effect is that, unless the leased assets and obligations are capitalised, potentially large liabilities build up off balance sheet; equally, the leased assets employed are not reflected on the balance sheet. These omissions may mislead users of a company's accounts – both external users and the company's own management. SSAP 21 therefore requires assets held under finance leases and the related leasing obligations to be capitalised on a company's balance sheet.

Capitalisation of finance leases will be helpful in at least two respects: to external users of companies' accounts and for internal management purposes. External users may use a company's accounts when making investment or credit decisions. Capitalisation of assets held under finance leases results in a company's assets and obligations being more readily apparent than if leased assets and obligations are not recognised. The information provided by SSAP 21 should in this way enhance the usefulness of the accounts for decision-making purposes.

In the latter context, divisional managers may in some cases not be aware of or involved in the choice of finance for the assets which they use. Without capitalisation, the choice of lease instead of buy could result in a divisional manager's performance being assessed by reference to a misleading figure of capital employed, whilst at the group level assets (and obligations, and thus gearing) would be similarly understated. SSAP 21 removes these anomalies by requiring recognition on a balance sheet of the leased assets and related obligations.

It is sometimes argued that leased assets should not be recognised on a company's balance sheet as the company does not have legal title to the asset. Whilst it is true that a lessee does not have legal ownership of the leased asset, however, he has the right to use the asset for substantially the whole of its useful economic life. These rights are for most practical purposes equivalent to legal ownership. It has long been accepted that assets held under hire purchase contracts should be recognised on the balance sheet of the hirer of the asset. SSAP 21 extends this treatment to finance leasing; it recognises that whether an asset is owned, leased or held under a hire purchase contract, it represents an economic resource which is needed in the business and which the accounts ought to reflect in a consistent manner.

Detailed guidance notes are published separately from the attached standard. They are non-mandatory and their primary purpose is to recommend practical methods which will assist companies to comply with the standard.

Finally I would stress that the standard, like all accounting standards, need not be applied to immaterial items. Hence, it is only of relevance to companies engaged in a significant amount of leasing.

Ian Hay Davison, *Chairman*  
Accounting Standards Committee

*Accounting for leases and  
hire purchase contracts*

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## STATEMENTS OF STANDARD ACCOUNTING PRACTICE

# *Accounting for leases and hire purchase contracts*

*(Issued August 1984)*

*The provisions of this statement of standard accounting practice should be read in conjunction with the Explanatory Foreword to accounting standards and **need not be applied to immaterial items**. The provisions apply equally to financial statements prepared under the historical cost convention and to financial statements prepared under the current cost convention.*

*This statement does not apply to lease contracts concerning the rights to explore for or to exploit natural resources such as oil, gas, timber, metals and other minerals. Nor does it apply to licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights.*

### **Part 1 – Explanatory note**

#### **Background**

- 1 Leases and hire purchase contracts are means by which companies obtain the right to use or purchase assets. In the UK there is normally no provision in a lease contract for legal title to the leased asset to pass to the lessee.
- 2 A hire purchase contract has similar features to a lease except that 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).
- 3 Current tax legislation provides that in the normal situation capital allowances can be claimed by the lessor under a lease contract but by the hirer under a hire purchase contract.
- 4 Lessors fall into three broad categories. They may be companies, including banks and finance houses, which provide finance under lease contracts to enable a single customer to acquire the use of an asset for the greater part of its useful life; they may operate a business which involves the renting out of assets for varying periods of time probably to more than one customer; or they may be manufacturer or dealer lessors who use leasing as a means of marketing their products, which may involve leasing a product to one customer or to several customers.
- 5 As a lessor and lessee are both parties to the same transaction it is appropriate that the same definitions should be used and the accounting treatment recommended should ideally be complementary. However, this will not mean that the recorded balances in both financial statements will be the same because the taxation consequences and hence the pattern of cash flows will be different.

## ACCOUNTING FOR LEASES AND HIRE PURCHASE CONTRACTS

### Forms of lease

Leases can appropriately be classified into finance leases and operating leases. The distinction between a finance lease and an operating lease will usually be evident from the terms of the contract between the lessor and the lessee. 6

An operating lease involves the lessee paying a rental for the hire of an asset for a period of time which is normally substantially less than its useful economic life. The lessor retains most of the risks and rewards of ownership of an asset in the case of an operating lease. 7

A finance lease usually involves payment by a lessee to a lessor of the full cost of the asset together with a return on the finance provided by the lessor. The lessee has substantially all the risks and rewards associated with the ownership of an asset, other than the legal title. In practice all leases transfer some of the risks and rewards of ownership to the lessee, and the distinction between a finance lease and an operating lease is essentially one of degree. 8

Sometimes, the lessor may receive part of his return in the form of a guarantee from an independent third party, in which case the lease may be a finance lease as far as the lessor is concerned, but not from the lessee's point of view. 9

Briefly, this standard requires that a finance lease should be capitalised by the lessee, that is, accounted for as the purchase of rights to the use and enjoyment of the asset with simultaneous recognition of the obligation to make future payments. A hire purchase is normally accounted for in a similar way. Under an operating lease, only the rental will be taken into account by a lessee. 10

The effect of a lease is to create a set of rights and obligations related to the use and enjoyment by the lessee of a leased asset for the term of the lease. Such rights constitute the rewards of ownership transferred under the lease to the lessee whilst the obligations, including in particular the obligation to continue paying rent for the period specified in the lease, constitute the risks of ownership so transferred. Where the rights and obligations of the lessee are such that his corresponding rewards and risks are, despite the absence of the ability to obtain legal title, substantially similar to those of an outright purchaser of the asset in question, the lease will be a finance lease. 11

Conceptually, what is capitalised in the lessee's accounts is not the asset itself but his rights in the asset (together with his obligation to pay rentals). However, the definition of a finance lease is such that a lessee's rights are for practical purposes little different from those of an outright purchaser. Hence, it is appropriate that lessees should include these assets in their financial statements, but they should describe them as 'leased assets' to distinguish them from owned assets. 12

### Part 2 – Definition of terms

*Company* includes any enterprise which comes within the scope of statements of standard accounting practice. 13

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- 14 A *lease* is a contract between a lessor and a lessee for the hire of a specific asset. The lessor retains ownership of the asset but conveys the right to the use of the asset to the lessee for an agreed period of time in return for the payment of specified rentals. The term 'lease' as used in this statement also applies to other arrangements in which one party retains ownership of an asset but conveys the right to the use of the asset to another party for an agreed period of time in return for specified payments.
- 15 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 (normally 90 per cent or more) of the fair value of the leased asset. The present value should be calculated by using the interest rate implicit in the lease (as defined in paragraph 24). If the fair value of the asset is not determinable, an estimate thereof should be used.
- 16 Notwithstanding the fact that a lease meets the conditions in paragraph 15, the presumption that it should be classified as a finance lease may in exceptional circumstances be rebutted if it can be clearly demonstrated that the lease in question does not transfer substantially all the risks and rewards of ownership (other than legal title) to the lessee. Correspondingly, the presumption that a lease which fails to meet the conditions in paragraph 15 is not a finance lease may in exceptional circumstances be rebutted.
- 17 An *operating lease* is a lease other than a finance lease.
- 18 A *hire purchase contract* is a contract for the hire of an asset which contains a provision giving the hirer an option to acquire legal title to the asset upon the fulfilment of certain conditions stated in the contract.
- 19 The *lease term* is the period for which the lessee has contracted to lease the asset and any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, which option it is reasonably certain at the inception of the lease that the lessee will exercise.
- 20 The *minimum lease payments* are the minimum payments over the remaining part of the lease term (excluding charges for services and taxes to be paid by the lessor) and:
  - (a) in the case of the lessee, any residual amounts guaranteed by him or by a party related to him; or
  - (b) in the case of the lessor, any residual amounts guaranteed by the lessee or by an independent third party.
- 21 The *gross investment* in a lease at a point in time is the total of the minimum lease payments and any unguaranteed residual value accruing to the lessor.
- 22 The *net investment* in a lease at a point in time comprises:
  - (a) the gross investment in a lease (as defined in paragraph 21): *less*
  - (b) gross earnings allocated to future periods.

## ACCOUNTING FOR LEASES AND HIRE PURCHASE CONTRACTS

- The *net cash investment* in a lease at a point in time is the amount of funds invested in a lease by a lessor, and comprises the cost of the asset plus or minus the following related payments or receipts: 23
- (a) government or other grants receivable towards the purchase or use of the asset;
  - (b) rentals received;
  - (c) taxation payments and receipts, including the effect of capital allowances;
  - (d) residual values, if any, at the end of the lease term;
  - (e) interest payments (where applicable);
  - (f) interest received on cash surplus;
  - (g) profit taken out of the lease.
- The *interest rate implicit in a lease* is the discount rate that at the inception of a lease, when applied to the amounts which the lessor expects to receive and retain produces an amount (the present value) equal to the fair value of the leased asset. The amounts which the lessor expects to receive and retain comprise (a) the minimum lease payments to the lessor (as defined in paragraph 20), plus (b) any unguaranteed residual value, less (c) any part of (a) and (b) for which the lessor will be accountable to the lessee. If the interest rate implicit in the lease is not determinable, it should be estimated by reference to the rate which a lessee would be expected to pay on a similar lease. 24
- Fair value* is the price at which an asset could be exchanged in an arm's length transaction less, where applicable, any grants receivable towards the purchase or use of the asset. 25
- Unguaranteed residual value* is that portion of the residual value of the leased asset (estimated at the inception of the lease), the realisation of which by the lessor is not assured or is guaranteed solely by a party related to the lessor. 26
- Finance charge* is the amount borne by the lessee over the lease term, representing the difference between the total of the minimum lease payments (including any residual amounts guaranteed by him) and the amount at which he records the leased asset at the inception of the lease. 27
- Gross earnings* comprise the lessor's gross finance income over the lease term, representing the difference between his gross investment in the lease (as defined in paragraph 21) and the cost of the leased asset less any grants receivable towards the purchase or use of the asset. Where a lessor selects option (b) of paragraph 41 the grants to be deducted should be the grossed-up amount. 28
- The *inception of a lease* is the earlier of the time the asset is brought into use and the date from which rentals first accrue. 29
- Initial direct costs* are those costs incurred by the lessor that are directly associated with negotiating and consummating leasing transactions, such as commissions, legal fees, costs of credit investigations and costs of preparing and processing documents for new leases acquired. 30

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### Part 3 – Standard accounting practice

#### Hire purchase and leasing

- 31 Those hire purchase contracts which are of a financing nature should be accounted for on a basis similar to that set out below for finance leases. Conversely, other hire purchase contracts should be accounted for on a basis similar to that set out below for operating leases.

#### Accounting by lessees

- 32 A finance lease should be recorded in the balance sheet of a lessee as an asset and as an obligation to pay future rentals. At the inception of the lease the sum to be recorded both as an asset and as a liability should be the present value of the minimum lease payments, derived by discounting them at the interest rate implicit in the lease.
- 33 In practice in the case of a finance lease the fair value of the asset will often be a sufficiently close approximation to the present value of the minimum lease payments and may in these circumstances be substituted for it.
- 34 The combined benefit to a lessor of regional development and other grants together with capital allowances, which reduce tax liabilities, may enable the minimum lease payments under a finance lease to be reduced to a total which is less than the fair value of the asset. In these circumstances, the amount to be capitalised and depreciated should be restricted to the minimum lease payments. A negative finance charge should not be shown.
- 35 Rentals payable should be apportioned between the finance charge and a reduction of the outstanding obligation for future amounts payable. The total finance charge under a finance lease should be allocated to accounting periods during the lease term so as to produce a constant periodic rate of charge on the remaining balance of the obligation for each accounting period, or a reasonable approximation thereto.
- 36 An asset leased under a finance lease should be depreciated over the shorter of the lease term (as defined in paragraph 19) and its useful life. However, in the case of a hire purchase contract which has the characteristics of a finance lease, the asset should be depreciated over its useful life.
- 37 The rental under an operating lease should be charged on a straight-line basis over the lease term, even if the payments are not made on such a basis, unless another systematic and rational basis is more appropriate.

#### Accounting by lessors

- 38 The amount due from the lessee under a finance lease should be recorded in the balance sheet of a lessor as a debtor at the amount of the net investment in the lease after making provisions for items such as bad and doubtful rentals receivable.
- 39 The total gross earnings under a finance lease should normally be allocated to accounting periods to give a constant periodic rate of return on the lessor's **net cash investment**



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in the lease in each period. In the case of a hire purchase contract which has characteristics similar to a finance lease, allocation of gross earnings so as to give a constant periodic rate of return on the finance company's **net investment** will in most cases be a suitable approximation to allocation based on the net cash investment. In arriving at the constant periodic rate of return, a reasonable approximation may be made.

As an alternative to paragraph 39, an allocation may first be made out of gross earnings of an amount equal to the lessor's estimated cost of finance included in the net cash investment calculation, with the balance being recognised on a systematic basis. 40

Tax free grants which are available to the lessor against the purchase price of assets acquired for leasing should be spread over the period of the lease and may be dealt with either: 41

- (a) by treating the grant as non-taxable income; or
- (b) by grossing up the grant and including the grossed-up amount in arriving at profit before tax.

Where treatment (b) is adopted, the lessor should disclose the amount by which the profit before tax and the tax charge have been increased as a result of grossing up such grants.

An asset held for use in operating leases by a lessor should be recorded as a fixed asset and depreciated over its useful life. 42

Rental income from an operating lease, excluding charges for services such as insurance and maintenance, should be recognised on a straight-line basis over the period of the lease, even if the payments are not made on such a basis, unless another systematic and rational basis is more representative of the time pattern in which the benefit from the leased asset is receivable. 43

Initial direct costs incurred by a lessor in arranging a lease may be apportioned over the period of the lease on a systematic and rational basis. 44

### **Manufacturer/dealer lessor**

A manufacturer or dealer lessor should not recognise a selling profit under an operating lease. The selling profit under a finance lease should be restricted to the excess of the fair value of the asset over the manufacturer's or dealer's cost less any grants receivable by the manufacturer or dealer towards the purchase, construction or use of the asset. 45

### **Sale and leaseback transactions**

#### *Accounting by the seller/lessee*

In a sale and leaseback transaction which results in a finance lease any apparent profit or loss (that is, the difference between the sale price and the previous carrying value) should be deferred and amortised in the financial statements of the seller/lessee over the shorter of the lease term and the useful life of the asset. 46

## STATEMENTS OF STANDARD ACCOUNTING PRACTICE

- 47 If the leaseback is an operating lease:
- (a) any profit or loss should be recognised immediately, provided it is clear that the transaction is established at fair value;
  - (b) if the sale price is below fair value, any profit or loss should be recognised immediately except that if the apparent loss is compensated by future rentals at below market price it should to that extent be deferred and amortised over the remainder of the lease term (or, if shorter, the period during which the reduced rentals are chargeable);
  - (c) if the sale price is above fair value, the excess over fair value should be deferred and amortised over the shorter of the remainder of the lease term and the period to the next rent review (if any).

### *Accounting by the buyer/lessor*

- 48 A buyer/lessor should account for a sale and leaseback in the same way as he accounts for other leases, that is, using the methods set out in paragraphs 38 to 45 above.

### **Disclosure by lessees**

- 49 The gross amounts of assets which are held under finance leases\* together with the related accumulated depreciation should be disclosed by each major class of asset. The total depreciation allocated for the period in respect of assets held under finance leases\* should be disclosed by each major class of asset.
- 50 The information required by paragraph 49 may, as an alternative to being shown separately from that in respect of owned fixed assets, be integrated with it such that the totals of gross amount, accumulated depreciation, net amount and depreciation allocated for the period for each major class of asset are included with similar amounts in respect of owned fixed assets. Where this alternative treatment is adopted, the net amount of assets held under finance leases\* included in the overall total should be disclosed. The amount of depreciation allocated for the period in respect of assets held under finance leases\* included in the overall total should also be disclosed.
- 51 The amounts of obligations related to finance leases\* (net of finance charges allocated to future periods) should be disclosed separately from other obligations and liabilities, either on the face of the balance sheet or in the notes to the accounts.
- 52 These net obligations under finance leases\* should be analysed between amounts payable in the next year, amounts payable in the second to fifth years inclusive from the balance sheet date, and the aggregate amounts payable thereafter. This analysis may be presented either (a) separately for obligations under finance leases\* or (b) where the total of these items is combined on the balance sheet with other obligations and liabilities, by giving the equivalent analysis of the total in which it is included. If the analysis is presented according to (a) above, a lessee may, as an alternative to analysing the net obligations, analyse the gross obligations, with future finance charges being separately deducted from the total.

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\*Including the equivalent information in respect of hire purchase contracts which have characteristics similar to that type of lease (see paragraph 31).

## ACCOUNTING FOR LEASES AND HIRE PURCHASE CONTRACTS

The aggregate finance charges allocated for the period in respect of finance leases* should be disclosed.	53
Disclosure should be made of the amount of any commitments existing at the balance sheet date in respect of finance leases* which have been entered into but whose inception occurs after the year end.	54
The total of operating lease rentals* charged as an expense in the profit and loss account should be disclosed, analysed between amounts payable in respect of hire of plant and machinery and in respect of other operating leases*.	55
In respect of operating leases*, the lessee should disclose the payments which he is committed to make during the next year, analysed between those in which the commitment expires within that year, in the second to fifth years inclusive and over five years from the balance sheet date, showing separately the commitments in respect of leases of land and buildings and other operating leases*.	56
Disclosure should be made of the policies adopted for accounting for operating leases* and finance leases*.	57
<b>Disclosure by lessors</b>	
The net investment in (i) finance leases and (ii) hire purchase contracts at each balance sheet date should be disclosed.	58
The gross amounts of assets held for use in operating leases*, and the related accumulated depreciation charges, should be disclosed.	59
Disclosure should be made of:	60
(a) the policy adopted for accounting for operating leases* and finance leases* and, in detail, the policy for accounting for finance lease income*;	
(b) the aggregate rentals receivable in respect of an accounting period in relation to (i) finance leases* and (ii) operating leases*; and	
(c) the cost of assets acquired, whether by purchase or finance lease*, for the purpose of letting under finance leases*.	
<b>Date from which effective for lessors and finance companies</b>	
The accounting practices set out in this statement should be adopted as soon as possible and regarded as standard for financial statements relating to accounting periods beginning on or after 1 July 1984 in respect of leases and hire purchase contracts (a) entered into on or after 1 July 1984 or (b) which have five years or more to run on 1 July 1984. If the provisions of this statement are not applied retroactively to all leases and hire purchase contracts existing at 1 July 1984, lessors and finance companies should disclose the amounts of gross earnings from finance leases and hire purchase contracts for the current year and the comparative period which have arisen under each of the principal bases used.	61

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\*Including the equivalent information in respect of hire purchase contracts which have characteristics similar to that type of lease (see paragraph 31).

## STATEMENTS OF STANDARD ACCOUNTING PRACTICE

### **Date from which effective for lessees and hirers**

- 62 The accounting practices set out in this statement should be adopted by lessees and hirers as soon as possible and regarded as standard in respect of financial statements relating to accounting periods beginning on or after 1 July 1987. However, the disclosure requirements in paragraphs 52 and 54 to 57 should be regarded as standard in respect of financial statements relating to accounting periods beginning on or after 1 July 1984.

### **Part 4 – Legal requirements in Great Britain**

- 63 Paragraph 50 (5) of Schedule 8\* provides that ‘Particulars shall also be given of any other financial commitments which:
- (a) have not been provided for; and
  - (b) are relevant to assessing the company’s state of affairs.’
- Insofar as finance leases are capitalised by lessees, the obligations under finance leases *are* provided for in the accounts. This will not be the case to the extent that lessees take advantage of the delayed implementation of capitalisation as set out in paragraph 62.
- 64 Paragraph 53 (6) of Schedule 8 requires disclosure of the ‘amount charged to revenue in respect of sums payable in respect of the hire of plant and machinery’ (standard, paragraphs 49, 50, 53 and 55 and guidance notes).
- 65 The balance sheet formats in Schedule 8 require that creditors falling due within one year should be shown separately from creditors falling due after more than one year (standard, paragraph 52 and guidance notes).
- 66 The balance sheet formats in Schedule 8 provide that the ‘amount falling due after more than one year shall be shown separately for each item included under debtors’. This is relevant to the disclosure of amounts receivable by a lessor (standard, paragraph 58 and guidance notes).

### **Part 5 – Legal requirements in Ireland**

#### **Northern Ireland**

- 67 The Schedule references in Part 4 (paragraphs 63 to 66) apply equally to Schedule 6 of the Companies Act (Northern Ireland) 1960, as inserted by Article 3 of the Companies (Northern Ireland) Order 1982.

#### **Republic of Ireland**

- 68 General provisions as to accounts are set out in the Sixth Schedule to the Companies Act 1963. There are no legal requirements in the Republic of Ireland similar to those outlined in Part 4.

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\* All references to Schedule 8 refer to the new Schedule 8 to the Companies Act 1948, as inserted by section 1 of the Companies Act 1981.

## ACCOUNTING FOR LEASES AND HIRE PURCHASE CONTRACTS

### **Part 6 – Compliance with International Accounting Standard No. 17 ‘Accounting for leases’**

The requirements of International Accounting Standard No. 17 ‘Accounting for leases’ accord very closely with the content of the United Kingdom and Irish Accounting Standard No. 21 ‘Accounting for leases and hire purchase contracts’ and accordingly compliance with SSAP 21 will ensure compliance with IAS17 in all material respects. 69



