FINANCE LEASES, HIRE-PURCHASE & CHATTEL MORTGAGE CONTRACTS

THE INCOME TAX, GST & ACCOUNTING TREATMENTS

mobility | accounting solutions

Written by: Tony D'Agostino
Director
Mobility Accounting Solutions
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Phone: (07) 3666 0091
Email: email@mobilityas.com.au

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1. <u>Introduction</u>

The accounting for various types of finance instruments is a topic which should be understood and able to be applied by all bookkeepers as it is not uncommon for business of all shapes and sizes to need to finance assets at some stage of their existence.

The purpose of this paper is to show the reader the journal entries required once a business has entered into those types of agreements. Included in this paper will also be some discussion of the GST treatment of the monthly payments made under each type of agreement.

The paper will exclude the journal entries required under a simple bank loan.

2. Types of Asset Finance

In Australia, there are essentially four types of ways to finance the purchase of moveable assets such as cars, boats, caravans and other items of plant and equipment.

The first and perhaps simplest of those methods is the standard bank loan where the purchase of the asset is secured against the asset itself or other property. This type of finance is often good if you have equity in other assets such as property, as the interest rate can often be cheaper than the other forms of finance discussed here.

A standard bank loan however, is not so good for moveable type assets where other security is not available and because of this problem, other forms of loan contracts have arisen.

The other three types of loan contract are:

- Finance Lease
- Hire-Purchase
- Chattel Mortgage

A finance lease is a commercial arrangement where:

- The lessee (borrower) selects an asset
- The lessor (financier) purchases the asset
- The lessee is granted use of the asset during the period of the lease
- The lessee pays to the lessor a series of instalments for the use of the asset
- The lessor recovers a large part or all of the purchase price of the asset plus interest from the lease payments made by the lessee
- The lessee has the option to acquire ownership of the asset at the end of the lease

It is a unique loan contract therefore, where the lessor retains legal title but the lessee, having control over the asset, obtains the benefits and risks of ownership.

A hire-purchase contract is one where the borrower agrees to pay for goods in part or a percentage at a time.

In cases where a buyer cannot afford the full price of the item but can afford to pay a percentage as a deposit, a hire-purchase contract allows the buyer to hire the goods for a monthly rent.

When a sum equal to the original full price plus interest has been paid in equal instalments, the buyer may then exercise an option to buy the goods at a pre-determined price or return the goods to the owner.

If the buyer defaults in paying the instalments, the owner may repossess the goods.

The final form of finance for moveable property is the chattel mortgage. This form of contract is similar to the bank loan where the purchaser borrows funds for the purchase of a moveable asset (a chattel) and the lender secures the loan with a mortgage over the chattel. Legal ownership of the item is transferred to the purchaser at the time of purchase and the mortgage is removed once the loan has been repaid.

Each of these contracts may have various names placed onto them by different financiers but these are essentially the only forms of finance available.

3. GST & Asset Finance

a) Finance Lease

If you account for GST on an accruals basis, you are entitled to a GST input tax credit of $1/11^{th}$ of the lease instalments for each tax period where:

- You make any part of the lease payment due in that period or
- You receive an invoice from the supplier

If you account on a cash basis, you claim a credit of $1/11^{th}$ of the lease instalment amounts paid in each tax period.

b) Hire-Purchase & Chattel Mortgage

i) Accruals Accounting

If you account for GST on an accruals basis, you can claim the full GST credit on your agreement in the tax periods when either:

- You make your first payment or
- If before making your first payment, an invoice is issued to you

ii) Cash Accounting

From 01 July 2012, the rules for claiming GST credits changed if you account for GST on a cash basis.

For agreements entered into on or after 01 July 2012, you may claim credits upfront in the same way you would as if you accounted for GST on an accruals basis. From 01 July 2012, all components of a supply made under these contracts will be subject to GST and therefore you will be able to claim $1/11^{th}$ of all components. Components of the payments will include interest and associated fees.

For agreements entered into before 01 July 2012, you may claim $1/11^{th}$ of the principal component of each instalment in the period you pay it. If the supplier provides details of this amount, you must use that information to work out your credit. If this is not provided, you must take reasonable steps to find this out from the supplier.

Example 1 – HP agreement entered into before 01 July 2012

Mick's Motorcycles is a motorcycle retailer who accounts for GST on a cash basis every quarter.

In March 2011 he purchased a wheel alignment machine under a hire purchase agreement for $3,000. Under the terms of the agreement, he will pay $670/month for 5 years for a total of $40,200 being principal of $33,000 and interest of $7,200.

The finance company (Can Do Bank) advises that the principal component of the first instalment is $550.

If Mick accounts for GST on an accruals basis, he is able to claim the full GST credit of $3,000 ($1/11^{th}$ of $33,000) in the tax period ending March 2011. Mick is happy.

If Mick accounts for GST on a cash basis, he can only claim a credit of $50 (1/11th of $550) in the first tax period ending March 2012 provided he has paid the instalment. Mick is not so happy.

Example 2 – HP agreement entered into after 01 July 2012

Assume the same facts with the exception that our hero Mick has entered into this HP agreement on 10 September 2012.

From this date, both principal and interest components of the supply are subject to GST.

Regardless of whether Mick accounts for GST on a cash or accruals basis in his September 2012 Business Activity Statement, he will be able to claim a GST credit of $3,654.54 (1/11th of $40,200). Mick is very happy.

The GST claim is higher than any scenario prior to 01 July 2012 because under the new rules, GST can now be claimed on the principal and interest components.

4. Accounting Treatments

a) Finance Lease

When accounting for a finance lease, the bookkeeper must take account of:

- The original acquisition of the item
- The lease payments made throughout the period
- The gradual write-off of the asset
- Allocate the liability between current and non-current

Assume for the purposes of this exercise that your client Super Mario has just leased a brand new Alfa Romeo 159 on the following terms:

- Start date – 15 June 2011
- Term – 48 months +
- Payment of $1,071.48 & GST/month
- Zero residual
- Cost price of the vehicle - $44,000

i) Account For The Acquisition Of The Asset

Like any acquisition, the journal entry for this is based around cost price of the asset.

Dr		**Motor Vehicle Under Lease**	**44,000**	
	Cr	Lease Liability		44,000

The reader will note the term motor vehicle under lease. It is used to inform the reader that whilst it is an item of plant, it is also under a finance lease arrangement. As an item of plant, it should be grouped with other fixed assets.

ii) Account For Lease Payments

Once the asset and initial liability have been established, you must account for the monthly payments.

In our example, these are $1,078.48 + GST each month for 48 months.

The allocation of the payment needs to be dissected for each component within the amount. These are, GST, interest and reduction of liability and the best method to calculate this dissection is with some form of automation either in excel or some other program which calculates interest. By way of note, the ATO will not accept calculations based upon the rule of 78.

A calculation of interest and principal amounts over the term of the lease is included at Appendix 1.

Journal entries are therefore:

Dr		**Lease Liability**	**XX**	
Dr		Interest Exp.	XX	
Dr		GST Paid	XX	
	Cr	Bank		XX

Using May 2012 as an example:

Dr		**Lease Liability**	**832.18**	
Dr		Interest Exp.	239.30	
Dr		GST Paid	107.15	
	Cr	Bank		1,178.63

The reader will note the amounts for the journal come directly from the contract dissection in the Appendix.

Lastly, monthly management accounts need not be 100% correct so if bookkeepers wanted to save time, a standing monthly journal which allocates interest and principal reduction for a 12 month period would generally suffice provided the balances at critical dates such as year-end were correct.

iii) Asset Write-off

It is also important that the asset be written-off over its life. In much the same way as we depreciate fixed assets, leased assets are amortised over the lease term.

It is the author's preference to amortise down to residual value on a lease using a straight line method, as it is very simple and at the expiry of the lease term, the bookkeeper is left with the residual to depreciate on payout. However, other methods are also acceptable.

Using this method, the monthly amortisation charge is calculated as follows:

$$\frac{\text{Asset Cost} - \text{Residual Value}}{\text{Number of Payments}}$$

In our example, this would be:

$$\frac{\$44{,}000 - 0}{48}$$

$$= \$916.67$$

And the journal would be:

Dr		**Amortisation Expense (P + L)**	**916.67**	
	Cr	Acc. Amortisation (B/S)		916.67

Accumulated amortisation like accumulated depreciation should be shown in the fixed asset section of the balance sheet.

iv) Allocation of Liability

Lastly, the liability must be allocated between current and non-current portions. Current represents that amount of liability which will be repaid within 12 months and non-current, the amount payable after that time.

For management accounts, this may not be essential. In fact, the author often advises bookkeepers to maintain only one liability amount in the non-current section of the balance sheet to avoid the extra work this dissection entails.

This allocation is best described using amounts from our example in the Appendix. Assume it is June 2011 and we have just posted the journal for the first payment and the remaining liability is $42,928.52.

To allocate between current and non-current, we simply take the amount of liability reduction for the subsequent 12 month period, the current portion, and put through the journal as required. From the contract dissection, that amount is $9,686.60.

The journal entry on the assumption all liability was initially classified non-current would be:

Dr		**Lease Liability – Non-Current**	**9,686.60**	
	Cr	Lease Liability – Current		9,686.60

v) How Does It Look?

At any point in time, bookkeepers should be carrying the following balances in their balance sheet for the lease:

Motor Vehicle Under Lease	**XX**	
Acc.Amortisation		(XX)
Lease Liability – Current	XX	
Lease Liability – Non-Current	XX	

Following these journals at 30 June 2012, these balances for our example would be:

Motor Vehicle Under Lease	**44,000**
Acc. Amortisation (13 months)	(11,917)
	32,083

Lease Liability – Current	**10,514.07**
Lease Liability – Non-Current	22,727.85
	33,241.92

I encourage the reader to do their own journals to verify these amounts.

b) Hire-Purchase or Chattel Mortgage

The journal entries for the accounting for a hire-purchase or chattel mortgage are essentially similar with subtle differences.

The process requires you to:

- Take up the asset and liability
- Account for the monthly payment
- Account for the write-off of the asset
- Allocate the liability between current and non-current

Assume for the purposes of the exercise your client Super Mario once again purchases the Alfa 159 under a hire-purchase contract.

- Start date 15 June 2011
- Term 48 months
- Payment of $1,071.48/month
- Cost price of vehicle $40,000 + GST

Assume also that the rules for input tax credits post 01 July 2012 apply.

i) Account For The Purchase

Dr		**Motor Vehicles**	**40,000**	
Dr		GST Paid	4,000	
	Cr	Hire-Purchase Liability		51,431.04
Dr		Unexpired Interest	7,431.04	

The reader should note two differences from the lease scenario:

- The motor vehicle is placed into the general pool for depreciable motor vehicles
- The liability raised is made up of a gross amount less interest over the period of the contract

The gross amount is simply the total of the contract payments over the period and the same is for the interest. See the Appendix for the amounts.

ii) Account For The Monthly Payment & Interest

The allocation of a monthly payment is also very similar with the exception that there is no GST on the payment amount and the interest amount is allocated to the unexpired interest amount.

Assume the payment for July 2012

Dr		**Hire-Purchase Liability**	**1,071.48**	
	Cr	Bank		1,071.48
Dr		Interest Expense	227.85	
	Cr	Liability		227.85

iii) Write-off The Asset

With assets purchased under a hire-purchase or chattel mortgage, they are brought onto the depreciation schedule for the entity like any asset purchased without finance.

The entry therefore is:

Dr		**Depreciation Expense**
	Cr	Acc. Depreciation

Whilst any depreciation rate can be used for management accounts, it is best to use the official ATO rates which will be required to be used for the entity's tax return.

iv) Allocation Of The Liability

In a similar manner to leases, the liability needs to be allocated between the current and non-current portions.

This is simply done by allocating the next 12 months payments to current liability and the balance to non-current.

v) How Does It Look?

For a hire-purchase or chattel mortgage, the bookkeeper should maintain the following balances in their ledger's balance sheet.

Asset-at cost	**XX**
Acc. Depreciation	(XX)
Hire-Purchase or Chattel Mortgage Liability - Current	(XX)
Less: Unexpired Interest – Current	XX
Hire Purchase or Chattel Mortgage Liability – Non Current	(XX)
Less: Unexpired Interest – Non-Current	XX

For disclosure purposes, both the liability and unexpired interest are classified as liabilities in the balance sheet.

Following the monthly journals at 30 June 2012, these balances would be:

Motor Vehicle at Cost	**40,000.00**
Less: Acc. Depreciation (13 months at 18.75%)	(8,125.00)
	31,875.00
Hire-Purchase Liability – Current	(12,857.76)
Less: Unexpired Interest – Current	2,343.69
	(10,514.07)
Hire-Purchase Liability – Non-Current	(24,644.04)
Less: Unexpired Interest – Non-Current	1,916.20
	(22,727.84)

Once again, I encourage the reader to do their own journals to verify this.

5. **Income Tax Considerations**

Lastly, it is important to note the income tax considerations of finance contracts.

a) Finance Lease

Under a finance lease:

- Amortisation of the asset is non-deductible
- Lease interest expense is not deductible

  however:

- Lease payments are

Referring once again to our example at 30 June 2012

Amortisation of $11,000 ($916.67 x 12)	➡	NON-DEDUCTIBLE
Lease Interest of $3,171.16	➡	NON-DEDUCTIBLE
Lease Payments of $12,857.76	➡	DEDUCTIBLE

b) Hire-Purchase & Chattel Mortgage

Under these contracts, both interest and depreciation are deductible. Monthly payments are not.

APPENDIX 1

CONTRACT PARAMETERS

Contract Code	- 05				
Description	- 2011 Alfa Romeo 159				
Classification (1)	-				
Contract date	-	15/06/2011	Balance date	-	01/07/2012
Financed Cost	-	44000.00	Residual Value	-	-
Gross payment	-	1071.48	Other charges	-	-
Payments/year	-	12 [In Advance]			
Total payments	-	48 [Actuarial]	Remaining payments	-	35
Interest/year (%)	-	8.23			

* Indicates the first payment in the current year

APPENDIX 1

CONTRACT SCHEDULE

Payment Number	Gross Payment	Other Charges	Minimum Payment	Interest Expense	Liability Reduction	Outstanding Liability
06/11	1071.48	-	1071.48	-	1071.48	42928.52
	1071.48	-	1071.48	-	1071.48	-
07/11	1071.48	-	1071.48	294.24	777.24	42151.28
08/11	1071.48	-	1071.48	288.92	782.56	41368.72
09/11	1071.48	-	1071.48	283.55	787.93	40580.79
10/11	1071.48	-	1071.48	278.15	793.33	39787.46
11/11	1071.48	-	1071.48	272.71	798.77	38988.69
12/11	1071.48	-	1071.48	267.24	804.24	38184.45
01/12	1071.48	-	1071.48	261.73	809.75	37374.70
02/12	1071.48	-	1071.48	256.18	815.30	36559.40
03/12	1071.48	-	1071.48	250.59	820.89	35738.51
04/12	1071.48	-	1071.48	244.96	826.52	34911.99
05/12	1071.48	-	1071.48	239.30	832.18	34079.81
06/12	1071.48	-	1071.48	233.59	837.89	33241.92
	12857.76	-	12857.76	3171.16	9686.60	-
*07/12	1071.48	-	1071.48	227.85	843.63	32398.29
08/12	1071.48	-	1071.48	222.07	849.41	31548.88
09/12	1071.48	-	1071.48	216.24	855.24	30693.64
10/12	1071.48	-	1071.48	210.38	861.10	29832.54
11/12	1071.48	-	1071.48	204.48	867.00	28965.54
12/12	1071.48	-	1071.48	198.54	872.94	28092.60
01/13	1071.48	-	1071.48	192.55	878.93	27213.67
02/13	1071.48	-	1071.48	186.53	884.95	26328.72
03/13	1071.48	-	1071.48	180.46	891.02	25437.70
04/13	1071.48	-	1071.48	174.36	897.12	24540.58
05/13	1071.48	-	1071.48	168.21	903.27	23637.31
06/13	1071.48	-	1071.48	162.02	909.46	22727.85
	12857.76	-	12857.76	2343.69	10514.07	-
07/13	1071.48	-	1071.48	155.78	915.70	21812.15
08/13	1071.48	-	1071.48	149.51	921.97	20890.18
09/13	1071.48	-	1071.48	143.19	928.29	19961.89
10/13	1071.48	-	1071.48	136.82	934.66	19027.23
11/13	1071.48	-	1071.48	130.42	941.06	18086.17
12/13	1071.48	-	1071.48	123.97	947.51	17138.66
01/14	1071.48	-	1071.48	117.47	954.01	16184.65
02/14	1071.48	-	1071.48	110.93	960.55	15224.10
03/14	1071.48	-	1071.48	104.35	967.13	14256.97
04/14	1071.48	-	1071.48	97.72	973.76	13283.21
05/14	1071.48	-	1071.48	91.05	980.43	12302.78
06/14	1071.48	-	1071.48	84.33	987.15	11315.63
	12857.76	-	12857.76	1445.54	11412.22	-
07/14	1071.48	-	1071.48	77.56	993.92	10321.71
08/14	1071.48	-	1071.48	70.75	1000.73	9320.98
09/14	1071.48	-	1071.48	63.89	1007.59	8313.39
10/14	1071.48	-	1071.48	56.98	1014.50	7298.89
11/14	1071.48	-	1071.48	50.03	1021.45	6277.44
12/14	1071.48	-	1071.48	43.03	1028.45	5248.99

APPENDIX 1

CONTRACT SCHEDULE

Payment Number	Gross Payment	Other Charges	Minimum Payment	Interest Expense	Liability Reduction	Outstanding Liability
01/15	1071.48	-	1071.48	35.98	1035.50	4213.49
02/15	1071.48	-	1071.48	28.88	1042.60	3170.89
03/15	1071.48	-	1071.48	21.73	1049.75	2121.14
04/15	1071.48	-	1071.48	14.54	1056.94	1064.20
05/15	1071.48	-	1071.48	7.29	1064.19	0.01
	11786.28	-	11786.28	470.66	11315.62	-
06/15	-	-	-	-0.01	0.01	-
TOTALS	51431.04	-	51431.04	7431.04	44000.00	-

Payment Number	Gross Payment	Other Charges	Minimum Payment	Interest Expense	Liability Reduction	Outstanding Liability
Last	12857.76	-	12857.76	3171.16	9686.60	33241.92
This	12857.76	-	12857.76	2343.69	10514.07	22727.85
Next	12857.76	-	12857.76	1445.54	11412.22	11315.63