Ultimate Guide to

Asset Finance

Maxxia FINANCE

Introduction

Businesses need capital to meet their growth objectives, keep pace with changes in customer demands and to update their equipment and technology.

The traditional route to accessing capital has been a loan from a bank or other finance provider, but there is a growing range of alternatives available that many businesses might find more attractive. This is particularly the case as bank finance continues to be challenging to arrange, especially for smaller businesses or those with a shorter period of trading.

What is Asset Finance?

Simply put, asset finance is the term used to describe funding provided for a specific business asset. This can be for the acquisition of a completely new asset or raising finance against an existing asset.

There are two broad categories; lease arrangements, where the business simply pays for the use of the asset over a period of time; and purchase arrangements where the customer intends to own the asset at the end of the agreement.

Asset finance is available on a very wide range of items including commercial vehicles, cars, plant and machinery and all types of business equipment. It's even available on what are known as 'soft assets', such as furniture and fittings, IT, security, catering and vending equipment.

The UK asset finance market has been growing rapidly in recent years, as businesses look for alternative forms of finance that better suit their specific circumstances.

With this popularity in mind, we've prepared this guide to give you some useful facts about how asset finance works. Obviously, any business financing must be selected as a result of careful analysis and balancing of need and affordability, and it's always prudent to gain expert advice before making any decision.

Why Choose Asset Finance?

Many businesses, in particular SMEs, find it hard to finance growth from their own resources. The outright purchase of new business assets is costly and ties up available capital, which can have a detrimental knock-on effect on cash flow. Also, many businesses have already invested their available funds in existing assets and simply don't have the capital to acquire more.

This can make it difficult to strike the right balance between having sufficient cash to take advantage of current opportunities and deal with any emergencies, and being able to invest in the most appropriate equipment for future business development.

While the business must still be credit-worthy, asset finance and re-financing can be more flexible and accessible than traditional lending methods. While there are still lending criteria that must be met, applications tend to be assessed on a case-by-case, commercial basis, rather than using the more regimented approach applied by banks. This can mean that a wider variety of assets and a broader range of business circumstances will be considered for funding, or that more favourable lending terms might be available.

There are other benefits to this type of finance and we've briefly highlighted the main ones below:

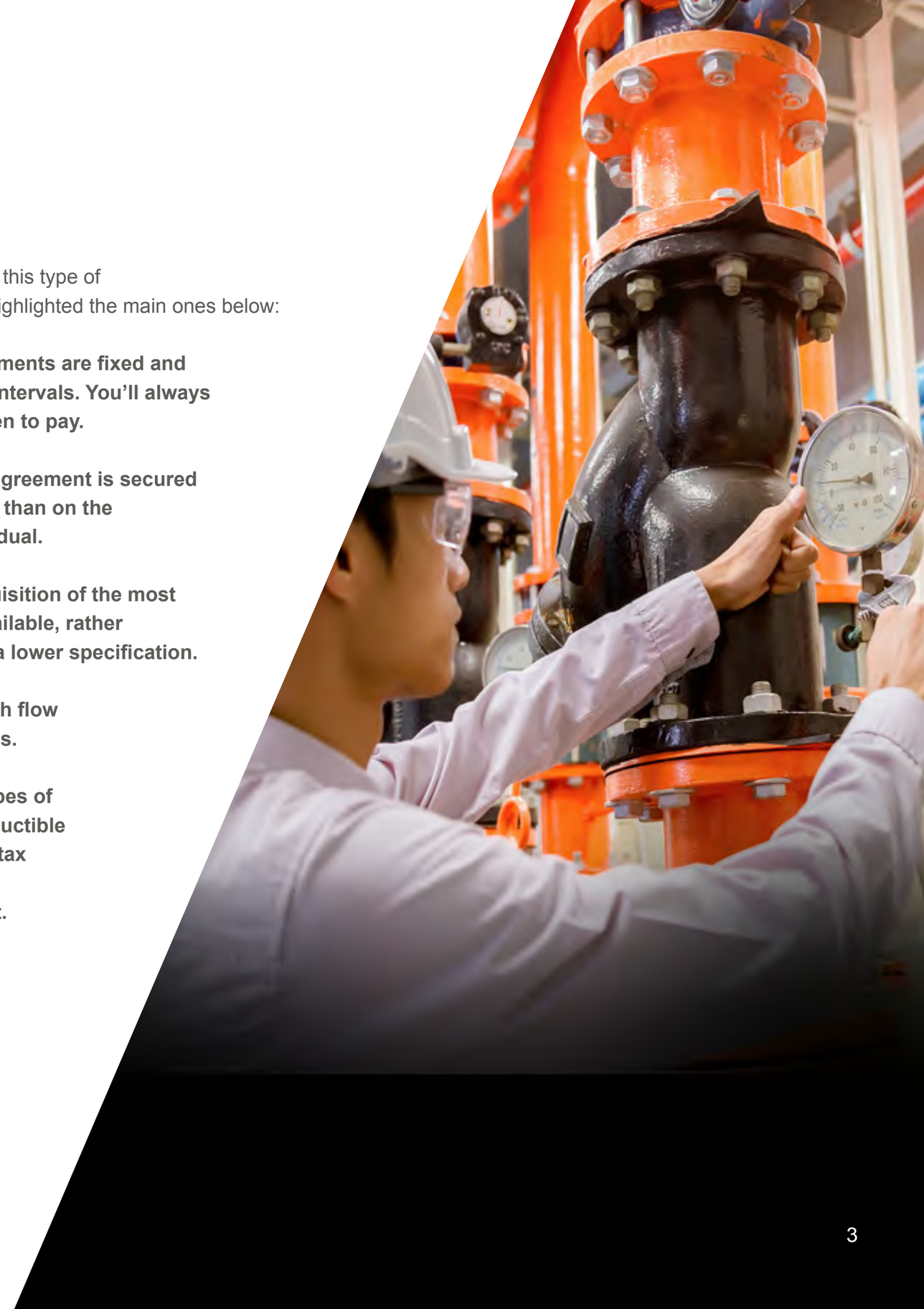
- **Easy budgeting, as payments are fixed and made at regular, agreed intervals. You'll always know how much and when to pay.**

- **In most instances, the agreement is secured on the asset itself, rather than on the business or by the individual.**

- **It can allow for the acquisition of the most up to date equipment available, rather than having to settle for a lower specification.**

- **Greater flexibility in cash flow and use of available funds.**

- **Payments on certain types of asset finance are tax-deductible business expenses, and tax relief may be available on the capital investment.**



Types of Asset Finance

Hire Purchase

Hire purchase (HP) has been around in a formal way since the early 20th century and is generally well understood. It's simply a finance agreement that allows you to pay for an asset in instalments over a set period, usually at a set interest rate, and to own it at the end of the term.
The payments (including a possible balloon payment at the end of the contract) will cover the original cost of the asset plus interest charges.

Although the business won't own the asset until the final payment is made, taxation and accounting treatment will apply as if you had already purchased the item.

Accounting Treatment

The asset is shown on the balance sheet and is depreciated over time as an expense in the profit and loss account. The purchase amount is also shown as a liability on the balance sheet, which is reduced by the capital element of the payments.

Taxation

The interest element of each payment (and non-recoverable VAT in the case of exempt businesses) can be claimed as a business expense to reduce tax liability.

Equipment, machinery and commercial vehicles financed on hire purchase will usually qualify for 100% first year allowances via the Annual Investment Allowance (AIA). The level of allowance available varies from year to year, for details on the current allowances visit the HMRC website. See the section on AIAs later in this guide for more information.

VAT

You will normally pay VAT on the value of the item along with the first instalment, but it is recoverable in the normal way if you are VAT registered. For cars, if the vehicle is used solely for business purposes (e.g. to be used as a taxi, driving school car or hire car) then 100% of the VAT is recoverable. If it is also used for private purposes, then the VAT is not reclaimable.

Finance providers will often give the option of financing the irrecoverable VAT on cars, or deferring the VAT payment until the date of your next VAT reclaim, where it is recoverable.

Finance Lease

If your business requires a piece of equipment for a set length of time, ownership is not required, and you are happy to take the risk of what its value will be at the end of the agreement period, then a finance lease could be the most appropriate form of funding.

The lessor holds the ownership of the asset throughout the agreement, but you'll get exclusive use of it, providing the terms of the lease contract are met and the regular payments are made. These payments (including a possible balloon payment at the end of the contract) will cover the original cost of the asset plus interest charges.

At the end of the term, you may be given the opportunity to extend the lease or to return the asset to the finance company. This is dependent on the terms of the agreement, but in most cases you'll find that at the end of the primary lease period you will have the option to extend your lease. If an extension is not required, the asset will be returned to the finance company, normally to be sold on, potentially with a portion of the sale proceeds being returned to the lessee by way of a rebate on rentals paid.

Alternatively, the lessee could potentially sell the asset to a third party. In this instance the lessee would act on behalf of the lessor and may be given a rebate of rentals equating to a part of the sales proceeds. This will again depend on the terms outlined in the finance lease agreement.

Accounting Treatment

For finance leases, the asset is recorded on the balance sheet of the lessee and depreciated over time. As there is an obligation to pay future rentals for the asset, these are reflected as a liability on the balance sheet.

Rental payments are split into the cost of the finance provided and the reduction in the outstanding liability for the asset. As with hire purchase, the lessee has to expense depreciation and the interest element of the finance charge.

Taxation

The tax treatment varies depending on whether the lease is for more or less than seven years. As of the 1st January 2019 (before this date it was 60 months), if the lease is greater than 84 months/seven years then the lessee can claim the capital allowances on qualifying assets. For shorter leases - less than 84 months - the lessor will claim these allowances.

Payments can normally be fully offset against the business' taxable profits for corporation tax purposes. However, the payments are not fully tax deductible if:

- **The agreement is for a car that has CO_2 emissions over 110g/km – here only 85% of the value of the car qualifies for tax relief[1], or**

- **The rentals aren't evenly spread over the life of the lease**

VAT

VAT is charged on each rental payment and is normally recoverable. There is a 50% reduction in the amount of VAT which can be recovered on business cars to take account of any private use, which will generally occur. For situations where there is genuinely no private use of a vehicle, the 50% restriction would not apply, however the onus would be on the lessee to be able to demonstrate this, which in practice is quite difficult.

Operating Lease

An operating lease is similar to a finance lease, in that you won't own the asset at the end of the lease, but there are some significant differences.

Where a finance lease's repayments will cover the whole cost of the item by the end of the term, an operating lease only covers part of the useful life of the equipment, which is then usually sold or re-hired by the lessor when your agreement ends.

The leasing company will calculate the difference between the cost of the asset and the estimated end-of-agreement resale value, and your payments will be based on this figure. Unlike finance leases, the leasing company takes the risk of the asset being worth less at the end of the term than projected.

As you are not repaying the whole of the value of the asset, repayments will tend to be lower and for some types of asset, maintenance cover can also be included at an additional cost.

Schools and certain other educational organisations, which are not allowed by law to enter into straight finance agreements, can take advantage of operating leases to obtain much-needed equipment without having to use scarce capital funds.

Accounting Treatment

One of the key benefits for many organisations is that the asset doesn't have to be included on the balance sheet of the lessee. This has, however, been complicated since the introduction of IFRS16 from 1st January 2019, which also impacts on the tax position. See the section on this later in the guide for more information. Rental payments are treated as a business expense in the profit and loss account.

Taxation

As with finance leases, payments can normally be fully offset against taxable profits for corporation tax purposes unless:

- **The agreement is for a car that has CO_2 emissions over 110g/km – here only 85% of the value of the car qualify for tax relief**
- **The rentals aren't evenly spread over the life of the lease, or**
- **The lease has clauses that may allow the company to eventually own the asset**

This does mean that capital allowances cannot be claimed as well. These stay with the leasing company.

VAT

VAT is charged on each rental payment and is normally recoverable. There is a 50% reduction in the amount of VAT which can be recovered on business cars to take account of any private use, which is presumed to occur.

The 50% reduction only applies to the lease element of the contract, if there is a maintenance element this is deemed to be a business expense, and you can reclaim 100% of the VAT as long as this is a separate item on the invoice.

	Hire Purchase	Finance Lease	Operating Lease
Accounting Treatment	Asset and liability on borrower's balance sheet Depreciation and finance charge (interest) on lessee's P&L	Asset and liability on borrower's balance sheet Depreciation and finance charge (interest) on lessee's P&L	Asset not on lessee's balance sheet unless reporting to IFRS rules Rental payments an expense on lessee's P&L
Taxation	Interest element of payments is deductible Capital allowances available for lessee	Rental payments are deductible No capital allowances for lessee unless a long lease (over 84 months) Cars with CO_2 emissions over 110g/km receive 15% disallowance so tax relief is limited to 85% of value	Rental payments are deductible No capital allowances for lessee Cars with CO_2 emissions over 110g/km receive 15% disallowance so tax relief is limited to 85% of value
VAT	Payable up front Recoverable except for cars with any element of private use	Payable on each instalment 50% deduction on cars due to private use	Payable on each instalment 50% deduction on cars due to private use

Contract Hire

This is the term used to describe the most common form of operating lease for cars and commercial vehicles. As with the leasing of other assets, you pay a fixed monthly amount for a set period of time for the use of the vehicle. There is usually an initial deposit to be paid, equating to a certain number of months' rental.

The repayments are calculated on the value of the vehicle and the projected resale value (residual value) at the end of the lease agreement, also taking wear and tear and mileage depreciation into account.

Contract hire has become very popular over the years, largely because it provides a great deal of certainty over the cost of running a vehicle fleet. This is particularly the case where the agreements include the cost of maintenance.

Other important factors in the growth of vehicle contract hire include the management of duty-of-care responsibilities; ensuring that business journeys are undertaken in new, well maintained vehicles; and in the provision of highly valued benefits to attract and retain the best staff.

Contract Purchase

To the user, contract purchase can appear very similar to contract hire, but there are some important differences. From a tax and accounting perspective, treatment of contract purchase is closely aligned to that of hire purchase. The rental payments for contract purchase are not subject to VAT and commercial vehicles acquired using this funding method are eligible for the business' Annual Investment Allowance. See the section on this later in the guide.

The other key variance is that there is an option at the end of the agreement to purchase the vehicle rather than returning it; usually following a final 'balloon' payment to make the purchase complete. Once the final payment has been made, and title transferred to the customer, there is often an option to sell the vehicle back to the finance company to dispose of it.

Balloon Payments

A balloon payment is a lump sum amount which has to be paid at the end of some lease agreements, or at several set intervals during the agreement. It is usually applied where the asset will have a residual value at the end of the lease term which at least equals the amount of the balloon payment.

A balloon payment has the effect of reducing the regular monthly payments, but you will have to be sure that you can cover the lump sum at the required time. This is often a good option for businesses which have a strong growth forecast.

Selecting the Right Type of Asset Finance

As well as assessing the tax, VAT and accounting implications of each type of asset finance, it's also important to consider the type of asset and its likely lifespan.

As a general guide, the shorter the duration of time before the asset needs upgrading or replacing, the stronger the case for an operating lease. This is due to the fact that the asset is more likely to have a substantial residual value at the end of the contract and will, therefore, require smaller monthly payments. The lender will, of course, price the residual value risk into the overall cost of the lease.

In cases where the asset has a longer useful life within the organisation, residual value is less of an issue, as it's likely to amount to a smaller proportion of the asset's original value. This means that the borrower faces a smaller residual value risk, which may be more palatable to retain than transfer to the lessor. In these situations, finance lease or hire purchase may be a more appropriate funding method.

Asset Re-finance

This type of leasing provides a very useful way for companies with a lot of tangible and unencumbered assets to raise capital, while still enjoying the use of them. Many different types of asset can be re-financed, including equipment, property, vehicles and technology.

Simply put, you can raise capital for re-use within the business by borrowing a lump sum from a finance company secured on the asset or assets. You then make monthly repayments over a fixed period of time to pay it back. The business will normally have to own the asset outright to do this and a valuation will be required confirming a loan to value ratio of 80% or less.

The main advantage of asset re-financing is that you can continue to use the equipment or property while releasing part of its value to use on other business projects. Also, the repayments are treated as a business expense for corporation tax purposes.

Asset re-finance can be further broken down into two categories; Sale and HP-Back agreements and Sale and Lease-Back. A Sale and HP-Back agreement allows you to sell an asset to a lender for a capital sum, with repayments over a specified term to allow you to own the asset again at the end of the agreement.

A Sale and Lease-Back agreement again allows you to raise a capital sum on an asset, but without owning it at the end of the term. At the end of the agreement the asset is either returned to the lender or an arrangement is made for a secondary leasing period.

Accounting Treatment of Finance and Operating Leases

From January 1st, 2019, important changes came into force in the way that leased assets are treated for businesses that report to International Financial Reporting Standards (IFRS). These tend to be public limited companies and large private limited companies.

For these organisations, both operating leases and finance leases must be reported in the company balance sheet and profit and loss account. For businesses not reporting to IFRS, operating leases remain 'off-balance sheet' items for the time being.

For businesses that do now have to reflect operating leases in their accounts, the impact is as follows:

- **Balance sheets – lessees will need to show their 'right to use' the asset as an asset and their obligation to make lease payments as a liability.**

- **P&L accounts – lessees will show depreciation of the asset as well as interest on the lease liability. The depreciation would usually be on a straight-line basis.**

Where operating lease agreements are for a period of greater than seven years, the same taxation rules apply as for long-term finance leases, with capital allowances becoming available to the lessee.

For businesses not reporting to IFRS, the ability to raise funding for assets while keeping them off-balance sheet can make operating leases more attractive than finance leases.

Annual Investment Allowances

The Government has used Annual Investment Allowances (AIA) to increase the level of interest in asset investment for a wide range of businesses. These allowances give businesses immediate corporation tax relief on 100% of the cost of a newly acquired asset. The level of allowance varies and details of current allowances can be found on the HMRC website.

To qualify for corporation tax relief, the assets must be categorised as 'purchased' and not 'leased'. This means that assets acquired through operational and finance leases are not eligible for AIAs.

However, by utilising funding methods such as hire purchase, organisations are able to gain full relief up to the amount of the allowance, without having to outlay the entire cost of the asset.

To find out more about Annual Investment Allowances, you can download our guide **here**.

Conclusion

Asset finance provides a useful alternative to bank lending, and the outright purchase of assets, for many organisations. Selecting the right type of funding is not straight-forward and will depend on a number of complex factors. This makes getting the right advice essential before entering into any arrangement.

Maxxia has many years of experience in all types of asset funding, across a wide range of sectors. If you are interested in reviewing the finance needs of your organisation, contact us for a no-obligation discussion.

Maxxia's experts can provide advice and guidance on the most appropriate form of finance for many types of asset.

For more information call us on **0845 643 1319**
or visit **maxxia.co.uk**

Please note that this document is for information only and does not constitute legal advice. Before making any investment decision, it is also vital that tax advice is gained from a qualified advisor or accountant.

1 Correct at time of publication (July 2019) – check HMRC website for current rules

About Maxxia

Maxxia is a UK based finance provider offering enterprise-wide asset finance and leasing solutions to the public and private sector. Our team has significant expertise in all forms of asset funding, including vehicle leasing and fleet management, IT asset leasing and lifecycle management, as well as financing options for all types of business equipment and machinery.

With a focus on transparency and collaboration with customers, we create leasing and asset finance solutions that meet the individual objectives of an organisation.

Find out more about how Maxxia's leasing solutions can benefit your organisation
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