Funding Options for Company Cars

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Overview

When a company is looking to provide cars to its employees there are a number of different funding options it can consider and the choice of funding route can have a significant impact on the cost as wider issues like administration and exposure to residual value risk. It is important for a company to look at all of these when looking to choose a funding option for its company car fleet.

Blended Solutions

It is often the case that a 'blend' of the following funding options can deliver the optimal cost solution for a company. However, operating a blended policy can give additional administrative complexity which often drives companies to choose a single financing method for all the cars in their fleet.

Contract Hire

Contract hire is a lease funding option that is structured so the company simply hires the car for a predetermined period and mileage at a fixed monthly rental. The ownership of the car, and all associated risks, rewards and responsibilities are retained by the leasing provider. The lease rentals are fixed by the leasing provider at the outset of the agreement and usually take into account all costs associated with the car with the exception of maintenance costs, which can be included in an optional maintenance agreement if required.

The company will pay the agreed lease rental charges and maintenance costs if they were included and then at the end of the agreed term the company will hand the car back and settle any end of contract charges due based on the mileage and condition of the car.

There is no option for the company to purchase the vehicle at the end of the lease period and it must be handed back to the lease provider, although some leasing providers may under a discretionary arrangement allow an employee to purchase the car directly from them as a sale to a private individual.

The benefits of contract hire are:

- A fixed cost making budgeting more simple
- A small initial cost
- No exposure to residual value risk
- VAT recovery on the lease rentals (subject to 50% block)
- VAT is payable on each lease rental (as opposed to upfront)
- Corporation tax relief available against the lease rental charges
- Eliminates most of the stresses and financial risks of vehicle ownership

- Reduced car fleet administration.

The potential downsides to contract hire are:

- The company will be tied into a fixed contract
- No ability to profit from residual values
- It will be necessary to forecast the expected term and mileage for the car at the outset of the contract
- There is no option for the company to purchase the vehicle.

Finance lease

Finance lease is a lease funding option that allows the company to lease a vehicle for a fixed monthly fee. The structure of the arrangement also means that it transfers substantially all the risks and rewards of ownership of the vehicle to the company.

There are two main types of finance lease product that are offered, usually selected depending on the cash flow needs of the company, and these are known as a "fully amortised finance lease" or a "finance lease with a balloon payment".

Finance lease (fully amortised)

The lease rentals are based on the full cost of the car spread over the term of the contract and take no account of any anticipated residual value for the car. At the end of the agreement the car must be sold to a 3rd party and the company will receive an element of the sale proceeds as agreed with the leasing provider at the outset.

It is also possible with a fully amortised finance lease to take up the option of a secondary rental agreement for continued use of the car if this is required by the company. Generally, the capital cost and interest has been covered within the primary period and then a nominal "peppercorn rental" is charged for the secondary period which will be much less than the previous payments.

Finance lease (with balloon)

The lease rentals are based on part of the cost of the car, with a balance (the balloon) being offset to the end of the agreement, usually to reduce the lease rentals paid. At the end of the agreement the car must be sold to a 3rd party and sale proceeds that are in excess of the balloon payment can be retained by the company. If the sale proceeds fall short of the balloon payment the company will be responsible for any shortfall.

The benefits of acquiring a car under a finance lease are:

- The option to choose a fully amortised or balloon agreement to suit the cash flow needs of the company
- A small initial cost
- Usually, provided acquisition of title is optional rather than obligatory, VAT should be payable on each lease rental
- VAT recovery on the lease rentals (subject to 50% block)
- Corporation tax relief available against the lease rental charges

The potential downsides to a finance lease are:

- The company will be tied into a fixed contract
- Exposure to residual value risk for the company

Contract purchase

Contract purchase is a deferred purchase funding option that is structured so the company makes fixed monthly payments for a predetermined period and mileage and at the end of the agreement it has the option to purchase the car or hand it back to the leasing provider. The ownership of the car and some of the associated risks, rewards and responsibilities are retained by the leasing provider until the final balloon payment is made.

The monthly payments are fixed by the leasing provider at the outset of the agreement and usually take into account all costs associated with the car and the forecast balloon payment. As with contract hire, it is possible to include an optional maintenance agreement if required.

The company will pay the contracted payments and then at the end of the agreed term the company will have the option of meeting the balloon payment and owning the car or selling it back to the leasing provider at the price agreed at the outset. If the latter option is chosen there may be end of contract charges due based on the mileage and condition of the car.

The benefits of contract purchase are:

- A fixed-cost method of financing a vehicle purchase making budgeting more simple
- A small initial cost

- No exposure to residual value risk (if the car is sold back to the leasing provider)
- Potential residual value profit if the residual value is greater than the balloon payment due
- Tax relief provided via capital allowances
- Eliminates most of the stresses and financial risks of vehicle ownership
- Reduced car fleet administration

The potential downsides to contract purchase are:

- Upfront VAT cost, as supply of goods, not services
- VAT is ordinarily fully blocked
- It will be necessary to forecast the expected term and mileage for the car at the outset of the contract

Hire purchase

Hire purchase is a deferred purchase funding option that is structured so the company makes fixed monthly payments for a predetermined period and mileage. At the end of the agreement it has typically paid the full cost of the car and interest and ownership of the car transfers to the company. The ownership of the car is retained by the leasing provider until the final payment is made, however, the associated risks, rewards and responsibilities rest with the company.

The company will typically pay a deposit and then the balance of the cost of the car and any interest charges are spread evenly over an agreed term. As with other funding options, it is possible to include an optional maintenance agreement if required.

The benefits of hire purchase are:

- Greater degree of flexibility within the agreement
- No end of contract charges
- Potential residual value profit (compared to funding option with fixed residual value/balloon)

The potential downsides to hire purchase are:

- Upfront VAT cost, as supply of goods, not services
- VAT is ordinarily fully blocked
- Exposure to residual value risk
- Uncertain costs making budgeting more complex
- Management of the vehicles (purchase, disposal and maintenance) can be time consuming

Outright purchase

An outright purchase describes the straightforward situation where the company directly buys the car. The purchase is usually either funded through borrowings or use of the company's own cash resources. The ownership of the car and all of the associated risks, rewards and responsibilities rest with the company.

An outright purchase involves a large upfront payment when the company purchases the car and when it is sold the company will receive the full amount of the sale proceeds. A company can request fleet management services to support ownership of a car in areas like servicing, roadside assistance and vehicle sale from a fleet provider if required.

The benefits of outright purchase are:

- The flexibility provided by full ownership of the car and no fixed contract
- No end of contract charges

The potential downsides to outright purchase are:

- Upfront VAT cost, as supply of goods, not services
- VAT is ordinarily fully blocked
- Exposure to residual value risk
- Uncertain costs making budgeting more complex
- Cash flow implication of the large upfront purchase cost
- Management of the vehicles (purchase, disposal and maintenance) can be time consuming

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How do the funding options compare to each other?

The table below provides a simple way of comparing some of the key characteristics of the funding method explained above.

Funding comparison table

	Contract Hire	**Finance Lease (fully amortised)**	**Finance Lease (with balloon)**	**Contract Purchase**	**Hire Purchase**	**Outright Purchase**
What is the upfront payment/deposit?	Typically 3 months advance rentals (c8% of car cost)	Typically 10%-15% of car cost	Typically 10%-15% of car cost	Typically 3 months advance payments (c8% of car cost)	Typically 10%-15% of car cost	100% of car cost
Who owns the car?	The leasing provider	The leasing provider until the final payment is made	The leasing provider until the final payment is made	The leasing provider until the final payment is made	The leasing provider until the final payment is made	The company
Typically, who meets the maintenance cost?	Leasing provider (assuming optional maintenance agreement is taken)	Your business or select logical™*serviceplus+* (stand alone SMR product)	Your business or select logical™*serviceplus+* (stand alone SMR product)	Leasing provider (assuming optional maintenance agreement is taken)	Your business or select logical™*serviceplus+* (stand alone SMR product)The company	Your business or select logical™*serviceplus+* (stand alone SMR product)The company
Who retains the residual value risk?	The leasing provider	Your business or select logical™*serviceplus+* (stand alone SMR product)	Your business or select logical™*serviceplus+* (stand alone SMR product)	The leasing provider	Your business or select logical™*serviceplus+* (stand alone SMR product)	Your business or select logical™*serviceplus+* (stand alone SMR product)
Typically, who is responsible for administration of the car? e.g., Arranging road fund licence and disposal	The leasing provider	Your business or select logical™*serviceplus+* (stand alone SMR product)	Your business or select logical™*serviceplus+* (stand alone SMR product)	The leasing provider	Your business or select logical™*serviceplus+* (stand alone SMR product)	Your business or select logical™*serviceplus+* (stand alone SMR product)
Does the company own the car at the end of the contract?	No, it is returned to the leasing provider	No, it is sold to a 3rd party	No, it is sold to a 3rd party	Yes, subject to making the final payment	Yes, subject to making the final payment	Yes
Is the car treated as on, or off balance sheet?	Off balance sheet	On balance sheet	On balance sheet	On balance sheet	On balance sheet	On balance sheet
How does the company claim tax relief for car costs?	Monthly rental can be offset against profits for tax relief	Monthly rental can be offset against profits for tax relief	Monthly rental can be offset against profits for tax relief	Tax relief is provided via capital allowances	Tax relief is provided via capital allowances	Tax relief is provided via capital allowances
Can the company recover VAT on the rentals/payments made?[1]	Yes, subject to a 50% restriction	Yes, subject to a 50% restriction	Yes, subject to a 50% restriction	No	No	No
Can the company recover VAT on an optional maintenance agreement?	Yes, 100% of VAT can be recovered	Yes, 100% of VAT can be recovered	Yes, 100% of VAT can be recovered	Yes, 100% of VAT can be recovered	Yes, 100% of VAT can be recovered	Yes, 100% of VAT can be recovered

[1] Assumes that the car is made available for private use

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How are the different funding options accounted for?

The funding option chosen will ultimately determine the accounting treatment and this can be a significant part of the decision-making process for some companies, particularly for those with large company car fleets. Leasing provides the benefit of having a set monthly cost as well as being more flexible and avoiding working capital becoming tied up compared to an outright purchase. The decision as to whether to opt for contract hire or a finance lease or hire purchase arrangement currently makes a significant difference as to how the arrangement is treated within company accounts.

Contract hire

Under a contract hire agreement the car (an asset) is leased for a defined period and returned to the leasing provider (the legal owner) at the end of the agreed lease term. The asset is not capitalised in the balance sheet because from an accounting perspective the risks and rewards of ownership (typically the residual value risk) remains with the leasing provider.

Rental payments are typically charged to the profit and loss account on a straight line basis over the lease term.

Finance lease

Under finance lease contracts the car is treated as if it has been purchased outright and initially capitalised in the balance sheet at cost. It is then subject to an annual depreciation charge based on the estimated useful economic life and estimated residual value.

The lessee recognises an obligation to pay the future rentals in the balance sheet and the rentals payable are allocated between the finance charge and the capital amount (which equates to the fair value of the asset).

The total finance charge is allocated to accounting periods during the primary lease term on a constant yield basis and recorded as an expense in the profit and loss account.

Contract purchase

This has the same accounting treatment as finance lease.

Outright purchase

The cost of the car is capitalised in the balance sheet and an annual depreciation charge based on the estimated useful economic life of the car and the estimated residual value is shown in the profit and loss account. The car is recognised in the balance sheet at cost less accumulated depreciation.

How will lease accounting be affected by the current proposals for the reform of lease accounting?

The International Accounting Standards Board (IASB) has announced draft proposals to reform the way in which leases are accounted for. The proposals are intended to bring all leased assets onto the balance sheet in order to provide a clearer picture of the financial position of businesses and to provide greater clarify to investors.

This new approach, known as the 'right of use' model, differs substantially from the current lease accounting model which requires operating leases to be reported 'off balance sheet'. Under the new model a lessee would identify its rights to use the asset on its balance sheet and report a corresponding liability to reflect its obligation for future rental payments. The new Standard will initially only affect listed companies, however, all companies will then be affected as International and UK Accounting Standards converge.

Whilst the initial proposals were published in the form of an Exposure Draft in 2010, the level of public comment meant that a decision was made to revisit the proposals and a re-Exposure Draft was targeted for the second half of 2012 with the Boards planning to finalise the standard midway through 2013. Based on this the implementation of the Standard is unlikely to take effect until 2016.