Vehicle funding

What are the options?

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CLM

Introduction

The provision of company cars is typically the second or third most expensive business overhead after salary and pensions for employers, so it is important to select the appropriate funding method.

There are a variety of these, each of which has its features and benefits depending on an organisation’s operational objectives, accounting and cash flow requirements.

Here we review some of the options.

Contract hire

The most popular type of vehicle funding, contract hire (or sometimes referred to as an operating lease) allows a lessee or user to hire a car for a set period of time and pre-determined mileage, in return for a fixed monthly rental. There is no option for the lessee to purchase the vehicle and, at the end of the contract, it is returned to the leasing company. The driver may be able to acquire the vehicle at market value.

The monthly rental or lease rate usually takes into account the cost of the car including vehicle registration fees, road tax, its period of use and agreed mileage, funding costs, and forecast residual value (the car's estimated value at the end of the contract).

This part of the monthly charge is often referred to as the 'finance' element of the rental.

Vehicle mileage will have a big impact on the lease rate because the number of miles has major implications for both service requirements and resale value.

Underestimating mileage can reduce the monthly rental rate for the lessee, but it can result in excess charges at the end of the contract if contracted mileage is exceeded.

The choice of vehicle model can also be a major factor. Two cars can have an almost identical list price, but if one has a much higher forecast residual value this will be reflected in a lower monthly rental rate.

The monthly rate for most contract hire agreements will also include a 'service' element of the rental, which can cover a range of additional services.

Examples of such services include maintenance, replacement vehicles, roadside assistance, accident management and fuel cards. Hirers are able to choose from a menu of options to meet their individual needs and level of in-house fleet support resources.

Pros

- ✓ Fixed-cost motoring
- ✓ Frees up capital and off balance sheet
- ✓ Steady cash flow
- ✓ 100% of VAT reclaimable where vehicle only used for business
- ✓ 50% of VAT is reclaimable if private use is allowed on finance. 100% of the maintenence is reclaimable
- ✓ Rentals are considered an expense item
- ✓ Additional line of finance that may not affect banking arrangements
- ✓ Reduces the stresses of vehicle ownership
- ✓ The leasing company reclaims input VAT thus reducing the capital cost

Cons

- ✖ Need to accurately estimate the time and mileage for use of the vehicle (or keep a close eye on the actual mileage versus contract mileage to see if a contract re-set is needed)
- ✖ No option to purchase the vehicle

Finance lease

As with contract hire, a finance lease allows the lessee to hire a vehicle for a fixed monthly fee, but it also transfers substantially all of the risks and rewards of ownership of the vehicle to the lessee.

Using a finance lease means that the vehicle will appear on the lessee's balance sheet, with outstanding rentals represented as a liability.

A finance lease generally conforms to one of two standard formats – the residual value lease or the fully amortised lease.

In a residual value lease, the diminishing value of the vehicle is reflected in the monthly rental, with a final balloon payment covering the estimated residual value at the end of the contract.

If the sold price is above the predetermined balloon payment then the leasing company will usually refund a percentage of the proceeds to the lessee. If the price is below the balloon payment then the lessee will be liable to pay the shortfall to the leasing company.

A fully amortised lease accounts for the full value of the vehicle over the primary lease period within the monthly payments. Under these circumstances the lessee may be offered a lease on the vehicle for a secondary period at a nominal 'peppercorn' rental.

Pros

- Fixed monthly rentals
- 50% of VAT can be claimed on the finance element
- Rentals usually Corporation Tax deductible
- Potential to carry on using the vehicle at the end of the lease period
- Additional line of finance that may not affect core banking arrangements
- The vehicle will appear as an asset on the balance sheet *(may also be a con)*
- The leasing company reclaims input VAT thus reducing the capital cost

Cons

- The lessee will not be the overall owner of the vehicle
- The lessee will still be responsible for the servicing and maintenance of the vehicles
- The vehicle will appear as an asset on the balance sheet *(may also be a pro)*

Sale and leaseback

With a sale and leaseback agreement, an organisation frees the capital tied-up in its owned vehicles by selling them to a leasing company and contract hiring or finance leasing them back for an agreed monthly fee.

In doing so the organisation gains the advantage of fixed, monthly fleet budgeting and will no longer bear the financial risks associated with vehicle depreciation if a sale and contract hire back is chosen. If a sale and finance lease back is taken, the lessee retains the risk and reward of future values.

There should be no VAT on the sale to the leasing or contract hire company if the seller has allowed the cars to be used for private use. The subsequent lease charges will be subject to VAT.

Pros

- A cash injection to the business which can be invested in core activities or to fund expansion
- The removal of heavily depreciating assets from the balance sheet if a sale and contract hire back is chosen
- Protection from future residual value risk if a sale and contract hire back is chosen
- Improvement in key business ratios
- Straightforward budgeting
- Detailed management reporting from day one

Cons

- Having sold and leased the vehicle, the leasing company will own it and the company has no option to purchase back

Contract purchase

Under a contract purchase, a customer agrees to purchase a vehicle via a series of monthly instalments, typically 36 or 48.

At the end of the contract, the company can then purchase the car for a predetermined amount – known as a balloon payment – as long as the terms of the initial agreement have been met.

Having gained title to the vehicle, the new owner can either keep it, sell it directly, commission the leasing company to sell it on their behalf or sell the car back to the leasing company for a sum agreed at the contract's inception (called a 'guaranteed buy back').

The latter option relieves the customer of carrying the residual value risk and injects a key benefit of risk management into what is essentially a purchase arrangement.

Optional added value fleet management services can also be included within a contract purchase agreement as they can with contract hire.

Pros

- Purchase cost may be Corporation Tax deductible through capital allowances
- Interest elements of monthly payments may be Corporation Tax deductible
- Can benefit from higher residual values

Cons

- Outstanding instalments appear as a liability on balance sheet
- Vehicle appears on balance sheet
- Not VAT efficient because VAT cannot be reclaimed (unless used exclusively for business purposes)

Hire or lease purchase

Another method of achieving vehicle ownership is hire purchase, which can be referred to as lease purchase. In this section both hire and lease purchase arrangements will be referred to as 'hire purchase' (HP).

Under this type of agreement the purchaser hires the vehicle from a third party with an option to purchase it at the end of the hire term. The agreement may require a three or six-month deposit at the outset and usually terminates with a balloon payment – typically equivalent to the expected residual value of the car. Both the deposit and the balloon payment can be varied to reduce or increase the monthly repayment amount.

This type of funding appeals to companies that want to retain ownership of their vehicles, do not want to use their capital or overdraft to pay for them and want to avoid mileage restrictions. On the negative side it presents a residual value risk and requires in-house expertise and management resources.

Hire purchase agreements can be based on a fixed interest rate, thereby creating fixed monthly instalments and eliminating exposure to fluctuating interest rates.

Pros

- ✓ Purchase cost may be Corporation Tax deductible through capital allowances
- ✓ Interest elements of monthly payments may be Corporation Tax deductible
- ✓ Can benefit from higher residual values

Cons

- ✖ At risk from lower residual values
- ✖ Outstanding instalments appear as a liability on balance sheet
- ✖ Not VAT efficient because VAT cannot be reclaimed (unless used exclusively for business purposes)
- ✖ Vehicle appears on balance sheet
- ✖ Cost of in-house management

Outright purchase

The purchase of vehicles, using company or borrowed funds, for ongoing use in a company's operations, is usually regarded as an acquisition of a fixed asset for accounting purposes. As such, they would be recorded on the organisation's balance sheet.

This funding method gives the greatest level of control in terms of what, where and how a vehicle is procured. Outright purchase also provides a potential influx of funds when vehicles are sold.

However, funding a vehicle this way means tying-up capital in a rapidly depreciating asset. It uses money that could be invested elsewhere, perhaps in growing the business, funding stock, or reducing debts.

Outright purchase also exposes the owner to fluctuations in the car market, both for new and used vehicles. In residual value terms, this may result in an accounting profit if the sale price exceeds the net book value, but it could also produce an accounting loss if the price falls short of the net book value.

Cash flow and budget forecasts are often complicated by the used car market's unpredictability and the range of disposal options open to companies owning vehicles. These include auctions, dealers, trade-ins, local paper advertisements or direct sales to employees.

Pros

- Purchase cost may be Corporation Tax deductible through capital allowances
- As the owner, the benefits from any higher resale values on the used car market pass to you rather than the leasing company
- May be the only form of acquisition for new companies and start ups due to restricted credit history
- The vehicle will appear as an asset on the balance sheet *(may also be a con)*

Cons

- Carries full resale value risk
- Any outstanding loan payments appear as a liability on balance sheet
- Ties-up capital
- The vehicle will appear as an asset on the balance sheet *(may also be a pro)*
- VAT cannot be reclaimed unless the vehicle is used solely for business purposes

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