

Study Unit 4: Hire Purchase

Learning objectives

1. To define hire purchase
2. To understand hire purchase agreement
3. To understand the different concepts of hire purchase

Hire Purchase Accounts

The Nature of Hire Purchase Under Hire Purchase Act 1967 (Amendment) And the Islamic Perspective.

Definition of Hire Purchase

Section 2(1) Hire Purchase Act 1967: The agreement which includes hiring of goods and at the same time giving an option to buy. It is a business transaction whereby a seller allows a buyer to buy asset(s) by installments, based on interest rate charged.

Characteristics of Hire Purchase

The transaction is based on the rules of Hire Purchase Act 1967 and Hire Purchase Act (amendment) 1976.

- i. Right of the goods is still belonging to seller. The rights will be transferred at the end of the installment period. The owner will have a right to confiscate the assets if installment is not been paid by the buyer.
- ii. Interest rate will be charged on any balance from the payment in certain agreed period. The purposes of the interest rate are for additional administrative/management expenditure and to protect the goods from risk of damaged.
- iii. A buyer will be informed on a cash price but if he/she wants to buy on hire purchase, installment will be made for a certain agreed period.
- iv. Deposit will be charged when the agreement is signed.

- v. Claim of goods. A buyer is assumed to hire the goods. If he/she intends to return/end the agreement, he/she can do so with condition that total installments will not be returned back. However, balances of the installment not need to be paid.

Hire Purchase Documentation

When entering hire purchase contract, normally the procedure of the hire purchase agreement can be described as follows:

When the customer agrees to buy an asset under a Hire Purchase Contract, he/she is required to complete the Hire Purchase Application Form, which indicates all the particulars about the customer.

- The Finance Company will set an interview with the customer confirm the entire particulars stated in the Hire Purchase Application Form.
- If the finance company is satisfied with the application, the customer will have to receive and complete following details:
 - i. Offer letter form
 - ii. Acceptance memorandum
 - iii. Letter of statutory acknowledgement of customer/guarantor
 - iv. Hire purchase agreement
 - v. Stamp duty
 - vi. Invoice to finance company
 - vii. Registration card for the original asset
 - viii. Cover Note, Copy of Road Tax *

The Terms Used

- i. Cash price = price of asset paid at once
- ii. Hire purchase price = cash price + interest
- iii. Installment = schedule payment during required period
- iv. Deposit = down payment / initial payment

- v. Interest = perquisite / profit or privilege given
- vi. The buyer/user = a person who agreed to buy or to accept good(s) from the dealer based on hire purchase agreement
- vii. The dealer = a person who sells good(s) based on hire purchase agreement.

Differences Between Hire Purchase and Credit Sales

	HIRE PURCHASE	CREDIT SALES
1. Right or ownership	Belongs to seller/dealer as long as installment not yet settled.	Belongs to buyer
2. Responses	The seller has a right to responses if there has been 4 successive defaults of payments.	Cannot taking possession of goods but can sue the buyer in court.
3. Product type	Long term usage	Short term usage
4. Interest	Have interest charge	No interest charge but have discount
5. Price	More expensive	Cheap
6. Deposit	Chargeable	None
7. Act	Hire Purchase Act 1967	None
8. Risk	High	Low
9. Installment period	Long term	Short term
10. Value installment	Fixed	Variable
11. Agreement	Yes	No

Differences Between Conventional and Islamic Approach in Hire Purchase

Bai' Bitaman Ajil refers to the concept of hire purchase in Islamic Financial Instrument, which is allowed under Syariah. It is a suspense monthly installment plan for the customers who possess an asset. It seems to be similar to Hire Purchase Contract under the conventional financial instrument, but we can examine their differences as follows:

	Bai' Bitaman Ajil	Hire Purchase Contract
a) Provision in the Act	Subjected to Bai'Bitaman Ajil Agreement	Subjected to HP Act 1967
b) Legal title on asset	Stated under clause 4 under Bai'Bitaman Ajil Agreement	The legal title to the asset does not pass on to the purchaser until ha has paid the final installment and exercise his option to purchase.
c) Term of interest	If the purchase unable to make payment or delays the monthly installment, the cost of delay is called wage.	The purchaser will be charged a certain percentage of interest because of delayed payment.
d) Sales price	Customer will receive the cost of HP as the sale price between the finance company and customer. Finance company as a part of the buyer with the original seller.	The cost of HP includes the cost price and interest charged to the customer.
e) Aqad (intention)	Aqad on purchases (which is compulsory in Islamic method) between customer and finance company is subjected to sale price.	Aqad is not compulsory.

Hire Purchase Interest Allocation

Description Of Hire Purchase Interest Allocation

When each payment is made on a hire purchase contract, it will consist of the following

- i. Part of the installment will be paying off part of the amount owing for the cash price of the asset
- ii. The other part of the installment will be for the interest that has occurred for the period of time.

Formula / Method in Calculating the Hire Purchase Interest

- Under the hire purchase contract, the purchase price consists of two elements that are the cash cost price and the hire purchase interest.
- These two elements make up the hire purchase price but which must be Accounted for separately.
- The hire purchase interest must be written off as an expense over the life of the contract.
- There are THREE methods in calculating Hire Purchase Interest:

a) Sum of Digit (Rule of 78) (SOD)

b) Other methods

- i. Straight Line Method (SLM)
- ii. Reducing Balance Method (RBM)Th basic formula of calculating total hire purchase interest is as follow:

The basic formula of calculating total hire purchase interest is as follow;

HIRE PURCHASE PRICE = TOTAL INSTALLMENT + DEPOSIT

@

HIRE PURCHASE PRICE = CASH PRICE + HP INTEREST

$$\text{HP INTEREST} = \text{HP PRICE} - \text{CASH PRICE}$$

Example 1 : Formula of calculating hire purchase interest

En. Razi bought a radio on 1/4/2012 from Syarikat Abu Sdn Bhd. The cash price is RM8,000. Deposit RM2,000 and the balance will be paid at the end of every month with installment of RM600 for a year. The depreciation is 12% per annum.

Answer:

$$\begin{aligned}\text{HP price} &= \text{Total installments} + \text{deposit} \\ &= (12 \times \text{RM}600) + \text{RM}2,000 \\ &= \text{RM}9,200\end{aligned}$$

$$\begin{aligned}\text{Hire Purchase Interest Suspense (HPIS)} &= \text{HP price} - \text{Cash price} \\ &= \text{RM}9,200 - \text{RM}8,000 \\ &= \text{RM}1,200\end{aligned}$$

The commonly used methods of apportioning hire purchase interests are:

a) Sum of the Years' Digit Method (SYD)

- Number the installment, given the highest digit to the first installment and the digit 1 to the last installment;
- Add up the digits;
- The interest proportion to each Accounting period is the:
- Digit given to the installment X Interest

Sum of digits

Example 2: Method of calculating HP Interest using SYD

Under a Hire Purchase Agreement, an asset with a cash price of RM2,500 is to be paid by a deposit of RM500 and a 5 monthly installment starting from January. The interest is RM400.

The apportioning of hire purchase interest is as follows;

Step 1:

Cash price	RM2,500
-) deposit	RM500
Outstanding liability	RM2000
Interest	RM400
Total installment	RM2,400

Step 2:

The installments are numbered as follows;

January	5
February	4
March	3
April	2
May	1

Step 3

Apportion the interest according to each accounting period:

January	$5/15 \times \text{RM}400$	=	RM133
February	$4/15 \times \text{RM}400$	=	RM107

March	$3/15 \times \text{RM}400$	=	RM80
April	$2/15 \times \text{RM}400$	=	RM53
May	$1/15 \times \text{RM}400$	=	RM27
			RM400

Other Methods

Straight Line Method (SLM)

- under this method, the interest is deemed to accrue evenly over the period of the Hire Purchase Agreement.

Example 3: Method of calculating HP Interest using SLM

- Under a Hire Purchase Agreement, an asset with a cash price of RM2,500 is to be paid by a deposit of RM500 and a 24 monthly installments of RM100.

The apportioning of hire purchase interest is as follows:

Cash price	RM2,500
-) Deposit	RM500
Outstanding liability	RM2,000
Interest	RM400
Total installment	RM2,400

Therefore;

Installment! month	=	$\text{RM}2,400/24$	=	RM100
Interest! month	=	$\text{RM}400/24$	=	RM16.70

ii. Reducing Balance Method (RBM)

Under this method, simple interest is calculated based on outstanding debt after each installment becomes payable.

Example 4: Method of calculating HP Interest using RBM

Under the Hire Purchase Agreement, an asset with a cash price of RM2,500 is to be paid by a deposit of RM500 and 4 annual installments of RM631. Interest rate is at 10% per annum.

The apportioning of Hire Purchase is as follows:

Cash price	RM2,500	
-) Deposit	(RM500)	
Outstanding liability	RM2,000	
+) 10% Interest	RM200	
		RM2,200
-) 1st installment	(RM631)	
		RM1,569
+) 10% Interest	RM157	
		RM1,726
-) 2nd installment	(RM631)	
		RM1,095
+) 10% Interest	RM110	
		RM1,205
-) 3rd installment	(RM631)	
		RM574
÷) 10% Interest	RM57	
		RM631
-) 4th installment	(RM631)	

Therefore, the apportioning for the interest is as follows:

1st year = RM200

2nd year = RM157

3rd year = RM110

4th year = RM57

RM524

The Records Of Hire Purchase

Preparation Of Accounts In A Purchaser's (Buyer) Book

Journal entry

a. To record total debts at hire purchase price

Dt Asset

 Ct Creditor

(asset recorded at cash price)

Dt Hire Purchase Interest Suspense (HPIS) Account

 Ct Creditor

(declare the HPIS as expenses)

b. To record deposit and installments paid

Dt Creditor

 Ct Bank/Cash

c. To transfer interest expense to Profit and Loss Account

Dt P&L

 Ct HPIS

In the balance sheet, creditors balance was the installments that have not been paid. The HPIS balance was a payment for the following period and need to be deducted from creditors balance to get the value of current liability.

Asset A/C

Creditor	Balance c/d	x
----------	-------------	---

HP Creditor A/C

Bank: deposit	Asset	x
Bank: 1 st installment	Hire Purchase Interest Suspense (HPIS)	x
Bank: 2 nd installment		
Balance c/d		

Hire Purchase Suspense (HPIS) A/C

HP Creditor	<u>x</u>	P&L	x
		Balance c/d	<u>x</u>
	<u>xx</u>		<u>xx</u>

Provision for Depreciation A/C

Balance c/d	<u>x</u>	P&L	<u>x</u>
	<u>xx</u>		<u>xx</u>

Statement of financial position (extract) as at.....

Non-Current Assets	<u>X</u>
Asset	X
(-) Prov. for depreciation	XX
Current Liabilities	
Creditor	<u>X</u>
(-) HPIS	<u>X</u>
	<u>XX</u>

Preparation of accounts in a seller's book

Journal entry

a Upon signing up HP agreement

Dt Debtor x

Ct HP Sales x

b Receipt deposit/installment

Dt Cash/Bank x

Ct Debtor x

c. At the end of the year, gross profit is to be calculated:

1. Determine the gross profit on sales
2. Unrealized profit
3. Realized profit

d. Unrealized profit is deducted from the debtor in the sofp under current asset

Debtor's A/C

Hire purchase sales (HP price)	x	Bank: Deposit	x
		Bank: Installment	x
		Balance c/d	<u>x</u>
	<u>xx</u>		<u>xx</u>

Hire purchase sales A/C

Trading A/C (SOCl)	x	Debtors	x
--------------------	---	---------	---

Statement of comprehensive income (extract) for the year ended.....

Sales	xxx
(-) cost of goods sold	(xxx)
Unrealized profit	<u>(xxx)</u>
Realized profit	xxx

Statement of financial position (extract) as at....

Current Assets	
Debtor	xxx
(-) Provision of unrealized profit	<u>(xxx)</u>
	xxx

HP = HP Sales - Cost of Goods Sold (COGS)

Unrealized profit = Outstanding Installment x Hire Purchase Profit
Hire Purchase sales

Realized profit = HP profit - Unrealized profit

Example 5. (Seller's book):

Autoworld sold a car to Peter on 1 July 2012. The cash price was RM25,000. Under the HP agreement, Peter was required to pay deposit of RM5,000 upon signing up the agreement. The balances together with the interest of 20% per annum need to be paid by 12 monthly installments beginning on 31 July. The cost of the car was RM15,000.

a) Calculate the HP profit on 31 Dec 2012

$$\begin{aligned}\text{HP profit} &= \text{HP sales} - \text{Cost of Goods Sold} \\ &= 29,000 - 15,000 \\ &= \text{RM}14,000\end{aligned}$$

b) Unrealized profit = outstanding installment x HP profit

$$\begin{aligned}\text{HP sales} &= 6 \times 2,000 \times 14,000 \\ &= 29,000 \\ &= \text{RM}5,793\end{aligned}$$

c) Realized profit = HP profit – Unrealized profit

$$\begin{aligned}&= \text{RM}14,000 - \text{RM}5,793 \\ &= \text{RM}8,207\end{aligned}$$

Debtor's A/C		
2012	2012	
1/7 HP Sales	1/7 Bank: deposit	5,000
	31/7 Bank: 1 st installment	2,000
	31/8 Bank: 2 nd installment	2,000
	30/9 Bank: 3 rd installment	2,000
	31/10 Bank: 4 th installment	2,000

	30/11 Bank: 5 th installment	2,000
	31/12 Bank: 6 th installment	2,000
	Balance c/d	<u>12,000</u>
<u>29,000</u>		<u>29,000</u>

2013

1/1 Balance b/d 12,000

Hire Purchase Sales A/C

31/12/12 Trading A/C (SOCI)	29,000	1/7/12 Debtor	29,000
-----------------------------	--------	---------------	--------

Statement of comprehensive income (extract) for the year ended 31 December 2012

Current Assets	
(-) Cost of Goods Sold	29,000
Unrealized profit	(15,000)
Realized profit	<u>(5,793)</u>
	8,207

Statement of financial position (Extract) as at 31 December 2012

Current Assets	
Debtor	12,000
(-) Provision of unrealized profit	<u>(5,793)</u>
	6,20

Accounting procedures for early termination

Tutor Marked Assessment-Study Unit 4

- a) State the advantages of hire purchase.
- b) Under hire purchase agreement, an asset is a cash price of shs.2,500 is to be paid by deposit of shs.500 and 5 monthly instalments starting from January. The interest is shs.400.

Required:

Using the sum of digit method, apportion the interest according to each accounting period.