13 Capital Leases

Policy Statement

It is the policy of the Province of Nova Scotia to report in its financial statements the province's capital lease obligations and related expenses.

Definitions

CICA
Canadian Institute of Chartered Accountants

CAPITAL LEASE
Under the terms and conditions of the lease, substantially all of the benefits and risks incident to ownership are, in substance, transferred to the government without necessarily transferring legal ownership.

LEASED TANGIBLE CAPITAL ASSETS
Non-financial assets that have physical substance and a useful life extending beyond an accounting period and are held under lease by a government for use, on a continuing basis, in the production or supply of goods and services.

NET PRESENT VALUE
Economic worth of a lease in terms of today's dollars. The future lease payments are discounted using the province's borrowing rate.

OPERATING LEASE
Under the terms and conditions of the lease, substantially all of the benefits and risks incident to ownership are, in substance, NOT transferred to the government.

PSAB
Public Sector Accounting Board

Policy Objectives

This objective of this policy is to define the measuring and reporting of the obligation for capital leases and a means by which to attribute the related costs to the periods in which the related costs are incurred.

Application

This policy applies to all capital leases of the consolidated fund.

Policy Directives

A lease is assessed as operating or capital based on the recommendations and guidelines of the *CICA Handbook* and PSAB.

In the case of an operating lease, lease payments are expensed in the period for which they are payable, regardless of cash flow (accrual accounting).

In the case of a capital lease, the obligation is recorded when incurred at the net present value of the future lease payments. As payments are made, the allocation between principal repayment and interest costs should be recorded in a rational manner over the term of the lease. It is preferable to calculate the principal and interest amortization schedules at the beginning of the lease to be used for recording and budgeting for the principal repayment amount and interest expense in future years.

Policy Guidelines

A capital lease is explained by the Canadian Institute of Chartered Accountants (CICA) Handbook, Section 3065.03 as " a lease that, from the point of view of the lessee, transfers substantially all the benefits and risks incident to ownership of property to the lessee." Section 3065.06 provides further guidance as follows:

> From the point of view of a lessee, a lease would normally transfer substantially all of the benefits and risks of ownership to the lessee when, at the inception of the lease, one or more of the following conditions are present:
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> a) There is reasonable assurance that the lessee will obtain ownership of the leased property by the end of the lease term. Reasonable assurance that the lessee will obtain ownership of the leased property would be present when the terms of the lease would result in ownership being transferred to the lessee by the end of the lease term or when the lease provides for a bargain purchase option.

b) The lease term is of such a duration that the lessee will receive substantially all of the economic benefits expected to be derived from the use of the leased property over its life span. Although the lease term may not be equal to the economic life of the leased property in terms of years, the lessee would normally be expected to receive substantially all of the economic benefits to be derived from the leased property when the lease term is equal to a major portion (usually 75% or more) of the economic life of the leased property. This is due to the fact that new equipment, reflecting later technology and in prime condition, may be assumed to be more efficient than old equipment which has been subject to obsolescence and wear.

c) The lessor would be assured of recovering the investment in the leased property and of earning a return on the investment as a result of the lease agreement. This condition would exist if the present value, at the beginning of the lease term, of the minimum lease payments, excluding any portion thereof relating to executory costs, is equal to substantially all (usually 90% or more) of the fair value of the leased property, at the inception of the lease.

In view of the fact that land normally has an indefinite useful life, it is not possible for the lessee to receive substantially all the benefits and risks associated with its ownership, unless there is reasonable assurance that ownership will pass to the lessee by the end of the lease term.

If the leased asset qualifies as a tangible capital asset (refer to *Chapter 12:* Tangible Capital Assets), then the asset is recorded in SAP Asset Management system at an amount equal to the net present value of the future lease payments. An amount equal to the net present value of the future lease payments is recorded as a capital lease obligation (debt). Any lump sum payment made at the beginning of the lease is added to the asset value as well.

If the asset does not qualify as a tangible capital asset, the net present value of the future lease payments is expensed and the capital lease obligation is recorded. Any lump sum payment made at the beginning of the lease is also expensed.

Accountability

Departments are responsible for identifying their capital lease arrangements and notifying Government Accounting of capital lease obligations as they are considered and arise. The department will work with Treasury Services to establish arrangements for payment processing and principal/interest allocations.

Government Accounting is responsible for ensuring that any identified capital lease obligations and expenses are initially assessed in an appropriate manner and accurately reflected in the Public Accounts of the Province. Government Accounting will prepare or help prepare the capital lease obligation amortization schedule for purposes of allocating the payments to principal and interest.

Treasury Services is responsible for adjusting the accounts for the principal repayment portion of capital lease payments, recording the related interest expenses, and reconciling the remaining obligation values. Treasury Services will provide required discount rates for the assessment of capital lease repayment schedules.

Monitoring

Government Accounting will monitor the policy's implementation, performance, and effectiveness.

References

CICA Handbook
PSAB Accounting Guideline PSG-2 Leased Tangible Capital Assets, April 2000

Enquiries

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