PSAB/Asset Management

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BUDGETING FOR TANGIBLE CAPITAL ASSETS (6) - CAPITAL LEASES

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In this series of six newsletters, we have been looking at how you may want to budget for a number of specific situations relating to tangible capital assets. Our final one will look at how you may want to budget for capital leases.

Public Sector Guideline 2 (PSG-2)

PSG-2, entitled "Leased Tangible Capital Assets" was first issued in April 2000, with several updates over the past 9 years. Paragraph 3 defines a leased tangible capital asset as "*a non-financial asset that has physical substance and a useful life extending beyond an accounting period, and is held under lease by a government for use, on a continuing basis, in the production or supply of goods and services. 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.*"

Paragraphs 4 through 10 elaborate on how to identify when substantially all the benefits and risks of ownership have been transferred. For the purposes of this newsletter, we will assume that you have applied these criteria to your leases, and are dealing with leased assets that should be included in your tangible capital asset inventories.

Paragraph 11 requires us to account for such a leased asset as a tangible capital asset and as a liability. The first recognizes that for all intents and purposes, it is effectively your asset, even though you may not have legal ownership, as control, use and responsibility for the asset are all yours. It is a liability, because of the on-going stream of lease payments that you must make over the term of the lease.

Note that setting up the leased TCA in your accounting records will be a non-cash transaction, as the value of your asset will be the present value of your future liability stream, (PSG-2.14), plus any direct costs associated with the execution and initiation of the lease (PSG-2.16).

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Current Practice

Budgeting for capital leases is relatively easy. Provision would be made for the first year's payment stream in the operating budget, and any up-front costs, such as legal fees or registrations, may also be budgeted, or covered by other budget allocations. For future years, the total payments for each year will be included in the operating budget for that year.

The payments will be accounted for as an expense, and the remaining value or commitment outstanding at the end of each year with respect to the lease will be included in a note on capital leases in the financial statements for the year.

How will you budget for this in future years?

If you prepare your budget on a cash basis, there would be no change, as you will continue to budget to cover the payments due during the year. The accounting and particularly the financial reporting will be somewhat different, as you will now be recording the total value of the lease as a tangible capital asset, and then amortizing the lease over the period of expected use of the asset, normally the lease term. If the lease contains terms that allow the asset to be transferred to the government at some point in time, either gratis or for a nominal price, then the lease/asset should be amortized over the expected economic life of the asset.

If you prepare your budget on an accrual basis, it should be noted that the payments to be made during the year are really the discharging of a liability outstanding against the municipality, not an operating expense:

Debit		Accrued Liabilites (re capital lease)		$X
	Credit		Bank Account (make payment)	$X.

However, you will need to budget to raise sufficient funding to be able to cover those lease payments when they come due. If the life of the asset is the life of the lease, then the simplest approach is to budget for these payments, which will represent the decline in value of the leased asset during the year, and generate revenues to cover the required amount. In effect, you would budget to fund the amortization expense you will be recording for the year.

If there are substantial initial costs and/or the life of the asset will be longer than the lease term, how do you budget then? When budgeting on an accrual basis, you would ideally like the budget to reflect the consumption of assets in the fiscal year, or the amortization of all assets during the year, to have a more complete picture of the cost of providing the services during the year. At the same time, you will need to have funds available to cover the initial costs, if any, and for the annual lease payments for the term of the lease, while the extended life is essentially a free ride.

One could argue that this becomes a cash-flow issue, because while the Municipal Act (Ontario) requires a municipal budget to include estimates of all sums required during the year for the purposes of the municipality, the requirement of a cash budget may not be the same as the requirement reported in an accrual budget. For example, capital leases could be financed and paid for out of a reserve, with the reserve being financed from annual contributions from the beneficiaries of the leases, which are based on the amortization of those leases over the expected life expectancy of the assets.

Such a reserve obviously will need some up-front capital, as the disbursements will occur faster than the contributions. If such start-up capital is not available, then budgeting on a cash basis for capital leases may be the only viable option. That will at least guarantee that there will be cash available when the payments come due.

Summary

Budgeting for leased tangible capital assets will continue to be largely a case of budgeting for the payment stream during the budget year. However, if you want to budget on an accrual basis, there may be cash-flow issues where there are substantial initial costs, such as for set-up, or where the expected life of the asset extends well beyond the lease term. Do you perhaps use annual contributions to a reserve to finance and pay for such capital acquisitions?

This completes our look at how you might budget for specific types of tangible capital assets or situations. If there are others that you would like to have feedback on, please contact the MFOA or AMCTO at the addresses shown below, and we will endeavour to address your concerns, either personally or perhaps in a newsletter if the topic seems of more general interest.

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The Municipal Act requires you to prepare and have Council approve a balanced operating budget. What happens in 2009 and beyond, when you may have a significant non-cash expense - Amortization? Our next newsletter will look at what this may mean in terms of the balanced budget requirement. We will also look at how PS 3150 may impact on the interactions between your capital expenditure plan and its financing, and your operating budget.

For more information and resources regarding tangible capital asset management, go to PSAB/Asset Management or contact:

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