NEWSLETTER NO. 39

ACCRUAL ACCOUNTING 101
- AN OVERVIEW FOR NON-ACCOUNTANTS

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Cash accounting, modified accrual accounting and accrual accounting - accountants use these terms, but what do they really mean? Municipalities are being forced to move to full accrual accounting, and to account for their tangible capital assets. How is this different from current practice? What prompted this major upheaval in how municipalities account for capital assets? It is easy to see the downside to this change, but what are the supposed benefits?

In this newsletter, we will try to answer these questions, and provide a basic overview of accrual accounting in layman's language. This is not designed to be a definitive, all-encompassing accounting course. And we are talking here about accounting, not budgeting or financing, which are separate exercises, even though they are related to accounting.

Modified Accrual Accounting

Current practice in municipal accounting is called "modified accrual accounting." This is a hybrid approach of accrual accounting for current operations, or Revenue Fund activities. Capital Fund activities are also reported as revenues and expenditures in the period in which they occur, not based on the financing and acquisition of tangible capital assets. Modified accrual has been used by Ontario municipalities for over 20 years, and is to be replaced by full accrual accounting as of January 1, 2009.

The current flurry of activity with respect to accounting for tangible capital assets in municipalities across Canada is in order to prepare each municipality for changing over the accounting for capital operations to full accrual accounting. Now let's look at cash accounting and accrual accounting in more detail.

Cash Accounting

Cash accounting is the simplest approach, and is how we generally maintain our personal household accounts. In essence, revenue is recognized and recorded when the cash is received, and expenditures are recorded and recognized when the billing is actually paid. The accounting parallels the cash flows in and out, and net profit or surplus equals the actual funds on hand. Though you may get paid on a

Thursday for a pay period that may have ended the week before, your personal accounting likely records the salary as revenue as of the Thursday you receive it, and the source deductions would all be expensed that day, even though the pension contributions (OMERS and CPP) are actually contributions towards two future revenue streams. For you, they are not really an expense, but more of a receivable, as you hope (and expect) to get the funds back – with interest and more.

Similarly, an expenditure is recorded as such when the cost is paid, whether it is for something that may have already been consumed, or for something that will last 20 years. Personally, we tend to view a car or mortgage payment as a monthly expense, not as a capital investment, which the principal component of the payment is. As a result, there is no matching or relationship between revenues and expenditures in the accounts. In situations where one is providing billable goods and services, expenditures may have been made and recorded long before the client or recipient is invoiced or charged, which may be some time again before the payment is actually received. .

While suitable for personal finances and in farming, where the availability of ready cash is the prime concern, this method is inadequate for reasonably presenting the financial position of any public or private entity. It cannot give you an accurate picture of how much you earned in a given period, and how much you spent or used up to generate the revenue because it does not include the consumption of assets that occurred in the period, which is normally called depreciation.

For current operations, or Revenue Fund activities, municipalities moved away from cash accounting a few decades ago. However, Capital Fund activities are essentially reported on a cash basis. Financing is recorded as revenue in the year that it is received, though carried forward for multi-year projects. Expenditures are charged against the financing available, and reported as “capital expenditures” in the Capital Fund for the year to which the invoices relate.

When the capital acquisition is completed in full, and the last bills are paid, the municipality closes the books. The entire cost has been reported as expenditures or outlays in the year(s) in which they occurred, so that there is no residual value left for the purposes of financial reporting. It is as though the asset has been 100% written off. There is no reporting of such non-financial or tangible capital assets in the statements, even though they may be worth many millions of dollars in total.

Accrual Accounting

Accrual accounting recognizes revenues when they are earned, as opposed to received, and expenses are charged as the goods and services are actually utilized or consumed, rather than when they are paid for. The accrual basis stresses the allocation and reporting of revenues and related expenses to the appropriate accounting period to which they relate, and is therefore a more realistic indicator of profitability for an enterprise or of financial health for an individual. Revenues and expenditures that straddle accounting periods are allocated out proportionally to the corresponding periods. Where invoices have not been sent or received for goods and services rendered in whole or in part, the revenue or expense will be “accrued,” or estimated for the period, and added into the accounts. In the following period, the accrual will be reversed, and the invoice accounted for at full face value.

Municipalities have been accounting for their current operations, or Revenue Fund activities, this way for several decades now.

Accrual accounting records the acquisition of tangible capital assets at full value, as a capital asset of the organization, and then proportionally allocates the total acquisition cost as a charge against the operating program using the asset over the expected useful life of the asset. This annual charge or writing down of an asset is what is called "amortization expense", or depreciation. The result is a much truer picture of the total cost of operations, as the on-going "consumption of assets" is also included.

Instead of progress payments for a capital acquisition being expensed, these become investments in a Work-In-Progress, an incomplete tangible capital asset, which is also reported as a non-financial asset. Note that a Work-in-Progress is never amortized, because it is incomplete, and not providing the anticipated services and benefits. The Work-in-Progress will be added to the inventory of tangible capital assets on the day it opens or is turned over by the contractor, and its amortization begins at that time.

For municipalities, this is the major change in accounting practice that is to be implemented by January 1, 2009. To make this change, it will be necessary to identify and value all assets that are to be included in your asset inventories for tangible capital asset accounting. Then it will be necessary to track on-going acquisitions and dispositions of assets, and calculate the annual amortization expense to be charged against operations. This series of 40 PSAB newsletters has addressed various issues to assist you in carrying out these tasks.

Why has this change been mandated?

There has probably always been some concern that public sector financial statements did not provide a complete financial snapshot of the organization's net worth. This change is designed to bring accounting for governments into line with that for other entities by requiring more complete expense accounting and proper asset accounting.

This shortfall in public sector financial reporting was really not an issue until the late 1980s and early 1990s, when the Canadian Federal Government and nearly every province were running large deficits each year and reporting record levels of debt outstanding. These massive liabilities were seen as precursors of future financial disaster and debasement of the currency.

A few voices pointed out that the statements of all governments, municipalities included, recorded the total debt outstanding, but did not show what assets may have been bought with that debt, such as buildings, roads, and airports, down to vehicles and computers. In short, the financial statements published told only a part of the story, and probably understated the net worth of the entity. This prompted pressure to have the public sector report its non-financial assets in its financial statements, and to record the using up or amortization of those assets, similar to the way that private sector organizations had been doing for many years.

Further impetus came about through the growing movement to charge fees for services, and to want to recover the full cost of providing those services on an on-going basis. While this was relatively straight-forward on the operating side, a major issue has been how to tie in capital expenditures on a meaningful basis. Contributions to reserves/reserve funds have been a way around this problem, especially for financing purposes, but the term "contribution" implies a voluntary transfer, not an inherent cost of doing business. Amortization expense, on the other hand, makes the relationship quite clear.

The Public Sector Accounting Board (PSAB) of the Canadian Institute of Chartered Accountants (CICA) issues standards and guidelines with respect to matters of accounting and financial reporting in the public sector. These standards and guidelines are consolidated in the Public Sector Accounting Handbook, which is the primary authority on generally accepted accounting principles for the Canadian public sector. In response to the demand for reporting on public sector assets, PSAB developed Section PS3150 of the Handbook, which covers accounting and reporting of tangible capital assets (TCA), and also Sections PS1100 and PS1200 on financial reporting, which requires public sector organizations to account and report annually on an accrual basis.

Implementation of these Sections has been carried out in the various parts of the public sector over the past decade with the Canadian municipal sector being the last to implement TCA accounting. In consultation with all interested parties, the mandatory start date for TCA accounting was established as January 1, 2009, with full disclosure of non-financial assets required to be included in the annual financial statements for fiscal 2009 and all subsequent years, in a format that is consistent with the Guidelines.

The Impact of moving to Accrual Accounting and Accounting for Tangible Capital Assets

There are three major impacts that you and your municipality have to deal with.

1) Asset inventory and valuation - a one-time exercise. To be able to report on the acquisition cost of your tangible capital assets, you have to know what they are, and how much you paid for them, or what they were worth when you acquired them. The reporting is to be based on historical cost, or a reasonable estimate of it. This is why you are being asked to inventory all of your assets, and to try to determine what each one cost at the time of acquisition, or estimate the cost, if historical records may not be available. .

Historical cost is used as the basis for asset valuation in financial statements because it is equal to the value of financial assets that were paid out to acquire the asset. Most important, the amount is independently verifiable, and is not based on someone's professional judgment, no matter how knowledgeable that person may be. It is also a consistent value over many accounting periods or sets of financial statements. In general, it will not overstate the value of the assets over time, or result in the inclusion of unrealized income in the statements, such as when land and buildings appreciate, as they generally have over the years.

An important part of the valuation of every existing asset will be to amortize its value from the date of acquisition up to December 31, 2008. Collectively, this will give the starting value for accumulated amortization. Note that you will be recording the total historical cost of your assets, or gross book value, and the total accumulated amortization for those assets, which, when subtracted from gross book value, gives net book value. While this may be an indication of what the assets are currently worth, net book value has no direct relationship to market value.

2) On-going accounting requirements and new policies. There will be the on-going requirement to maintain satisfactory asset accounting records, and particularly what may be needed to do to ensure that your municipality will be able to report fully and accurately on an on-going basis. We looked at this issue in more detail in Newsletter No. 30. Since the on-going maintenance of accounting records will have to start from the beginning of 2009, that will mean putting procedures, processes and systems in

place before the end of this year to ensure that your municipality will be ready to go, come start of business on January 2, 2009. While it will be beneficial to have your tangible capital assets identified and valued by the end of this year, you do not really need the information for reporting purposes until preparing your 2009 financial statements in the spring of 2010. However, it will be hard to track asset transfers and dispositions in 2009, if your asset inventories are not fairly complete.

3) Calculation and charging of Amortization Expense. Someone will have to be responsible for this, and ensure that the calculations are done on a timely and consistent basis. The alternative is to implement asset accounting software that will prepare the accounting journals automatically. That is fine, as long as the asset database is complete and well maintained in the system.

Then there is the issue of timing. Will you allocate amortization out monthly? As of January 1st? As of July 1st, or mid-year? Or as of December 31st? And how will you calculate amortization for assets acquired and disposed of during the year? Will you assume everything done at mid-year, and charge only half the annual amount for the year of acquisition and of disposition, or calculate it monthly? The answers to these questions should be included in the tangible capital asset accounting policies that you have for your municipality.

On the operations side, your municipality is already accruing revenues and expenses to the appropriate accounting periods, so that there should be no major changes, other than the appearance of the new line item, "Amortization Expense." The requirement to account for this using up of assets may have budget and tax implications.

The Benefits of moving to full Accrual Accounting

First and foremost, the accounting for the acquisition and using up of capital assets will finally be directly tied into accounting for operations, through the charging of amortization expense to each individual program. Thus it will be easier to determine the true total cost of providing a service. As mentioned, by accounting for tangible capital assets, it will now be possible to get a much better idea of the total net worth of your municipality, as you will be accounting for **all** of the assets that the municipality has, not just the financial ones. In turn, this will put your debenture levels and other financial liabilities into a much more meaningful perspective. While this is true for the municipality as a whole, it will also be true at the program level, as statements can and will be published for organizational segments (as discussed in Newsletter No. 31).

In more general terms, this change will encourage thinking of capital acquisitions as long-term investments that will be written off over their expected life expectancies, or amortized, from the benefits they provide to future operations of the municipality. It also promotes the concept of an asset having a finite life (land excepted), and the expectation that it will have to be replaced or abandoned at a certain point in time. This in turn supports providing for on-going maintenance of the asset, or for sustainability of the services being provided by the municipality's assets through maintenance and replacement, as and when required.

We recently looked at the relationship between asset accounting and asset management in Newsletter No. 38, but this change will assist all of us to address or avoid the issue of infrastructure deficit.

Last, but not least, by reporting on non-financial assets, and especially by including tangible capital assets in financial statements, the taxpayer and the potential investor will have a much clearer picture of how a municipality has used its financial resources. The statements will now show what has been acquired with the funding spent, and the operating statements will include a measure (amortization) of how those acquisitions are being used up to provide services to the public. In addition, the statements will show the financial net worth of the municipality, or how well the funding received has been invested over time.

How will my Municipality's Financial Statements change?

Full accrual accounting and reporting of tangible capital assets will result in some significant changes to your financial statements, and to the Ontario Financial Information Return (FIR). The Ontario Ministry of Municipal Affairs and Housing has revamped the FIR to reflect the changed reporting requirements. This will be discussed in a future newsletter.

With respect to municipal financial statements, there will be changes to the Consolidated Statement of Financial Position, and the Consolidated Statement of Operations, which will no longer include capital revenues and expenditures. New reporting requirements will be a Consolidated Statement of Net Debt and a Consolidated Statement of Cash Flows. Each of these statements will be the subject of a future newsletter that is expected to be posted early in 2009

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Up to now, these newsletters have looked at various aspects of developing your asset inventories, from a more high-level view. It is now the fall of 2008, and you have hopefully made a lot of progress towards completing your asset inventories for January 1, 2009. The next set of ten newsletters will take a look at the theme of the Spring Workshops, PS3150 and budgeting. They will cover how to budget for certain types of tangible capital assets, and a couple of major issues. The next newsletter will start with a look at whether you need to change your budget reporting, because of the accounting change.

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

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NOTE: This Newsletter is published to assist you with your implementation of tangible capital asset accounting and with related matters. The Public Sector Accounting Handbook is the only authoritative primary source on matters relating to GAAP, and you should consult with your auditor to resolve specific issues that you may have.