PSAB/Asset Management

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BUDGETING – WILL THAT BE CASH OR ACCRUAL?

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The theme of the MFOA/AMCTO Spring Workshops was "Municipal Budgeting in the New PSAB World". In this and the next nine newsletters, we will explore a number of issues relating to the impact of PS3150 on municipal budgeting.

First, it must be stressed that the process of budgeting is the planning of financing for future activities and acquisitions. For municipalities, this is an important pricing exercise, one that determines the tax rate that Council will be asked to approve for the year. The budget is not an accounting exercise. The implementation of PS 3150 starting with fiscal 2009 is an accounting change, not a budgeting change.

Although the Handbook does not require a particular form or content for the budget, the budget and financial statements are both important financial documents that have obvious linkages. For example, the financial statements provide a measure of a government's performance in the achievement of its objectives as set out in budget documents. The budget and budget bylaw include direct authority to staff to provide services at specified costs, to spend, to raise revenue, to invest and to borrow. Financial statements provide assurance to users that financing and operations were carried out in accordance with the authorities and powers granted. Financial statements also assist users in assessing the municipality's performance in the management of financial affairs by identifying variances that need explanation. A government's budget is a critical element in the accountability cycle and the standard against which subsequent performance is judged. To facilitate meaningful comparisons, planned results need to be ***reported*** on a basis and for a scope consistent with that used to report the actual results of the current period.

While the Handbook does not compel a particular format for municipal budgets, it does have a good deal to say about the presentation of financial information in general as well as on the concept of accountability. Financial statements, which are governed by the Handbook, are only one element in understanding the financial position of a municipality. PS 1000.12 states that:

> Financial statements cannot be expected to fulfill all of the users' needs served by a government's financial reporting system. Governments produce many kinds of financial reports in addition to financial statements. For example, there are reports prepared by individual entities to comply with legislation; there are reports to measure and report on the performance of individual funds, programs and activities; and there are special purpose reports designed to meet particular needs of specific users. In addition, governments set out their fiscal plan in budgets and estimates of expenses or expenditures. Some information, such as related performance information and narrative explanations, can only be provided in other financial reports or as supplementary information to the financial statements themselves. Thus, certain information is better provided, or can only be provided, by financial reports other than financial statements.

A future "mini series" of Newsletters will deal in more detail with the provisions around accountability, the financial reporting framework and the financial statements. This Newsletter suggests that the form of a budget might not change and there will always be the need for a budget to set a tax rate. However, the budget is a key document that enshrines a financial plan for the municipality. **It should be informed by new information available to you from TCA accounting and the financial statements.**

Finally, you will be required to report your accounting data in the new formats, on a basis congruent with full accrual accounting, and **you will be required to report budget figures on the same basis.** That's the dilemma and the potential discontinuity that you face, if you stay with your current approaches.

All of this raises the question: do you have to change your budget process at all? Going forward, will you budget on a cash basis like you currently do, or on an accrual basis? The requirement for full compliance with PS 1200 (Financial Statement Presentation), including the recording of tangible capital assets (PS 3150) starting next year is a major change in the financial **reporting** of municipalities. However, if you so decided, you could conceivably continue to use your existing accounting systems and methodologies, as well as your existing budget processes. The Handbook does not direct you to change them per se.

Current Practice

The US Government Accounting Office has conducted at least two surveys of the use of accrual budgeting around the world. It is utilized to varying degrees in Australia, Canada, Iceland, The Netherlands, New Zealand, the United Kingdom and the United States. Denmark and Switzerland recently expanded the use of accrual budgeting. On the other hand, Norway and Sweden considered it, but ultimately decided against using it altogether.

To put it bluntly, the international jury on accrual budgeting is still deliberating, even though the verdict has long been in with regard to accrual accounting.

Implementations range from the most limited, such as at the government-wide level, to full accrual budgeting at all levels and agencies of the government. It was found that cash-based and accrual-based budgeting are useful for different purposes. In particular, cash-based budgeting was more useful for determining fiscal flexibility, whereas accrual-based budgeting proved useful in costing of programs, and where it is believed that a cash basis does not provide adequate information for tax levies or user rates.

Pros and Cons

These were very succinctly summarized at the 2008 MFOA/AMCTO Spring Workshops as follows:

Cash-based Budgeting		**Accrual-based Budgeting**	
Advantages	**Disadvantages**	**Advantages**	**Disadvantages**
Easily understood by current Councillors and Taxpayers - and by staff	Budgets for tax purposes only – fails to focus on the long-term	Consistent with the new financial reporting requirements	Difficult to understand, especially for non-accountants
Ensures cash is available in the period	Large projects look expensive and may be delayed due to an unfavourable view of large upfront costs	Long-term focus on asset renewal, which will lead to full capital budgeting (e.g. tangible capital assets, post-closure costs)	Without cash-flow budgets, it may lead to under-funding
Budget authority for current full price of asset	Short-term view of Council leads to budgets based upon affordability rather than need	Any under-funding of or provision for future replacements becomes obvious	Complexity of accrual budgeting may lead to misunderstanding by Councils
Provides decent view of government sustainability **in the short-term**	Inconsistent with the new financial reporting requirements – may be difficult to monitor, especially if the daily accounting is on an accrual basis		May be difficult to monitor, depending upon budget-system design

Under either approach, one of the prime objectives of the operating and capital budgets is to determine the tax rate required to support the services and initiatives that any municipality is expected to be involved with and deliver. Budgeting is and should be viewed as a pricing mechanism where tax rates and user rates are set to recover all the costs of a municipality's operations and capital requirements, including costs related to the use of tangible capital assets. The budget process determines what basket of services and service levels can be provided for that price, or tax rate, which the taxpayer is willing to pay.

Accrual accounting and accrual budgeting do not and will not change that. Neither requires you to change or raise your tax rate, as your municipality's financial requirements will not necessarily change, unless you choose to change them.

The same is equally true for capital expenditures. The capital budget under either approach is an allocation out of the financial resources available or obtainable (contributions, debentures and short-term debt) to finance selected capital investments. This will be no different whether you budget capital expenditures on a cash or on an accrual basis. The issue still remains an allocation assignment of available financial resources between multiple demands for capital funding.

It is entirely possible, of course, that you might wish to change your financial requirements in light of information arising from the asset management plan that was built from your TCA asset inventories. This work often suggests that higher levels of investment are needed in the future to sustain the existing asset base and to accommodate growth. In this sense, TCA accounting can, and should, have an impact on your budget.

Why Bother?

It would certainly be easier to maintain your current budget processes and systems, if there is no compelling requirement to change. You probably have an environment that is working effectively as is, and would not welcome the upheaval that a move to accrual accounting would cause.

There are two major reasons to seriously consider migrating, especially if your accounting system is moving to full accrual accounting as of January 1, 2009.

First are the serious disconnects between cash-based budgeting and accrual accounting. Variance reports would be comparing apples and oranges as the budget numbers would include repayment of debenture principal, whereas the actuals would include only repayment of debenture interest. There are potential workarounds for this, or one can do a reconciliation exercise. But do you want to have to do this every time you want to compare budget to actuals for a department, division or program?

The same is equally true for financial reporting. For in-year reporting for in-house purposes, you are free to present financial statements however you wish, though if you have your budget numbers on a cash basis, and your actuals are on a full accrual basis, a reconciliation will be required, and the one set of figures will need to be restated on the same basis as the other set. Again, do you want to have to do that every time you need to present such reports?

In the case of the Financial Information Return and your year-end financial statements, you have no choice. The actuals presented must be stated on a full accrual basis, and any budget figures provided for comparison purposes must be stated on the same basis. This is a one-time exercise where a reconciliation may or may not be onerous, depending on how complex your capital investments are. We will provide greater detail on what it means to present budget information in financial statements on the "same basis" in future Newsletters.

Second, and perhaps more important, is that a cash-based budget is excellent as a financing plan, because expenditures should match the revenues or financing that is available. However, as the US GAO survey discovered, it may be quite inadequate in providing for the true cost of providing a service, as there is no consideration of the consumption of tangible capital assets over time or other non-cash expenses. Thus the pricing derived or used from cash-based budgeting is perhaps only part of the story, whereas accrual-based budgeting provides a more comprehensive view of the costs involved in providing a service or a product, resulting in a more sustainable price or tax rate being determined. Further, by highlighting the consumption and de facto using up of assets through the recording of amortization expense, the focus will shift more to the need to provide for on-going maintenance and future sustainability of services than is perhaps the case at present.

Summary

Either way, your tax rate will be the same, if you budget for the same set of services and service levels, though you will come up with it in somewhat different ways. Basically, the choice is between:

1 Leave your budget process as it is, on a cash basis
= avoid the pain of changing, but have to deal with the disconnects with your accounting system for variance and financial reporting;

2 Migrate to an accrual-based budget
= deal with the implementation issues, and with educating staff and Council, and have budget numbers that will be fully congruent with your accounting data

In either case, you will want a budget process that integrates the information on assets that comes from the financial statements and TCA accounting.

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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.