PSAB/Asset Management

NEWSLETTER NO. 42

MOVING TO BUDGETING ON AN ACCRUAL BASIS

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This Newsletter has been made available as a result of financial support from the Province of Ontario

As stressed in the previous newsletter, the requirement to implement full accrual accounting as of January 1, 2009 does not require you to implement accrual-based budgeting, though you will be required to present comparative budget information in your financial statements on an accrual basis (PS 1200.122). In fact, quite a few jurisdictions around the world have made the decision not to move to full accrual budgeting. We did point out two reasons to make the change:

1. the disconnects between budget and accounting data for variance and financial reporting; and

2. the inadequacy of cash-based budgeting for doing effective costing and pricing on a full-cost of service/product delivery basis.[i]

The first point is not insurmountable. Paragraphs PS 1200.124 and PS 1200.125 talk about your reporting options if the basis and scope of the budget are different than actual.[ii] In accordance with PS 1100.66, the key is to provide a link between budgets approved by elected officials and the amounts presented on the Statement of Operations or Changes in Net Debt, through reconciliations provided in notes or schedules to the financial statements.[iii] As stated in the previous newsletter, this would be largely a once-a-year, year-end exercise. The second point is a different story, as this relates to on-going performance and management reporting throughout the year.

This newsletter is written for those who are interested in changing to accrual-based budgeting next year or perhaps in 2010. In short, you are prepared to put up with some short-term pain, for long-term gain and the benefits that this change will give to you and to your municipality.

A major reason that there are few good budgeting software packages available is that every organization's budget process is unique. The process is based on standard requirements, but tempered to reflect the unique culture and values of the organization. Thus there will be no attempt to describe or document an accrual-based budgeting process, as in many ways, the process will likely be little different from your current practice. We will look at the migration process, and also what an accrual-based budget should include, and what you may want to include.

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Let us start with a migration process that you may want to follow.

2008

You have a 2008 Operating Budget, and a 2008 Capital Works or Investment Program that were approved by your Council earlier this year. The first covers the current operations of your municipality, and is the mechanism for determining what the approved tax rate for the year will be. The second itemizes capital works in progress and their committed requirements in this and future years, along with new initiatives requiring approval for this year, and proposed new initiatives in future years, for which sanction/blessing is being sought. The approved Capital Works Program allocates out available capital funding, and identifies additional funding that may be required and its source(s), to underwrite the capital priorities of the municipality.

In 2008, there were already well-established processes in place for identifying and determining needs and future priorities and possibilities, for determining current and future potential financing requirements, and for making choices between options and priorities, and for establishing the capacity of the municipality to raise the financing required for operational activities and for capital investment.

2009 – Phase 1

This will not change in 2009. You will still have to determine your operating requirements, and the resulting tax rate to support them. You will still have to determine what capital investments will be required, and how you will finance them. The implementation of PS 3150 will not change or affect that. You are probably already well underway with your budget process for 2009.

Probably the best advice available to you is the oft-repeated observation of Calvin Hawke, CA, formerly a project manager for one of the Ontario Municipal Benchmarking Initiative Tangible Capital Accounting Implementation Pilot sites:

"*Prepare your 2009 budget in the same way as you did for 2008. Staff and especially your Council are familiar with the process, presentation and terminology, and your 2009 budget will be readily comparable against the 2008 budget. This will facilitate the whole process. Do this for your operating budget and for your capital program. ……*"

In short, practice business as usual for 2009, for getting your operating and capital budgets approved by your Council.

2009 – Phase 2

Once your operating budget and capital works program have been approved by your Council, the advice continues:

"….. Then take the approved budget and capital program, and re-express them to be congruent with PS 3150. Include amortization expense, and identify the sources of financing for capital expenditures to be consistent with PS3150 reporting. Once you have re-expressed the numbers, go back and present the reworked documents to your Council – showing old and new formats – for information and to educate members on how the accounting change works and impacts on budgeting. The budget was already

approved.   This is simply a restatement, and the numbers shown are not, or should not be, a political issue. .....”

In short, restate your 2009 budgets in a way that reflects accrual accounting, such as including amortization as an operating expense. For 2009, you should still provide the reconciliation in the notes or schedules of the restated budget numbers in the financial statements to the original approved budget. This is because the amounts presented in the statements will differ from those originally approved by Council, unless you wish to run another bylaw through Council, to approve the accrual-based budget numbers.

2010

“..... Prepare and present the two budgets in the new format, as you already have 2009 figures ready for comparison, and Council will have seen, and have had the opportunity to learn about the new format. The transition is thus completed.”

This approach will make preparing the 2009 budgets easier, no matter how far along you are with implementing tangible capital asset accounting. It will allow you to eventually table a 2009 accrual-based budget that is congruent with TCA accounting in a non-politicized manner, so that staff and Council can focus on the changes resulting from moving to full accrual budgeting, and not on issues and pet priorities (which should be ruled to be out of order). And it gives you a bit more time to make the transition.

Now let us look at how “2009 Phase 2” may differ from “2009 Phase 1.”

Key Differences

First and foremost, cash budgeting is basically a financial plan that determines how you will generate the cash needed to meet your obligations during the budget period. In short, what expenditures will you incur in the period or year, and how will you finance them. This is equally true of capital as of operating. In the case of capital, this period’s expenditures may likely be financed from funding obtained or allocated in prior periods, but the principle is the same.

Thus a cash budget covers:

OBLIGATORY	Direct Operating Expenses	Required to cover the day-to-day operating requirements of the program.
	Debt Repayment (principal and interest)- if any	Mandated by the Ontario Municipal Act. Repayment of past borrowings.
DISCRETIONARY	Amortization expense (2009+)	If you choose to budget for it. **If you do not budget for this, how do you plan to finance future replacements and betterments?**
	Payments to Reserves	If you choose to make them.
	Acquisition of Capital Items	Rather than include them in your capital program.

	Provision for Equipment Replacement	To even out the cost of major equipment, and where timing may be a problem, such as for a bulldozer.
	Special Levy for Capital	If you choose to raise capital financing this way.

An accrual budget, on the other hand, shows the true cost of providing programs, goods and services. You will still have to determine the cash requirements to cover principal repayments, current financing of capital expenditures, transfers to reserves and reserve funds, etc. You may add back non-cash expenses like amortization, employee future benefits or landfill closure and post closure care liability depending on your strategy for funding these items. Although not part of a full accrual budget, you may also factor in how you will provide for expansion for additional services required in the future, and for changed standards or higher levels of service that will or may be required. This latter would be particularly relevant with respect to your capital investment plan.

Thus a full accrual budget reports the true costs of service provision and will give some indication as to whether planned revenues will cover the expenses of the period. It will include:

OBLIGATORY = raise sufficient tax revenues to cover these	Operating Expenses	Required to cover the day-to-day operating requirements of the program.
	Debt Interest - if any	Likely to be mandated by the Ontario Municipal Act. This is the minimum requirement to carry outstanding debt.
	Amortization expense	Provision for the "consumption" or using up of current assets. To this point, you are just meeting the total costs for the current period.
DISCRETIONARY= may raise tax revenues to cover these	Funding for Repayment of Debt Principal Repayment	Note that debt outstanding as of January 1, 2009 will need to be paid off, the principal, that is. How will you finance it?
	Funding for Service Enhancements, Changed Standards	How will you finance what may be required, when it will be required?
	Funding for Service Growth	How will you finance what may be required, when it will be required?
	Funding for Inflation in Asset Costs	As discussed in Newsletter #38, amortization will likely not cover replacement cost. How will you finance the difference that may be required, when it will be required?
	Funding for Historic Under-Investment	If this is an issue, how will you finance what may be required, when it will be required?
	Acquisition of Capital Items	Rather than include them in your capital program.

Capital Investment Plan	Capital expenditures – acquisition of tangible capital assets	What will they be? How much? How do you intend to finance them? - Through current revenues, existing own source financial assets, or through debt (debentures, leasing, etc.)?

Note that the first three items cover the consumption of goods, services and tangible capital assets, plus the period cost of any outstanding debt (debenture or other).

The first five discretionary items represent issues that an on-going business should be addressing, as these represent the discharging of existing obligations, and preparing for future investment requirements. As noted in Toward Financial Sustainable Drinking-Water and Wastewater Systems, released by the Ontario Ministry of the Environment (August 2007) on page 27, "*Revenues in excess of current period expenses will be reflected as an accounting surplus in financial statements*." As such, they will be available to finance appropriate future capital acquisitions and betterments of tangible capital assets.

The final discretionary item, Acquisition of Capital Items, is totally your call. Putting capital items in the operating budget would be most logical for those assets that are below your capitalization thresholds, and which would not be included in your asset inventories. You will account for them as an expense in the year of acquisition, so why not budget for them as an expense in that year. Then you are preparing a budget on the same basis and for the same scope as the actual results that will be reported. You will need to raise sufficient revenues to meet your expenditures that must be covered from revenues in the period. Note, you may also plan to finance using debt, existing reserves and reserve funds, etc. especially for the items in your capital investment plan.

Summary

This Newsletter has hopefully provided some insight into how to move to an accrual budget in a way that is congruent with full accrual accounting and with PS 1200 and PS 3150. We have suggested a way to migrate to the new accounting environment, using an old and new format approach for 2009 that should ease the transition. We have not discussed details, because your budget process must first and foremost be one that works for you, your staff and your politicians.

The Appendix provides an overview of a how a cash-based budget compares to an accrual –based budget, for both operating and for capital.

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Our next newsletter will look at how you may want to budget for purchases of tangible capital assets in the years to come, and how that may be impacted by PS3150.

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

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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.

Appendix to Newsletter 42

TABLE 1 – OPERATING BUDGET

Current Format = Cash Basis	Changed Format= Accrual Basis

CURRENT	OPERATING
REVENUES	**REVENUES**
User fees, grants and transfers, other revenue	User fees, grants and transfers, other revenues
1 - Proceeds from sale of assets	1 - Net gain from disposal of capital assets
	2 - Value of donations and transfers of TCA's into the program - if known
TOTAL REVENUES	**TOTAL REVENUES**
EXPENDITURES	**EXPENSES**
Operating expenses	Operating expenses
Debt repayment - interest	Debt repayment - interest
3 - Debt repayment - principal	
4 - Contributions to Reserves, Reserve Funds	
4 - Capital Allocation of Capital from Current levy	
5 - Capital expenditures from Revenue Fund	5 - Purchase of TCAs
	6 - Amortization expense
	7 - Maintenance of TCAs
	8 - Value of donations and transfers of TCAs to outside parties
	9 - Value of TCA write-downs and write-offs
TOTAL EXPENDITURES	**TOTAL EXPENSES**
	10 - Funding to repay principal of pre-2009 debt
	11 - Funding required to provide for inflation in asset costs
	11 - Funding for growth in service demand
	11 - Funding for service enhancements
	11 – Funding for past under-investment
NET LEVY	**NET LEVY**

NOTES

1. Currently, all of your assets have a book value of zero, so that whatever an item fetches at sale is revenue. Starting in 2009, there is a gain or revenue if the proceeds are greater than the net book value. If the amount is lower, there will be a loss, or a charge against the program. For budgeting purposes, you may decide not to include this, as the amount is an unknown.

2. We will discuss this in more detail in Newsletter #45. If you receive an asset from an outside organization, it will be valued at fair market value at the time of transfer, and that value, less any transfer costs or fees paid will be revenue for the receiving program.

3. Currently, debt charges include principal and interest. Starting in 2009, only the interest will be an expense. See also Note #10.

4. These are currently charged as an expense, whereas they are really the accumulation of working capital for some specified purpose. Starting next year, these will be treated as an accounting surplus, or a source of capital funding.

5. Assets are currently bought and paid for out of the Revenue Fund, and then for reporting purposes, the expenditures are transferred to the Capital Fund. Starting next year, TCAs may still be expensed to operating, but these will likely be the ones whose value is below the capitalization threshold. They will not be included in asset inventories and will not be amortized over their expected life. This is like amortizing them 100% in the year of acquisition.

6. This is a new line item, starting in 2009, and is essentially a non-cash transaction. It would be prudent to budget for funding this charge, in order to have at least some funding for buying replacement assets, when required. See Note #11, also Newsletter #37.

7. The issue of maintenance versus betterment of TCAs has been discussed in earlier newsletters and at the MFOA/AMCTO workshops. If your Administration Building is a single asset, you will have to budget here as a maintenance expense whenever you replace the roof or the elevators. Alternatively, you may choose to budget an annual provision for TCA maintenance, to try to smooth out the costs more.

8. We will discuss this in more detail in Newsletter #45. If you donate or transfer a tangible capital asset outside of the organization, this will be transferred out at fair market value as of the date of transfer, and you have made a donation costing that amount, i.e. an expense. If the net book value of the asset is different from the fair market value, there will be a loss or gain triggered, as in Note #1.

9. We will discuss these more in Newsletter #46. In short, these are a charge against the program. If you know this may be an issue, budget for it, or provide for it, or face the alternative.

10. In full accrual accounting, repayment of debt principal is paying down a liability, an accounts payable, but not an expense. From 2009 forwards, this will be dealt with in another way. How will you handle the debt outstanding as of December 31, 2008? You may want to budget to raise the funds to pay this down, just as you currently do, until it has all been discharged. Alternatively, will the financing raised to cover amortization on TCAs acquired before 2009, be sufficient in amount to cover these repayments?

11. Particularly for full-cost recovery programs, you will almost certainly want to include these four items in your budgeting, so that the operation will be financially self-sustaining over the long-term. For a municipality, these would be methods and rationales for raising capital funding internally, as opposed to using outside financing. In both cases, what you may want to budget will be tempered by what the market is willing to bear.

Now let's look at budgeting for tangible capital assets. The current approach in municipal accounting is to include capital operations in the Consolidated Statement of Operations. Starting in 2009, accounting for tangible capital assets moves to the Consolidated Statement of Financial Position, and is really about allocations between balance sheet accounts.

TABLE 2 – CAPITAL BUDGET

Current Format = Cash Basis	Changed format= Accrual Basis
CAPITAL	**CAPITAL ACQUISITIONS PLAN**
REVENUES	**SOURCES OF FINANCING**
Government grants	2 - Government grants
Development charges	2 - Development charges
Proceeds from issuing debt	3 - Proceeds from issuing debt
Other revenues	2 - Other revenues
Contribution from current levy (capital from current)	2 - Contribution from current levy (capital from current)
1 - Transfers from Reserves, Reserve Funds	
	4 - Other transfers from Municipal Surplus
TOTAL REVENUES	**TOTAL FINANCING**
EXPENDITURES	**INVESTMENTS**
Capital expenditures during the fiscal year	5 - TCA's purchased during the fiscal year
	5 - Expenditures on Work-in Progress
	5 - Advances towards future acquisitions
	5 - Betterments of existing TCAs
TOTAL EXPENDITURES	**TOTAL INVESTMENTS**

NOTES

1. These will no longer exist as such starting next year, as they are simply part of the "Municipal Surplus" or "Municipal Equity". However, you may well want to identify that your municipal surplus, or net worth, relates to specific purposes or initiatives, and allocate it out appropriately, analogous to having a group of reserves and reserve funds, so that this is not seen as a pool of funds available for whatever Councils desires, much as you do now with your reporting on Reserves and Reserve Funds.

2. These will still likely be budgeted as revenue, but they are really sources of financing. At the same time, they are revenues to the municipality, as the net cost of the asset to the municipality will be less than the book value or historical cost.

3. The issuance of debt will be a source of financing, as it is now. As stated earlier, the repayment of the principal of the debt will be the repayment of a liability, as opposed to a program expense – a balance sheet transaction, no longer an income statement one.

4. As indicated in Note #1, the Municipal Surplus may have a number of "funds" notionally included, so that the program may budget to access some of these funds for financing its investment plan.

5. Your capital investment plan may not look very different from your current long-term capital program. These are the major types of situations that you will be budgeting to provide for. Note again that all are balance sheet items, not expenditures as they are currently, and all will increase the value of the program's tangible capital assets. Note that the advances towards future acquisitions are the same as progress payments, and would be accounted for as contributions to Work-in-Progress. When the item is delivered, the final payment will complete payment for the acquisition, which will be transferred to the tangible capital asset inventory account.

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[i] Budgets should include all the costs associated with providing services. Full cost recovery is meant to be comprehensive and include such things as operating costs, future repair and replacement costs, costs associated with growth, etc. A budget should also include a financing strategy to meet such costs. For an excellent treatment of concepts associated with full costing of services see *Towards Financially Sustainable Drinking Water and Wastewater Systems*. Although the focus of this piece is water and wastewater systems, the concepts are equally applicable to other municipal assets.

[ii] PS 1200.24 and 1200.125 are reproduced below for your information and convenience:

.124 On the statement of operations or the statement of change in net debt, when the scope of financial activity reported in the fiscal plan is not the same as that reported in the financial statements, it may be necessary to restrict the comparison of actual and budgeted results to the scope of financial activity reported in the budget or main estimates of expenditures. This comparison would be presented in a note or supporting schedule. To ensure that this disclosure is reconcilable to the information reported in the financial statements, a government would highlight the differences between the reporting entity used for the financial statements and that used for the fiscal plan.

.125 On the statement of operations or the statement of change in net debt, when a government's fiscal plan is not prepared on a basis consistent with that used to report the actual results, planned results should be reported on the same basis as that used to report the results of the current period. In those circumstances, it would be necessary to provide a reconciliation of the restated information with that originally presented in the fiscal plan.

[iii] PS 1100.66 is reproduced below for your information and convenience:

.66 If a government's budget or appropriations are prepared on a different basis or for a different scope than its financial statements, the government needs to provide a link with the financial statements so that the legislature or council understands how the government's results for the period compare to the results it planned and the amounts authorized to accomplish those plans. In either circumstance, or when neither the budgeted scope nor basis is consistent with that used for reporting actual results, the financial statements will need to provide a reconciliation of the planned information included in the financial statements with that originally budgeted.