Re: EX12.3

STAFF REPORT
ACTION REQUIRED

Additional City of Toronto Act Reporting Requirements as a Result of Recording of Tangible Capital Assets

Date:	January 12, 2016
To:	Budget Committee
From:	Deputy City Manager & Chief Financial Officer
Wards:	All
Reference Number:	P:\2016\Internal Services\acc\bc16001acc (AFS 22023)

SUMMARY

This report discusses the impact of excluding amortization expenses, post-employment benefits expenses, and Solid Waste landfill closure and post-closure expenses from the 2016 Operating Budget.

Ontario Regulation 286/09 "Budget Matters – Expenses" requires that the City prepare a report, prior to adoption of its budget, detailing amortization, post-employment benefits and landfill closure and post-closure expenses, if excluded from the budget. It also requires that the City adopt the report by resolution.

Consistent with prior years, the City's 2016 Operating and Capital budgets have been prepared on the modified cash basis and therefore exclude the expenses listed above.

RECOMMENDATIONS

The Deputy City Manager & Chief Financial Officer recommends that:

1. City Council receive this report for information.

Financial Impact

There are no financial implications as a result of this report.

Table 1 of this report outlines that the consolidated budget, (tax – operating and capital, water, solid waste, agencies and corporations), would show a surplus of $1.1B, if these budgets were prepared on an accrual basis.

The Deputy City Manager & Chief Financial Officer has reviewed this report and agrees with the financial impact information.

DECISION HISTORY

This report has been provided annually since 2010 to the Budget Committee.
To view the last two reports on-line, please follow the hyperlinks below:
http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2014.BU52.2
http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2015.BU5.5

ISSUE BACKGROUND

Beginning in 2009, municipal accounting and financial statement reporting changed substantially with the adoption of full accrual accounting, and the requirement to record tangible capital assets.

This accounting change had material impacts on City-reported revenues and expenses, as well as the City's annual surplus or deficit for financial statement purposes, as the City's large capital investments are no longer expensed in the financial statements. Although a new expense – 'amortization' - was recognized, this expense is generally much lower than capital assets purchased. Amortization is based on the historical cost of the City's assets, while the City's annual investments in replacing and expanding assets should exceed this amount for the foreseeable future.

The Province recognized that the former Section 228 in the *City of Toronto Act, 2006* with its requirement for balanced budgets, and annual disposition of any surplus or deficit, would need to be amended to reflect these accounting changes. At the same time, the section had not been updated to reflect additional standards imposed by the Public Sector Accounting Board in the prior ten years, specifically the recording of landfill closure and post-closure liabilities, and employee future benefit liabilities. The province has begun a review of the Regulation however there are no indications at this time as to whether the Province will be initiating any changes to the regulation.

COMMENTS

The Public Sector Accounting Board (PSAB) is the standard setter for financial statement reporting for all levels of government in Canada. Prior to the creation of PSAB, federal and provincial governments set their own rules for financial reporting and provinces set the rules for their municipalities.

Traditionally, governments reported their financial statements on the same basis as they budgeted. More often than not, governments reported out on a cash basis or "modified-cash" basis of accounting (some limited accruals for expenses incurred but paid after year end). Governments budgeted cash coming in through revenues and budgeted cash going out for operating expenses and debt repayment. The financial statements reported the actual cash in and out compared to the budget. The financial statements, at that time, measured how well the government adhered to their plan.

PSAB recognized that the cash basis of accounting had some major shortcomings. Overall, while the cash basis of accounting recognized how well the government (i.e. those in power) did against their plan, there was no measurement as to whether or not the government entity (i.e. the province or city) was better or worse off because of that plan.

Some decisions that the government may make can have little or no cash impact in the current fiscal year but have a profound cash impact in future years. For example, a government may negotiate a pension or health benefit for current employees that will cost very little in the initial years of its implementation but could have a substantial impact when these employees start aging or retiring.

Alternatively, a government may decide to save money by not replacing its assets on a timely basis. In the short term, this appears to save money, but the government is letting its assets degrade. Since much of a municipality's asset base is underground, this fact is actually hidden from view.

To address these shortcomings, PSAB now requires full accrual accounting for all of the government's assets and liabilities. The change to these balances between the reporting periods, is reported out as a surplus or deficit. In other words, the financial statements now provide more information as to whether the government entity (i.e. the City, including all of its agencies, and corporations) is in better or worse condition than the previous year. The changes may be as a result of government actions, (the budget), or inaction, (not addressing aging assets), or the result of factors beyond the government's control, (such as interest rate changes or natural disasters damaging government property).

The following describes the five (5) key areas where there are significant differences between City budgets and City reporting for financial statement purposes.

Capital Assets

For budget purposes, the City outlines a 10 year plan of capital expenditures and funding sources for the assets it plans to build or acquire. The operating budget includes amounts set aside for funding capital (capital from current or CFC), as well as for debt repayment (interest and principal) for past asset purchases. These represent the cash requirements to acquire and pay for capital assets. Funding sources include provincial and federal funding, future debt, CFC, and draws from reserves.

For accounting purposes, capital acquisitions are accounted for as additions to the asset base, not expenses because they generate service benefits beyond one year. There are four (4) ways to fund the acquisition of an asset:

- Use existing cash (reserves) to buy it. As this is seen as simply trading one asset (cash) for another (physical asset), the use of reserves is not considered a revenue for accounting purposes.
- Generate cash from operations (CFC) to buy it. Although CFC is recognized as an expenditure for budget purposes, it is not recognized as an expense for accounting purposes.
- Receive money from others. Grants from other levels of government or contributions from other parties will sometimes fund a portion of certain assets. These monies are generally recorded as revenues once the asset is bought or built.
- Borrow the funds. Debt issuance is not a revenue and the repayment of the principal is not considered an expense for accounting purposes. For budget purposes, debt principal repayment is treated in the same way as CFC as the government must raise funds from operations to repay the debt. Interest on the debt is considered an expense for both accounting and budget purposes.

For accounting purposes, once the asset is acquired and put into service, the cost of the asset is amortized (expensed over its useful life). For example, if the asset cost $1,000,000 and is expected to last 10 years, $100,000 would be expensed each year representing one-tenth of the asset's cost. The City does not budget for amortization as it is an approximation of the asset's consumption and, as such, is a non-cash item.

There is also one other significant difference between the City's modified-cash budget and the City's accrual basis of accounting financial statements: the treatment of large maintenance expenditures. For accounting purposes, many expenditures for maintaining assets are considered as expenses in the year they occur. For budget purposes, large periodic expenditures for maintenance are considered capital works and are budgeted in the capital budget as opposed to operations.

Government Business Enterprises (GBEs)

The City owns three (3) GBEs, Toronto Hydro, Toronto Port Lands Company, and Toronto Parking Authority. GBEs are self-sustaining businesses, which are separate legal entities that carry on a business, and do not need ongoing support from the City. Although the City budgets for certain distributions from GBEs, the budget does not contain accounting adjustments or earnings in excess of distributions.

Post-Employment Benefits Expense

Post-employment benefits represent benefits that employees have earned through their service to-date, which will be paid out in the future. These benefits consist of: vested sick leave, Workplace Safety and Insurance Board entitlements, health, dental, life insurance and long-term disability, and non-OMERS pension benefits.

For budget purposes, the City estimates the amount of cash that will be paid out for these benefits. The cash requirement is fairly predictable and the amount required each year typically grows with the employment base and inflation.

For accounting purposes, however, there is recognition that benefits earned by active employees will be paid out after they leave the City. This is effectively deferred compensation that should be recognized as earned while the employee is working, rather than as paid out, when the employee is retired or disabled. Accordingly, the annual accounting expense will usually be higher than the cash requirement, and there will be a significant liability at each year end, which is only funded for budget purposes to the extent of contributions to reserves and reserve funds.

<u>Landfill closure and post-closure costs</u>

Landfill closure and post-closure costs represent the costs that must be incurred to close active landfills and to monitor and remediate any issue with inactive / closed landfills into perpetuity. The City has 160 closed landfills, and one (1) active landfill.

For budget purposes, the City budgets for the maintenance, monitoring and care of closed landfill sites, on a pay as you go (cash) basis. For the open landfill site at Green Lane, the City budgets an annual contribution to the reserve set aside to close the landfill site and cover maintenance and monitoring costs in the future.

For accounting purposes, closed landfill sites are seen as a perpetual liability for the City because the City is committed to the cost of their care for decades to come, while no further service is to be provided from those sites. The liability is the net present value of those future estimated costs.

While actual expenditures incurred on maintaining the sites are also considered as expenses for accounting purposes, if the liability changes from year to year, the change can result in an increase or a decrease to the expense reported. The liability also changes if the imputed interest or discount rate changes, or if new information comes to light that a particular site needs more or less work than previously thought.

<u>Liability for Contaminated sites</u>

New PSAB standard PS3260 – Liability for Contaminated Sites has to be implemented effective for year ending December 31, 2015. This standard requires the City to account for and report liabilities associated with remediation cost of contaminated sites.

For budget purposes, the City budgets for the cash cost of remediation, when required for contaminated sites.

For accounting purpose, the City will assess whether there is a liability for each contaminated site, each year end. The expense each year will be the costs of remediation during the year, plus or minus the change in the liability from the previous year end. At this point in time, it is difficult to estimate what this liability will be until the analysis is complete, in early 2016. As a result there is no dollar amount included in Table 1.

Sum of the Accounting Differences

The following estimates the impact of the change in accumulated surplus from these excluded items, and estimates the impact on future infrastructure funding.
The forecasted impacts on the consolidated accumulated surplus to the end of 2016 from inclusion of these estimated expenses are as follows:

TABLE 1: Estimated Accumulated Surplus December 31, 2015

	$ 000's	$ 000's
Est. accumulated surplus, consolidated Dec 31, 2015 *1		21,057,206
Impact of tangible capital assets:		
Estimated non-asset capital expenditures*2	(451,000)	
Amortization	(872,000)	
Capital from current and payments to capital reserves	1,269,335	
Monies received from others for assets*3	966,000	
Debt principal repayments budgeted and SF earnings	351,000	1,263,335
Impact of government business enterprises:		
Earnings from Government Business Enterprises	75,000	75,000
Impact of employee future benefits:		
Estimated increase in employee benefits liability	(225,000)	(225,000)
Impact of landfill closure and post-closure:		
Estimated change in landfill post-closure costs	(15,000)	(15,000)
Impact of contaminated sites:	n/a	n/a
Estimated Surplus for Accounting Purposes		1,098,335
Est. accumulated surplus, consolidated Dec 31, 2016		22,155,541

*1: Includes the City tax and rate based programs, and over 119 agencies and corporations which are consolidated as part of the City's annual financial statements.

*2: Non-asset capital expenditures are amounts paid from the capital budget which do not meet the accounting criteria for recognition of assets: mainly small value assets, maintenance and repair work, or studies which may not lead to an asset

*3: Monies received from others are mainly amounts received from the Federal and Provincial governments, and from development charges

The City's accounts are not yet closed for the 2015 fiscal year, as invoices continue to be received and journal entries will be posted well into February of 2016, as in prior years. In addition, liabilities have not been updated to reflect the impact of any change in discount rates as at December 31, 2015. Estimates in this report include both those amounts as at December 31, 2015, as well as amounts of revenues and expenses in 2016.

As in prior years, the budget information used as comparatives in the audited financial statements is reconciled to the budgets as presented. A reconciliation of accounting surplus to budget surplus is also included each year in the Annual Financial Report.

Analysis

Table 1 demonstrates that the amount of cash raised in the operating budget for capital acquisitions (debt repayment and CFC) exceeds the amortization expense for accounting purposes. As long as assets are being maintained or replaced on a regular basis, the cash amounts will always be higher than the accounting amortization, as amortization is based on old historical cost that does not reflect the impact of inflation on the cost of replacing assets.

However, Table 1 also shows that the City is not funding an estimated $451 million in "maintenance" projects from operations. Ideally these amounts should be funded on an annual basis, but given their large and periodic nature, the City finances them through the capital budget.

The table also shows that much of the revenue from third parties for capital acquisitions is recognized in the capital budget, while for accounting purposes, this revenue is shown as revenue in operations. As with asset purchases, these amounts vary significantly from year to year.

The table shows that on a full accrual basis of accounting, the tangible capital asset adjustments to the financial statements will add an estimated $1.263 billion to the City's accounting "surplus" for the year.

As in the past, there may be earnings in excess of distributions, as well as accounting adjustments in the GBEs. This has been estimated at $75 million.

The estimated increase in the employee future benefit reflects the fact that the liability has been growing. The accounting expense does not specifically recognize if any of the City's operational surplus will be set aside to fund the liability increases. This information is reported out in the annual variance report on the reserves and reserve funds.

Steps continue to be taken to manage these liabilities. For example, the City took action to replace the sick leave gratuity with an illness or injury plan for new employees which has reduced the growth of the City's liability in this area. For the Green Lane landfill site funds are being set aside to pay for its closure and perpetual care.

Staff are not recommending that Council move to a full accrual basis of budgeting, as the existing process for capital and operating budgets provides for a more transparent process to commit funds for the current and future years. Budget reports, the annual financial report, reports of progress against the City's Long-Term Fiscal Plan, and additional reports on various initiatives provide detailed information about the City's financial performance.

CONTACT

Mike St. Amant
Treasurer
Tel: (416) 392-8427
E-mail: mstaman@toronto.ca

Josie La Vita
Executive Director, Financial Planning
Tel: (416) 397-4229
E-mail: jlavita@toronto.ca

SIGNATURE

____
Roberto Rossini
Deputy City Manager &
Chief Financial Officer