STAFF REPORT
ACTION REQUIRED

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

Date:	February 8, 2011
To:	Budget Committee
From:	Deputy City Manager and Chief Financial Officer
Wards:	All
Reference Number:	P:\2011\Internal Services\Acc\Bc11001Acc (AFS13230)

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 2011 Operating Budget; and requests City Council to adopt the recommendation contained therein in accordance with Provincial requirements.

Ontario Regulation 286/09 "Budget Matters – Expenses" requires that the City shall 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 2011 Operating and Capital budgets have been prepared on the modified cash basis and therefore exclude the expenses listed above.

RECOMMENDATIONS

The Deputy City Manager and Chief Financial Officer recommends that:

1. This report be received for information.

Financial Impact

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

DECISION HISTORY

This report was first provided, for the 2010 budget, to the August 9, 2010 Budget Committee.
To view the report on-line, please follow the hyperlinks below:
http://www.toronto.ca/legdocs/mmis/2010/bu/bgrd/backgroundfile-32527.pdf

ISSUE BACKGROUND

For 2009 financial statement reporting, municipal accounting changed substantially – adopting full accrual accounting, and recording the city's tangible capital assets for the first time.

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' - is 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 last ten years, specifically the recording of landfill closure and post-closure liabilities, and employee future benefit liabilities.

Ontario Regulation 286/09 allows the City to draft and approve its operating and capital budgets in the traditional manner and still adhere to balance budget requirements as long as Council is made aware of the accounting expenses that are not included in the budgets before the budgets are approved.

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 the 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 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 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 measure whether the government entity (i.e. the City) is in better or worse condition from the previous year. The changes may be as a result of government actions (the budget) or inaction (not addressing aging assets) or it could be the result of factors beyond the government's control (interest rate changes or natural disasters damaging government property).

The following describes the three key areas where there are significant differences between how the City budgets and how the City reports in it financial statements:

Capital Assets

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

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 ways to acquire 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.
- Generating surplus cash from operations (CFC) to buy it. For accounting purposes, the "surplus" generated for this specific purpose is not identified separately from total surplus generated by the government and thus CFC is not recognized as an expense.
- Receive money from others. Grants from other orders 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. Debt principal repayment is treated in the same way as CFC as the government must raise a "surplus" from operations to repay the debt. Interest on the debt is considered an expense.

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 is $1,000,000 and is expected to last 10 years, $100,000 would be expensed each year to expense 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 cash budget and the City's accrual basis of accounting financial statements and that is the treatment of large maintenance expenditures. For accounting purposes, many expenditures for maintaining an asset are considered an expense to operations in the year it occurs. For budget purposes, large periodic expenditures for maintenance are considered capital works and are budgeted in the capital budget as opposed to operations.

<u>Post-employment benefits expense</u>

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, 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 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 it is earned while the employee is working, rather than when it is paid out, when the employee is retired or disabled. Accordingly, the accounting expense will usually be higher than the cash requirement.

Landfill closure and post-closure costs

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 161 closed landfills, and one 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 pay to close the landfill site and pay 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 can change 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.

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 2011 from inclusion of these estimated expenses are as follows:

TABLE 1: Estimated Accumulated Surplus December 31, 2011

	$ 000's	$ 000's
Est. accumulated surplus, consolidated Dec 31, 2010		15,000,000
Use of previous year's surplus or reserves in 2011 budget		-346,000
Impact of tangible capital assets:		
Estimated non-asset capital expenditures	-600,000	
Amortization	-1,200,000	
Capital from current	946,000	
Monies received from others for assets	1,080,000	
Debt principal repayments budgeted	260,000	486,000
Impact of employee future benefits:		
Estimated increase in employee benefits liability	-97,000	-97,000
Impact of landfill closure and post-closure:		
Estimated increase in landfill post-closure costs	-5,000	-5,000
Estimated Surplus for Accounting Purposes		38,000
Est. accumulated surplus, consolidated Dec 31, 2011		15,038,000

The City's accounts are not yet closed for the 2010 fiscal year, as invoices continue to be received and journal entries will be posted well into February of 2011, as in prior years. In addition, liabilities have not been updated to reflect the impact of the decrease in discount rates as at December 31, 2010. Estimates in this report include both those amounts as at December 31, 2010, as well as amounts of revenues and expenses in 2011.

As in prior years, the budgeted 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) approximates the amortization expense for accounting purposes. Ideally, the cash amounts should always be higher than the accounting amortization as amortization is based on old historical cost and therefore does not recognize the impact of inflation on current replacement costs.

However, Table 1 also shows that the City is not funding an estimated $600 million in "maintenance" projects from the operations. Ideally these amounts should be funded from operations, but given their large and periodic nature, the City finances them though the capital budget to smooth the impact on the taxpayer. As well, much of the revenue from other third parties for capital acquisitions is recognized in the capital budget as opposed to recognition as revenue in operations, as the accounting rules require. Again, these amounts will vary significantly from year to year.

In total, the table shows that on a full accrual basis of accounting, the tangible capital asset adjustments to the financial statements will add an estimated $486 million to the City's accounting "surplus" for the year. However, it should be recognized that the "surplus" is generated primarily by third party revenues received for capital purposes that are not available for operational purposes.

With respect to the increase in the employee future benefit and landfill closure and post closure liabilities, the adjustments reflect that fact that the liability is growing. The accounting will 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 are being 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 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 at the present time as the existing process for capital and operation budgets provides for a more transparent process to commit funds for the current and future years.

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SIGNATURE

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ATTACHMENTS

Appendix A: Ontario Regulation 286/09