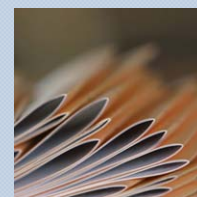


Government Financial Reporting Model – Time to Get Ready

March 6, 2008



In February of 2007 the CICA's Public Sector Accounting Board (PSAB) issued a number of new standards which will significantly alter financial reporting for local governments. These standards include:

- PS 1000 – *Financial Statement Concepts*
- PS 1100 – *Financial Statement Objectives*
- PS 1200 – *Financial Statement Presentation*
- PS 3150 – *Tangible Capital Assets*

Since the issuance of these new standards, much of the focus has been on PS 3150 – *Tangible Capital Assets* – due to the significant work effort required to comply with PS 3150. PS 1000, PS 1100 and PS 1200, which will collectively be referred to as the Government Financial Reporting Model, also presents challenges to organizations adopting the new reporting model. This publication will focus on the Government Financial Reporting Model. For information on PS 3150, *Tangible Capital Assets*; please read our March 12, 2007 publication "Tangible Capital Assets – Time to Get Ready".

Although we do not believe the information gathering requirements and work effort to comply with the Government Financial Reporting Model will be as onerous as the tangible capital asset project, it does have its challenges. The challenges relate to new information needs, changes in the budgeting process and the need to communicate early the anticipated results to stakeholders.

The new Government Financial Reporting Model becomes applicable to local governments for fiscal years beginning on or after January 1, 2009 on a retrospective basis. Therefore for governments with a calendar year, the first year end impacted is December 31, 2009 with 2008 comparatives. For a government with a March 31st fiscal year, the first year end impacted is March 31, 2010.

Inside

Introduction to the New Reporting Model

Statement of Financial Position

Statement of Operations

Statement of Changes in Net Debt

Statement of Cash Flows

Reporting Budget information

Conclusion



BDO Dunwoody LLP
Chartered Accountants
and Advisors

Introduction to the New Reporting Model

The current local government reporting model is based on Sections PS 1700, Objectives of Financial Statements – Local Governments, and PS 1800, General Standards of Financial Statement Presentation – Local Governments. The current model is a “modified accrual basis of accounting”, which concentrates on spending. Modified accrual accounting provides more information than just cash flows, but does not provide information about a government’s physical assets or the cost of using them to provide services. This model provides information about financial assets only, but requires a government to record and report all of its liabilities. The focus of this model is financial operations.

The new Government Financial Reporting Model is an “accrual basis of accounting”. This model of accounting recognizes the financial effects of transactions in the period(s) in which they occur, irrespective of whether cash has been received or paid. Unlike the current model which focused on financial operations, the new model focuses on both the financial condition at the end of the accounting period and its financial performance during the accounting period.

Elements of financial statements are the basic categories of items portrayed therein in order to meet the objectives of financial statements. The new Government Financial Reporting Model defines the following elements:

Assets are economic resources controlled by a government as a result of past transactions or events and from which future economic benefits are expected to be obtained. Assets have three essential characteristics:

- they embody a future benefit that involves a capacity, singly or in combination with other assets, to provide future net cash flows, or to provide goods and services;
- the government can control access to the benefit; and
- the transaction or event giving rise to the government's control of the benefit has already occurred.

Assets consist of two sub categories:

Financial assets are assets that could be used to discharge existing liabilities or finance future operations and are not for consumption in the normal course of operations. Financial assets consist of cash, a realizable asset that is convertible to cash (eg. cash equivalents), a contractual right to receive cash or another financial asset from another party (eg. taxes or grants receivable), a temporary or portfolio investment, an investment in a government business enterprise or government business partnership (eg. investment in the local electricity provider), a financial claim on an outside organization or individual; or an inventory or item for sale that meets the criteria in paragraph PS 1200.051 (eg. concessions at the local arena). See the example statement of financial position below, for the types of items typically classified as financial assets.

Non-financial assets include tangible capital assets, and other assets such as prepaid expenses and inventories of supplies. Non-financial assets are asset that are normally employed to deliver government services, may be consumed in the normal course of operations, and are not for sale in the normal course of operations. See the example statement of financial position below, for the types of items typically classified as non-financial assets.

Liabilities are present obligations of a government to others arising from past transactions or events, the settlement of which is expected to result in the future sacrifice of economic benefits. Liabilities have three essential characteristics:

- they embody a duty or responsibility to others, leaving a government little or no discretion to avoid settlement of the obligation;
- the duty or responsibility to others entails settlement by future transfer or use of assets, provision of goods or services, or other form of economic settlement at a specified or determinable date, on occurrence of a specified event, or on demand; and
- the transactions or events obligating the government have already occurred.

The definition of liabilities has not changed from the current reporting model. See the example statement of financial position below, for the types of items typically classified as liabilities.

Revenues, including gains, are increases in economic resources, either by way of increases of assets or decreases of liabilities, resulting from the operations, transactions and events of the accounting period. Revenues arise from taxation, the sale of goods, the rendering of services, the renting of assets, interest, royalties, dividends, grants, donations and bequests. Revenues do not include borrowings, such as proceeds from debt issues or transfers between government units or amounts collected on behalf of others.

Expenses, including losses, are decreases in economic resources, either by way of decreases in assets or increases in liabilities, resulting from the operations, transactions and events of the accounting period. Expenses include the cost of economic resources consumed in and identifiable with the operations of the accounting period. For example, the cost of tangible capital assets is amortized to expenses as the assets are used in delivering government programs. Expenses do not include debt repayments or transfers between government units.

Understanding the elements of financial statements is critical to understanding the impact the new reporting model will have on a government's financial statements. We believe it is very important to note the following with regards to the elements:

- Non-financial assets must now be recognized. The current model only required the recognition of financial assets. As a result the acquisition of non-financial assets are recorded as expenditures in the year of acquisition. They will now be recognized as assets and expenses as they are used.
- The definition of revenue and expenses is based on increases and decreases in assets and liabilities. This asset and liability approach to recognizing revenue and expenses will result in volatility in the annual surplus or deficit as there is less focus on matching revenue with expenditures as is done with the current reporting model

These points will be expanded on below as the individual financial statements are discussed.

The new reporting model will also impact what financial statements are required to be prepared. Under the current reporting model the financial statements consist of: the statement of financial position, statement of financial activities and statement of changes in financial position. Under the new reporting model the following financial statements will be required to be prepared:

- Statement of financial position
- Statement of operations
- Statement of changes in net debt
- Statement of cash flow

The requirements of each of these statements will be discussed below.

Statement of Financial Position

The Statement of Financial Position is not a new statement, as it is a required statement under the current reporting model. However the focus has changed as the new Government Financial Reporting Model requires the recognition of non-financial assets. The recognition of the non-financial assets will have a significant impact on the accumulated surplus or deficit. Given that financial assets and liabilities were previously recognized, the non-financial assets recognized will result in an equal increase/decrease to the accumulated surplus/deficit. Given users of the financial statements have traditionally focused on the accumulated surplus/deficit, it is important to educate users on what the new amounts mean. It is also important to educate the users that accumulated surplus /deficit should not be the only number that users focus on when reading the statement of operations. PS 1200 defines net debt and accumulated surplus/deficit as the two indicators that explain the financial position.

Net debt represents financial assets less liabilities. As the current reporting model only requires recognition of financial assets and financial liabilities, the net debt number is actually very similar to what would have been presented as the accumulated surplus under the current reporting model.

Below is an example Statement of Financial Position presented in accordance with the new Government Financial Reporting Model. You will notice how it highlights both Net Debt and Accumulated Surplus. You will also notice that the example presents the accumulated surplus as one line item. Currently many organizations using the current local government reporting model will present various fund and reserve balances on the face of the statement of financial position. The new reporting model prohibits such presentation. PSG-4, Funds and Reserves, states that a government may choose to present such information in the notes to the financial statements; however there is no requirement to do so.

Consolidated Statement of Financial Position

As at December 31 (\$ thousands)	2009	2008
Financial assets		
Cash and cash equivalents	1,577	1,366
Accounts receivable	1,864	1,708
Portfolio investments	7,031	6,932
Business enterprise equity	331	207
Inventories for resale	109	135
	<u>10,912</u>	<u>10,348</u>
Liabilities		
Accounts payable and accrued liabilities	2,383	2,644
Debt	9,363	9,796
Pensions and other employee benefits	4,813	4,890
Other accrued liabilities	1,703	1,841
	<u>18,262</u>	<u>19,171</u>
Net debt	<u>(7,350)</u>	<u>(8,823)</u>
Non-financial assets		
Tangible capital assets	87,218	97,215
Inventories of supplies	112	222
Prepaid expenses	30	20
	<u>87,360</u>	<u>97,457</u>
Accumulated surplus	<u>80,010</u>	<u>88,634</u>

From an information gathering standpoint, because the new sections are being applied retrospectively the non-financial asset balances are needed not only at December 31, 2009 for a calendar year end, but also at December 31, 2008 for comparative purposes and also December 31, 2007 as the change during 2008 will impact the 2008 statement of operations. The most significant effort will be related to determining the tangible capital asset balances. However we cannot forget about other non-financial assets. When considering inventories of supplies, inventory balances will have to be determined for items such as office supplies, parts for repairing machinery, road salt and sand, spare tires, etc. With regards to prepaid expenses, you should examine all contracts which cross over the fiscal year end. These contracts could include insurance policies, maintenance contracts, down payments on operating leases, etc.

Statement of Operations

The new Government Financial Reporting Model focuses on both financial condition at the end of the year and performance during the year. The statement of financial position is used to present the organization's financial condition. To present an organizations performance, the reporting model focuses on changes in financial position. The statement of operations is one of the statements used to present the change in financial position. As previously discussed the statement of financial position contains two

key indicators: net debt and accumulated surplus/deficit. The statement of operations presents the change in the accumulated surplus/deficit.

In the example statement of operations that follows, you can see that it looks similar to the statement of financial activities from the current reporting model. This is because a lot of the presentation requirements are similar to what was required by PS 1800. The new reporting model requires:

- revenues to be reported by significant type (revenues from taxes, non-tax sources, such as grants and user fees, and transfers from other governments)
- expenses to be reported by function or major program (i.e. general government, roadways, recreation, etc.)

Regardless of the similarities in appearance, the new reporting model could have a significant impact on the amounts reported. These differences are caused by the recognition of non-financial assets on the statement of financial position and the use of them on the statement of operations. For example, under the current accounting, purchase of supplies would have been recognized as expenditure at the time of purchase. Under the new reporting model the purchase of supplies would be recorded as an addition to inventory on the statement of financial position at the time of purchase and only the supplies used would be recognized as an expense during the year. Therefore expenses will not equal the purchases during the year. The current reporting model focuses on expenditures, while the new reporting model focuses on expenses.

The definitions of revenue and expenses, along with the accounting for non-financial assets will create volatility in the annual surplus/deficit. To illustrate how this volatility is created lets consider a situation where an organization receives a \$100,000 grant for the purchase of equipment with a cost of \$100,000:

Current Reporting Model

The \$100,000 grant would be recorded as revenue in the period that the equipment is acquired. The acquisition of the equipment would be recorded as a \$100,000 capital expenditure in the period acquired. As a result there is no impact on annual surplus/deficit.

New Government Reporting Model

The \$100,000 grant would continue to be recoded as revenue in the period that the equipment is acquired. The acquisition of the equipment would be recorded as an addition to tangible capital assets and it would be amortized over its useful life. If we assume the equipment is amortized over a useful life of 10 years on a straight line basis and there no residual value, the impact on annual surplus/deficit will be positive \$90,000 (\$100,000 revenue less \$10,000 in amortization expense) in year one and negative \$10,000 (\$10,000 in amortization expense) annually in years two to ten.

Just as users traditionally focused on the accumulated surplus/deficit, they have also traditionally focused on the annual surplus/deficit. Therefore it is important to educate users on what impact the new reporting model will have on the annual surplus/deficit.

Consolidated Statement of Operations

For the year ended December 31 (\$ thousands)

	2009	2009	2008
	Budget	Actual	Actual
Revenues			
Property taxes	8,034	8,628	9,503
User fees	3,381	3,746	3,788
Government transfers and grants	1,722	1,820	1,648
Fees, permits, licenses and fines	581	651	669
Investment income	409	610	747
Income from government business enterprises	50	525	97
Miscellaneous revenues	100	342	402
Total revenue	14,277	16,322	16,854
Expenses			
Protection to persons and property	4,329	4,061	3,938
Water and sewage	8,541	8,626	8,457
Roadways and transportation	7,360	7,557	7,449
Recreation and culture	3,094	3,310	3,269
General government	832	899	777
Other	93	493	413
Total expenses	24,249	24,946	24,303
Annual deficit	(9,972)	(8,624)	(7,449)
Accumulated surplus at beginning of year	88,634	88,634	96,083
Accumulated surplus at end of year	78,662	80,010	88,634

Please note the example presents the annual deficit and accumulated surplus as single line items. As is the case with statement of financial position, the statement of operations does not present information of various funds and reserves as the new reporting model prohibits such presentation.

Statement of Changes in Net Debt

As previously mentioned the reporting of annual performance focuses on changes in financial position. While the statement of operations focuses on changes in accumulated surplus/deficit, the statement of changes in net debt, as its name implies, focuses on changes in net debt, the second indicator of financial position. The presentation of the statement of changes in net debt is a new requirement under the new government financial reporting model.

The statement of changes in net debt provides information regarding the extent to which the expenditures of the accounting period are met by the revenues recognized in the period. Since the focus of the statement is expenditures, rather than expenses, the change in net debt will actually be similar to the annual surplus/deficit presented on the statement of financial activities under the current reporting model.

Consolidated Statement of Change in Net Debt

For the year ended December 31 (\$ thousands)

	2009	2009	2008
	Budget	Actual	Actual
Annual deficit	(9,972)	(8,624)	(7,449)
Acquisition of tangible capital assets	(294)	(294)	(250)
Amortization of tangible capital assets	10,000	10,226	10,230
(Gain) / loss on sale of tangible capital assets	-	(5)	(19)
Proceeds on sale of tangible capital assets	-	46	72
Write-downs of tangible capital assets	-	24	44
	(266)	1,373	2,628
Acquisition of inventories of supplies	-	-	(324)
Acquisition of prepaid expense	-	(30)	(20)
Consumption of supplies inventories	-	110	102
Use of prepaid expense	-	20	0
	-	100	(242)
Change in net financial assets / net debt	(266)	1,473	2,386
Net financial assets / net debt at beginning of year	(8,823)	(8,823)	(11,209)
Net financial assets / net debt at end of year	(9,089)	(7,350)	(8,823)

As you can see from the above example, the statement of changes in net debt begins with the annual surplus/deficit and adjusts for tangible capital asset acquisitions, amortization expense and other items related to the adoption of an "accrual basis" of accounting" to determine the change in net debt.

Statement of Cash Flows

The last statement that must be prepared under the new government reporting model is the statement of cash flows. Information about the cash flows enables financial statement users to assess the organization's capacity to generate cash and cash equivalents and the need for cash resources.

Under the current reporting model, a statement of changes in financial position must be presented. Although similar to the statement a cash flows, it has two differences: the statement of changes in financial position presented information about non-cash transactions while the statement of cash flows does not; and it presented cash flows by three major categories – operations, investing and financing, the statement of cash flows adds a fourth category – capital transactions.

Below is an example of a statement of cash flows prepared using the indirect method. The option also exists to prepare the statement using the direct method.

Consolidated Statement of Cash Flows

As at December 31 (\$ thousands)	2009	2008
Operating transactions		
Annual deficit	(8,624)	(7,449)
Non-cash items including amortization	10,504	10,522
Prepaid expenses	(30)	(20)
Change in deferred revenue	(23)	16
Other	(819)	77
Cash provided by operating transactions	1,008	3,146
Capital transactions		
Proceeds on sale of tangible capital assets	46	72
Cash used to acquire tangible capital assets	(294)	(250)
Cash applied to capital transactions	(248)	(178)
Investing transactions		
Proceeds from portfolio investments	1,030	4,126
Portfolio investments	(1,129)	(4,369)
Other	(17)	(15)
Cash provided by (applied to) investing transactions	(116)	(258)
Financing transactions		
Proceeds from debt issues	13,970	3,694
Debt repayment	(14,403)	(6,175)
Cash applied to financing transactions	(433)	(2,481)
Increase in cash and cash equivalents	211	229
Cash and cash equivalents at beginning of year	1,366	1,137
Cash and cash equivalents at end of year	1,577	1,366

Reporting Budget Information

Governments have always been required to present actual to budget comparisons in their financial statements. The presentation of budget information provides key accountability information about the government's performance in achieving its operational and spending plans. As can be seen from the example statement of operations and statement of changes in net debt previously presented this requirement continues under the new reporting model.

The challenge created by the new reporting model is that in most cases local governments do not budget on an "accrual basis" of accounting. Budgets have typically focused on expenditures and the taxation revenue needed to fund those expenditures. The budget process very much matched "modified accrual basis" of accounting of the current reporting model. The presentation of budget information on an accrual basis does not mean that the budget process must be changed to match the "accrual basis" of accounting. However a process of reconciling the budget to an "accrual basis" will have to be developed if the budget process isn't changed. If an organization chooses not to modify its budget process to an "accrual basis", a reconciliation of the official budget to the amounts reported on the statement of operations and statement of changes in net debt must be disclosed in the notes to the financial statements. Such disclosure is required so users understand how the government's results for the period compare to the results it planned and the amounts authorized to accomplish those plans.

It is also possible that the scope of financial reporting will differ from the scope of the budget. 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 reconciles 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.

We believe the reporting of budget information under the new reporting model is a significant change and organizations should begin considering if they are going to change their budget process or if they are going to prepare the reconciliations referred to above. If the budget process is going to be changed education of the stakeholders is critical so they understand what the budget information will mean going forward.

Conclusion

As mentioned above we do not believe that the adoption of the new Government Reporting Model (PS 1000, 1100 and 1200) will be as difficult or time consuming as PS 3150, Tangible Capital Assets, however it does present its challenges. It is essential that governments begin discussing the impact of the new financial reporting model with their councils and other stakeholders and considering what impact the change will have on their budgeting process. If you require further information on the new Government Financial Reporting Model, please contact your local BDO Dunwoody LLP office.