

Overview of Accrual-Based Budgeting and Appropriations

26 September 2006



AGENDA

- Accrual Accounting – The Basics
- Accrual Budgeting and Appropriations
- Why moving forward with this issue is important
- Some Challenges and Concerns
- What is happening internationally
- What is happening domestically
- Possible Committee Questions for Government
- Conclusion



Accrual Accounting – The Basics

- Recommended by the Canadian Institute of Chartered Accountants and international standard setting bodies for external reporting and fully used by Government in the Federal Budget and for its financial statements since 2003
- Recognizes income when earned and expenses when incurred, rather than when the cash or equivalent is received or paid
- Records assets (and costs of consuming them over time) as well as existing and potential liabilities



Accrual Accounting – The Basics

A simple example:

- An organization purchases and receives supplies for \$1,000 in the month of March but pays for the supplies in April.
 - Under the accrual method, it would record the \$1,000 of supplies when it purchases the supplies in March. In other words, the transaction would be recorded as soon as the expense was incurred.



Accrual Accounting – The Basics

Another example:

- Government purchases a piece of equipment costing \$100,000 on April 1, 2004. The equipment is expected to last for 10 years and to contribute to operations evenly over that period.
 - Under the government's current method of accounting (accrual), the government would record the \$100,000 cost as an asset in the fiscal year it was purchased (March 31, 2005) and then record \$10,000 of amortization expense for each year that it was used.
 - Under the former method of accounting, the government would have recorded, in the 2005 fiscal year, the entire cost (\$100,000) as an expenditure for that year.
- In addition, the accrual method continues to track the outstanding balance of the asset until it is sold or removed from service. The former basis, however, would not have reported that any balance was remaining.



Accrual Accounting – The Basics

Another example (continued):

- So the accounting for this example would be

	March 31	
	<u>2005</u>	<u>2006</u>
<u>Impact on Operations</u>		
Current Accrual basis	(\$10,000)	(\$10,000)
Former basis	(\$100,000)	nil
<u>Impact on Balance Sheet (Tangible Capital Assets)</u>		
Current Accrual basis	\$90,000	\$80,000
Former basis	nil	nil



Accrual Accounting – The Basics

A final example:

- On March 31, 2005, government requires environmental remediation of a toxic site following a regulatory ruling and it is estimated to cost \$100,000 over the next 10 years. Work begins July 31, 2005 and costs \$10,000 that fiscal year.
 - Under the government's current method of accounting (accrual), the government would record the entire \$100,000 cost of the clean-up in the fiscal year it was identified (March 2005)
 - Under the former method of accounting, the government would have recorded, in the 2006 fiscal year, only the amount paid toward the clean-up that year - \$10,000.

- In addition, the accrual method continues to track the outstanding balance owing regarding the clean-up after the initial \$10,000 is paid. The former basis, however, would not have reported that any balance was remaining.



Accrual Accounting – The Basics

A final example (continued):

- So the accounting for this example would be

	March 31	
	<u>2005</u>	<u>2006</u>
<u>Impact on Operations</u>		
Current Accrual basis	(\$100,000)	nil
Former basis	nil	(\$10,000)
<u>Impact on Balance Sheet (Accrued Liabilities)</u>		
Current Accrual basis	\$100,000	\$90,000
Former basis	nil	nil



Accrual Accounting – The Basics

Advantages:

- Reflects full scope and size of government's:
 - resources (all financial and non-financial assets)
 - obligations (all liabilities)
 - costs (resources consumed)
- Greater focus on consumption of resources
- Better link of the results to the resources used to achieve them



Accrual Accounting – The Basics

Advantages:

- Allows Parliament to hold government accountable for
 - stewardship of its assets
 - full costs of its programs
 - ability to meet short-term and long-term financial obligations
- Better reflects impacts of economic events and decisions during the year



Accrual Accounting – The Basics

Advantages:

- Fuller information available to government for improved decision making
 - more focus on assets (maintenance requirements, replacement policies, buy vs. lease)
 - more attention to managing liabilities
 - more focus on full cost of programs and services



Accrual Accounting – The Basics

CURRENT STATUS OF ACCRUAL ACCOUNTING IN GOVERNMENT	Government-wide	Departmental
Budgeting		
Federal Budget	Accrual	-
Departmental Budget/Estimates	Near-Cash	Near-Cash
Appropriations	Near-Cash	Near-Cash
Accounting (Reporting)		
Summary Financial Statements	Accrual	-
Departmental Financial Statements	-	Accrual (unaudited)
Departmental Performance Reports	-	Near-Cash



Accrual Budgeting and Appropriations

So if Budgeting and Appropriations were accrual

- Budgets, Estimates, Appropriations would be more closely related to costs and revenues anticipated during the year regardless of when paid or received
- Budgeting and forecasting would be based on anticipated economic events, revenues and operational costs in the fiscal year not anticipated receipts or payments in the fiscal year
- Departmental managers would be more accountable for accrual financial information than they have traditionally been
- Some variations also likely required to address capital assets acquired and/or used over many years and long-term financial obligations incurred in one year but paid at a later date



Why moving forward with this issue is important

- Some improvements in the quality of government operations would include
 - More comparable information, better control and monitoring of actual performance
 - Improved transparency of government's performance
 - Improved accountability at department and agency level - use of financial resources on same basis as budget
 - Better information for planning; controlling operating and capital spending and decision making
 - More focus on long-term consequences of current decisions
- Our 2005 and 2006 Status Reports highlight continuing concerns about retaining near-cash budgeting and appropriations at the departmental level



Some Challenges and Concerns

- **Some challenges and concerns expressed about implementing accrual-based budgeting and appropriations often include:**
 - Major investment in retraining financial managers
 - Concept of accrual accounting, budgeting and appropriations is difficult to understand
 - Still important for government to manage cash and for Parliament to play a role in approving the timing of certain expenditures
 - Unique approaches required to manage large non-cash expenses
 - A learning curve and change management issue is involved



Some Challenges and Concerns

- In particular, departmental managers need to be more accountable for managing non-financial assets and certain liabilities
 - For example, in the earlier example on accounting for environmental remediation costs, the current method of departmental budgeting and appropriations would recognize, in the 2006 fiscal year, only the amounts paid toward the clean-up that year. No amount would be charged to the 2005 fiscal year budget or appropriation even though the entire \$100,000 cost would be reflected in the government's and department's summary financial statements for that year.



What is happening internationally?

Accrual accounting

- Many OECD countries use full accrual accounting in reporting
- France has decided to move to accrual accounting but retain cash-based budgeting.

Accrual-based budgeting and appropriations

- Australia, New Zealand, United Kingdom use full-accrual methodologies for budgeting and appropriations. Others considering adoption.



What is happening domestically?

OAG surveyed provinces in the summer of 2006

Government-wide budget:

- Most provinces and territories have accrual-based government-wide budgets, with exceptions in some areas such as pensions, taxes, federal transfers.
- Canada has accrual-based government-wide budget

Departmental Budgeting and Appropriations:

- Accrual-based except in some areas such as tax, pensions costs for some provinces and territories: British Columbia, Alberta, Saskatchewan, Manitoba, Ontario, Nova Scotia, Prince Edward Island, Northwest Territories



Possible Committee Questions for Government

- Who in government is the champion advancing this issue? Has that person received enough support?
- What does the government propose as a strategy for moving toward accrual based budgeting and appropriations, including addressing the unique issues associated with capital acquisitions and long-term liabilities?
- Does government have enough human resources and skills to make such a change? If not, how can it overcome the limitation?
- Has government set aside enough funds to undertake a change in the budgeting and appropriations process?



Conclusion

- The concerns frequently raised about this issue need not impede progress
- The Committee's support may help persuade the Government to move forward with accrual budgeting and appropriations
- Thank you for your interest in this issue

