MANAGEMENT REPORT

Date: January 17, 2023
To: Finance & Labour Relations Sub-committee
From: Karmen Krueger, CPA, CA, Director of Corporate Services/Treasurer
Report #: FIN23-004
Attachments: None

Title: Ontario Regulation 284/09 – Excluded Expenses

Objective: To meet the legislative requirements of Ontario Regulation 284/09 for financial reporting and provide the Sub-committee, Committee and Council with information regarding expenses excluded from the budgeting process.

Background: In 2009, the Public Sector Accounting Board (PSAB) introduced revisions to the accounting standards whereby municipalities were required to move to a full accrual basis of financial statement reporting. The most significant change was with the accounting for capital assets whereby now assets are expensed (amortized) over the estimated life of the asset.

The new standards did not require that budgets be prepared on the same basis. Therefore, like most municipalities, the City of Stratford continues to budget on a modified cash basis to determine the annual tax levy. This is acceptable, as long as Council adopts a resolution to this effect.

Ontario Regulation 284/09 permits municipalities to exclude certain full accrual expenses from their estimated expenditures when setting its budget and tax rates.

The City of Stratford's 2023 draft budget excluded:

I. Amortization expenses on tangible capital assets
II. Post-employment benefits expenses
III. Solid waste landfill closure and post-closure expenses.

If the budget does not include these expenses, a report to Council is required outlining the impact to the financial statements.

The report shall include:

1. an estimate of the change in the accumulated surplus of the municipality resulting from the exclusion of any of these expenses and

2. an analysis of the estimated impact of the exclusion of any of the expenses on the future tangible capital asset funding requirements.

In addition to the items covered in the O. Reg, the following items are also excluded from the PSAB full accrual budget, but reporting on these items is not required as these items are deemed to be taken from the municipality's surplus.

- Principal paid on debt
- Transfers to reserve accounts
- Transfers from reserve accounts
- Acquisition costs of tangible capital assets

These exclusions are why the internal financial reports and budget process differ, sometimes significantly, from the audited financial statements, that are prepared in accordance with PSAB guidelines.

Analysis:

Amortization Expenses on Tangible Capital Assets:

An estimated amortization expense for the City of $8,817,210 was not included in the 2023 budget. This figure excludes any amortization estimates for the fully consolidated entities too.

This estimate was based on the 2020-2022 average and considers the acquisition of new assets in 2023 and the half-year rule depreciation. This annual expense would reduce the City's accumulated surplus for the purposes of this regulation, noting that investments back into the capital program do offset some of this impact.

It is worth noting, that while the City doesn't budget for amortization, which gets added during the year-end processes, it *does* budget for capital transfers to reserves and reserve funds, estimated at $13 million in 2023. These amounts are removed from the City's prepared statements during the year-end processes.

The intent of amortization is to capture the usage of existing assets, while the transfers to reserves and reserve funds' intent is to capture the future cost of replacement of the assets.

Practically, the amount of the annual usage of the current assets will typically be less than the annual amount required as transfers to the reserve funds for their replacement.

Post-Employment Benefits Liabilities

The City is obligated to report as a liability an estimate for future employee benefits, unused sick leave payments, and WSIB benefits.

Each year, an actuarial consultant reviews the accrued banks (the liability) and workforce demographics of the City, and forecasts future benefit obligations.

The City annually contributes funds into a reserve for these future expenses, and at 31st December 2022 the balance in the Sick & Severance Reserve was approx. $5,994,090.

If the City were to fully fund the entirety of post-employment benefits obligations, the budget would have to increase significantly, to fund the approximate $10 million obligation. This is adjusted each year based on actual payments and expected remaining service lifetime but there is still a shortfall in these accrued reserve funds.

The City does include an expense in their year-end adjustments to reflect the difference between what the annual contributions are and the actual expense. The planned contribution to the reserve in 2023 included in the draft budget was $350,000 while the expense recorded will likely be greater than this, resulting in a use of these reserves.

Solid Waste Landfill Closure and Post-Closure Expenses:

The City is obligated to report as a liability the estimated future cost of landfill closure and post closure expenses.

The latest estimate of this liability is $2,094,297. This amount has been increasing steadily over the past five years (was $918,524 in 2014). The liability will continue to increase as landfill capacity is progressively used, we get closer to full capacity and the post closure costs keep rising.

The 2023 unbudgeted expense is estimated to be $139,900 based on historical experience.

Based on a landfill study completed in 2021, the City has begun to contribute funds to a reserve for future landfill costs. The 2022 amount set aside through levy contributions was $28,400, 2023 is $85,000 and this will increase in future years based on the Waste study consultant's recommendations to shrink this gap.

Impact on Future Tangible Capital Asset Funding Requirements

It is important to note again that amortization expense is not an accurate representation of the City's "Infrastructure Deficit".

Amortization expense is a non-cash accounting entry that is recorded based on the historical cost of an asset when it was originally purchased, constructed, or put into service.

Amortization expense is recorded in our financial statements over the expected useful life of the asset with the intent to 'spread' the costs of an asset over its useful life.

Many of the City's infrastructure assets are already fully amortized and beyond their useful lives so there is no ongoing depreciation expense recorded.

The basis for amortization as historical cost tends to be only a fraction of the replacement cost, particularly in times of significant inflation. Therefore, it is a weak indicator of the amount needed to be set aside for asset replacement.

The City's comprehensive asset management plan is the best source for quantifying future capital funding needs and measuring the infrastructure deficit in today's dollars. It is intended as a living document, and updated as assets are sold and replaced, and decisions are made affecting future replacements.

Financial Implications:

Financial impact to current year operating budget:
There is no direct financial impact with this report as it does not affect the cash operating surplus/deficit. The intent of the report is to describe the conversion of the approved cash-based budget to a PSAB full accrual budget format, which complies with legislated requirements.

Under the PSAB reporting guidelines, the impact of representing a full accrual basis of budgeting would be a net annual decrease to the City's accumulated surplus of more than $12 million and would very significantly impact the levy annually.

Link to asset management plan and strategy:
Should the City by choice or through legislation move further towards preparing the budget on a full accrual-based method, then this will impact how we levy for these types of known future liabilities, including capital asset replacements. This could occur in the future but is not anticipated at this time. For now, the modified basis currently being used, is adequate and appropriate. It ensures that reserves are in existence and being built, but are not excessive for these future estimates.

Alignment with Strategic Priorities:

Strengthening our Plans, Strategies and Partnerships
Partnering with the community to make plans for our collective priorities in arts, culture, heritage and more. Communicating clearly with the public around our plans and activities.

Alignment with One Planet Principles:

Not applicable: This report is being prepared as required by Ontario Regulation 284/09 so there is no connection to the One Planet principles.

Staff Recommendation: THAT the report titled, "Ontario Regulation 284/09 – Excluded Expenses" (FIN23-004), be adopted.

Prepared by: Karmen Krueger, CPA, CA, Director of Corporate Services
Recommended by: Karmen Krueger, CPA, CA, Director of Corporate Services
Joan Thomson, Chief Administrative Officer