

ACCRUAL BASED BUDGETING

DEPARTMENT OF FINANCE
MARCH 2007



Accrual Based Budgeting

In the past, the Government of Nunavut (GN) budget development process was mainly prepared using the cash based budgeting method. The implementation of accrual based budgeting will strengthen the accountability and transparency of the budget development process. This is in line with the efforts in strengthening financial management within the GN.

Accrual based budgeting is an approach to budget preparation where the GN would recognize the financial impact of an event as it occurs. That is, a transaction is recorded in the time period when the activity causing the transaction takes place. On the other hand, cash based budgeting is an approach where the GN would recognize transactions when the cash is received or paid out, which is often different than when the event actually happens.

Example 1

Under accrual based budgeting, the value of goods received but not invoiced prior to the end of the fiscal year would be recorded and included in expenditures for the fiscal year that the goods were received. Under cash based budgeting the goods received prior to the end of the year would not be recorded and included in expenditures until the invoiced is received and paid.

Another example of accrual based budgeting is employee leave and severance benefits, which are recorded annually and included in Operation and Maintenance expenditures. Under the cash based budgeting method, this transaction is not recorded and included in expenditures until the employee terminates his/her employment with the GN.

The greatest change in the recording of transactions from cash based budgeting to accrual based budgeting is the accounting treatment for fixed assets, such as buildings. Under the cash budgeting method, the expense is included in expenditures when the transaction occurs. Under accrual based budgeting, the expense is amortized over the useful life of the facility; therefore, only the amortization portion is included in expenditures for a fiscal year.

Example 2

Assume that it would cost \$1 million to build a new facility and the building is expected to have a useful life of 20 years. Under cash based budgeting, the \$1 million would be included in expenditures when the funds to construct the facility are actually spent. Under accrual based budgeting, the \$1 million would be amortized over 20 years using the straight-line amortization method, which means only \$50,000 ($\$1,000,000/20$) would be included in expenditures during the fiscal year.

Benefits of accrual based budgeting

A comparison of accrual based budgeting with cash based budgeting yields the following conclusions about the accrual based budgeting method:

- Accrual based budgeting corresponds with the generally accepted accounting principles (GAAP) used in financial reporting, thereby allowing comparison of budget and actual information prepared on a consistent basis. Since the public accounts are prepared in conformity with GAAP, the accrual based budgeting method will permit relevant comparative analysis.
- Given that accrual based budgeting charges costs to the time period in which they will be consumed, a more accurate and complete estimate of the cost of government functions is available. Further, a more complete and detailed estimate of government obligations is provided when accurate and complete budget information is included. An example of this would be when accruing for employee leave and severance benefits.
- Accrual based budgeting will allow for easier and more accurate comparisons with other governments because this practice is becoming the standard throughout the public sector.

Changes to the Budget Process to Implement Accrual Based Budgeting are highlighted below:

Tangible capital assets and amortization:

- Under cash based budgeting, the total cost of a capital acquisition is recorded as an expense in the fiscal year when the expenditure occurs. Thus, the overall annual expenditures of government operations, and individual programs, can vary from year to year, often significantly, due solely to capital purchases.
- Under accrual based budgeting, a capital purchase is considered as the acquisition of a long term asset, available to provide future benefits to government activities. The cost of the capital purchase is not charged to the departmental operations and maintenance budgets, but is recorded in the financial statements as a capital asset.
- The method by which the capital asset cost is charged to government expenditures is called amortization. Amortization is a concept in which the cost of a capital asset is allocated over time to government expenditures. The time period used to allocate the capital cost is the estimated useful life of the asset. Using this approach, as the usefulness of the asset is consumed over time, a corresponding proportionate share of the capital asset cost is charged

to government expenditures as demonstrated in example 2 above. This allocation method provides a more accurate measure of activity cost, and thereby a more accurate summary for analytical purposes.

Capital leases:

- An operating lease agreement is typically short-term in nature and can be cancelled during the contract period. An operating lease arrangement is typically used to purchase items such as photocopiers or lease GN office space from private companies. These payments are budgeted by departments through their operations and maintenance budgets.
- A capital lease agreement typically extends to the useful life of the asset and substantial risks or benefits of the ownership of the asset are assumed by the GN. For example, if the GN enters into a lease arrangement with another party and the GN has the option to purchase the asset at some point in the lease arrangement at a bargain price or assume the ownership of the asset at the end of the lease agreement, the lease must be recorded as a capital asset. The interest portion of the capital lease payment of the asset will be charged as an expense over the estimated life of the capital asset and the principal portion will be used to retire the capital lease as it is consumed over time.

Various non-cash items:

- Non-cash items are expenses that occur each year which do not require payment of cash. For example, in the case of prepaid expenses, the cash has been spent in a prior period. This is usually the case for insurance coverage that is paid for over a twelve month period. However, the insurance coverage may be reflected over two fiscal periods. An asset may become worthless, such as allowances for doubtful accounts. If an account receivable is deemed to be uncollectible, it must be written-off as a bad-debt expense. Also, the value of inventory may decrease in value over time. For example, the GN has to write down the value of fuel inventory at year-end because fuels that are stored for a period of twelve months or longer, often evaporate over time.
- In each case, when the above events become known and the value of the transaction(s) is determined, departments should include these non-cash expenditures in their annual operation and maintenance budgets to provide a complete budget expense profile for the GN.
- Departments with non-cash transactions should review their programs and services and financial records to ensure these items are identified and proper budgetary provision is included annually in their operation and maintenance budgets to cover these expenses.

Employee entitlements:

- Employee entitlements cover a wide range of obligations for government, including: pension costs, removal costs, separation costs, and similar contractual or legal requirements. All employee related expenses should be identified, and where reasonable estimates can be obtained, should be included in the appropriate departmental budget.
- Although the liability for employee entitlements fluctuates on an annual basis, the entitlement continues to accrue. An appropriate provision for the growth in the liability is necessary so that annual government costs are accurately portrayed, and outstanding liabilities are correctly reflected.

The following Summary Financial Reports have been included in the 2007-2008 Main Estimates:

- **Summary of Operations:** expenditures based on an accrual basis, which includes capital expenditures not transferred to tangible capital assets, interest portion of lease payments and amortization of capital assets.
- **Summary of Cash flows:** provides information on how the activities of the Government have been financed and how its financial resources have been used during the fiscal year on a cash basis.
- **Summary of Changes in Net Debt:** reconciles surplus/deficit income used in the acquisition of tangible capital assets recorded in the financial statements.

The attached reports compare financial reporting using the accrual and cash based budgeting methods.

SUMMARY OF OPERATIONS
(\$000)

	2007-08 Accrual Budgeting	2007-08 Cash Budgeting
Revenues	1,066,640	1,066,640
Operations expense		
Compensation and Benefits	323,117	323,117
Grants and contributions	260,328	260,328
Other expenses	340,778	340,778
Capital	28,338	91,778
Housing Trust Fund Allocation	73,000	73,000
Amortization	32,972	-
Total operations expenses	1,058,533	1,089,001
Unadjusted surplus (deficit)	8,107	(22,361)
Estimated supplementary Requirements		
Other Supplementary Requirements	(70,100)	(70,100)
Estimated appropriation lapses		
Operation and Maintenance	-	-
Recoveries of prior years expenditures		
Projects for Canada and others		
Revenues	35,541	-
Expenses	(35,541)	-
Operating surplus (deficit)	(61,993)	(92,461)
Accumulated surplus, beginning of year	990,234	990,234
Accumulated surplus, end of year	928,241	897,773

STATEMENT OF CASH FLOWS
(\$000)

	2007-08 Accrual Budgeting	2007-08 Cash Budgeting
Cash provided by government operations:		
Transfer from Canada	966,820	966,820
Taxes	50,900	50,900
Other government revenues	48,920	48,920
Salaries and employee benefits	(323,117)	(323,117)
Grants and contributions	(260,328)	(260,328)
Goods and services acquired	(340,778)	(340,778)
Capital	-	(91,778)
Allocation of Housing Trust Fund	-	(73,000)
Other Supplementary Requirements	(70,100)	(70,100)
Cash provided by government operations	72,317	(92,461)
Cash (used for) capital activities		
Acquisition of tangible assets, net of long term debt assumed	(91,778)	-
Allocation of Housing Trust Fund	(73,000)	-
Cash (used for) capital activities	(164,778)	-
Cash (used for) investing activities		
Loans to municipalities, businesses and individuals	-	-
Loan repayments received by the government	-	-
Cash (used for) investing activities	-	-
Cash (used for) financing activities		
Principal and interest repayment of capital lease financing	(10,500)	(10,500)
Principal and interest repayment of Mortgage payable	(550)	(550)
Cash (used for) financing activities	(11,050)	(11,050)
Increase (decrease) in cash and investments	(103,511)	(103,511)
Cash and investments, beginning of year	134,909	134,909
Cash and investments, end of year	31,398	31,398

STATEMENT OF CHANGE IN NET DEBT
(\$000)

	2007-08 Accrual Budget	2007-08 Cash Budget
Surplus for the year	(61,993)	(92,461)
Tangible capital assets		
Acquisitions	(63,440)	-
Write-downs	-	-
Disposals	-	-
Amortization	32,972	-
Net use (acquisition) of prepaid assets	(30,468)	(92,461)
Increase in net debt	(92,461)	(92,461)
Net debt, beginning of year	38,132	38,132
Net debt, end of year	(54,329)	(54,329)