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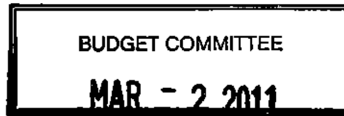

BUDGET COMMITTEE
MAR - 2 2011

DATE: February 18, 2011

TO: Chair and Members of Budget Committee
Meeting Date: March 2, 2011

FROM: Brenda R. Breault, CMA, MBA
Commissioner of Corporate Services and Treasurer

SUBJECT: **Additional *Municipal Act* Reporting Requirements Due to Implementation of Tangible Capital Assets**

RECOMMENDATION: That the report dated February 18, 2011 entitled Additional *Municipal Act* Reporting Requirements Due to Implementation of Tangible Capital Assets from the Commissioner of Corporate Services and Treasurer be received.

BACKGROUND: On June 5th, 2009, the Province approved legislation which changed financial reporting and budget requirements of municipalities. These changes address the implementation of PSAB 3150, which requires the recording of the cost of tangible capital assets and related annual amortization expense on municipal financial statements. The *Municipal Act* requires that municipalities prepare balanced budgets which include all the annual expenses of the municipality. With the implementation of tangible capital asset accounting, amortization becomes an annual expense of a municipality. However, the Province recognized that the requirement to include amortization expense in municipal budgets could have significant impacts on municipal tax levy requirements. For many municipalities, the amount being raised through property taxes to fund capital asset renewals is much lower than the annual capital asset amortization expense, as reflected in the financial statements.

In recognition of this concern, the new legislation allows municipalities to exclude amortization, post employment liability, and landfill closure expenses from their annual budgets but imposes reporting requirements to inform Council of the impact of excluding these costs.

The legislation requires that staff prepare an annual report to Council which:

- identifies the expenses that have been included in the Financial Report but excluded from the Budget;
- identifies the impact of these differences on the City's accumulated surplus; and
- analyses the impact of excluding these expenses from the budget on future capital asset funding requirements.

Ontario Regulation 284/09 permits municipalities to exclude the following expenses from their budgets:

- amortization expenses (related to tangible capital assets);
- post employment benefits expenses (related to early retirements and disability benefits, Workers Safety Insurance Board (WSIB) payments, sick leave and life insurance payments); and
- solid waste landfill closure and post-closure expenses (these do not pertain to the City).

This report must be prepared at the time the budget is approved. As the City's 2010 Financial Statements are not available, information included in this report relates to the financial information included in the 2009 Financial Statements.

COMMENTS:

The City has made provisions in the 2011 Budget for all the items which must be included in the Financial Report but are allowable exclusions in the budget, with the exception of amortization expense.

Amortization Expense and Impact on Accumulated Surplus

The amortization expense represents the value of tangible capital assets consumed during a fiscal year. PSAB requires amortization to be based on historical costs, and the City's policy is to calculate amortization on a straight line basis, over the useful life of the asset. Starting in 2009, the City's Financial Report includes tangible capital

assets and the associated amortization expenses. The 2009 amortization expense, totalling $95.7 million, is included in the annual surplus of $107.4 million and the accumulated surplus of $7.8 billion. If the amortization expense was not included, the annual and accumulated surpluses shown on the Consolidated Statement of Operations in the Financial Statements would increase by $95.7 million to $203.1 million and $7.9 billion, respectively. This accumulated surplus represents the net worth or equity which has been built up by the City since its inception, and primarily reflects the historical value of all its assets. The annual surplus from a financial reporting perspective is not the same as the operating surplus that arises out of the Operating Budget accounts. It does not represent cash available to offset any future tax rate increases, rather it represents the change in equity of the City for the year.

The following chart provides a summary of the changes to the annual and accumulated surplus as explained above:

	Per 2009 Financial Report ($000)	**2009 Amortization Expense ($000)**	**Financial Report removing 2009 Amortization Expense ($000)**
Accumulated Surplus, including adjustments at Beginning of Year	7,693,558		7,693,558
2009 Annual Surplus	107,354	95,681	203,035
Accumulated Surplus, End of Year	**7,800,912**		**7,896,593**

The amortization expense is an indicator of the cost of infrastructure utilized during the year which will ultimately need to be replaced and reduces the year end accumulated surplus balance. The amortization expense is an indication of the minimum amount the City should be setting aside annually for future asset replacement, if not for the impact on the tax levy.

Impact on Future Infrastructure Funding

Although the City does not include amortization costs in the Budget, a provision of $18.7 million was funded and transferred from the Capital Reserves in 2009 and 2010 through the Budget to provide for capital asset replacements and maintenance, as well as other capital enhancements. The 2011 Budget proposal includes a 1% infrastructure levy which will increase the transfer to $21.6 million. Based on the difference between the annual amortization expense ($95.7 million) and the annual transfer to capital reserves in 2009 and 2010 ($18.7 million), the annual infrastructure funding deficit, totalling $77 million, can be estimated. The annual amortization expense is based on the City's original cost to acquire or replace an asset. Using assumptions built into the City's Tangible Capital Asset system, the City's estimated annual replacement cost of assets is $355 million indicating a much larger shortfall than the $95.7 million based on historical costs. Although this a rough forecast, it provides an estimate of the type of capital maintenance costs that the City may be facing in the future. Based on replacement costs, the annual amortization expenses would be $355 million and the funding gap $336 million.

The following chart, which has been previously presented to Budget Committee, compares surrounding municipalities' amortization expense with their transfers from operating to capital for tax supported assets (i.e. excludes water and waste water). Other municipalities are funding between 26% and 114% of their amortization costs from property taxes – as compared to 20% for Mississauga. Comparisons must be used with caution but do serve as a general indication of the practices of other municipalities. It is important to reiterate the amortization expense being used reflects historical costs, therefore municipalities with older infrastructure will have lower amortization expenses. As the chart shows most of these municipalities also have infrastructure levies to address the funding gap. The City's infrastructure levy, at 1%, is among the lowest.

Municipality ($ Millions)	2009 Amortization (A)	2010 Budget Provision (B)	% of Amortization Recovered from Tax Based Funding (B/A)	Proposed 2011 Infrastructure Levy %
Mississauga	$96	$18.7	20%	1%
Peel	$58.8	$67.1	114%	1%
Brampton	$58	$25.7	44%	1%
Hamilton	$125.6	$32.7	26%	1%
Toronto	$156.4	$165.0	105%	1%
Oakville	$36	$25	69%	2%
Burlington	$23.7	$13.4	56%	1.3%
York	$129.8	$34.4	27%	1%

Currently, the City's funding shortfall is partially offset through draws on existing Reserve funds but starting in 2013, debt financing will be required to bridge the gap. Although managed debt is an appropriate tool for financing the construction of municipal assets, it is expensive as each $1.00 of debt triggers $1.45 of repayment assuming a 5% rate of interest issued on 15 year debt.

If the proposed 1% infrastructure levy were eliminated in 2011, approximately $30 million in funding would be eliminated over 10 years which would need to be recovered from increased debt issuance or reduced capital spending.

The Province has announced that it will be reviewing the legislation in 2012. While it is not anticipated that they will force municipalities to budget amortization, by moving to fixed asset accounting there is an implied message that municipalities begin to address their infrastructure funding gaps. If the City was required to incorporate the amortization expense of $97.5 million into the 2011 Budget, an additional 26% tax rate increase would be required based on a $77 million infrastructure gap.

FINANCIAL IMPACT: The City's 2009 Financial Statements include a provision for an amortization expense of $95.7 million based on historical costs. If this expense was not included, the reported annual surplus and accumulated surplus would be $203.1 million and $7.9 billion, respectively.

If this full amortization expense had been incorporated into the 2011 Budget, it would have required an approximate 26% additional tax rate increase. While this is unrealistic, it identifies the long-term financial pressures being faced to address the City's infrastructure replacement needs. The annual 1% infrastructure levy is part of the proposed long-term funding strategy that will help offset some of the City's future debt requirements once the tax based reserve funds are depleted. Each $1.00 of debt triggers $1.45 of repayment assuming a 5% rate of interest issued on 15 year debt.

As part of the 2011 Budget, Budget Committee is reviewing the need for increasing the transfer to capital via a 1% infrastructure levy which would increase the transfer to capital to $21.7 million. Any change in this purposed funding strategy will substantially increase costs to future taxpayers, above those currently identified in the ten year capital forecast.

CONCLUSION: As a result of revised provincial legislation, the City must prepare a report to Council before adopting the 2011 budget, reporting the value of the City's amortization expense excluded from the budget expenses and adopt this report by resolution. The City is required to estimate the change in the accumulated surplus from the beginning of the year to the end of the year as a result of excluding the amortization expense in the 2011 Budget. If this expense was not included in the annual and accumulated surplus, the restated balances would be $203.1 million and $7.9 billion, respectively.

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The City has estimated that the 2009 annual amortization costs, based on the historical costs to be $95.7 million. As the City's transfer to capital is $18.7 million, the annual infrastructure funding deficit is estimated at $77 million.

Brenda R. Breault, CMA, MBA
Commissioner of Corporate Services and Treasurer

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