MARKHAM

Report to: General Committee Date Report Authored: February 20, 2014

SUBJECT: C.D. Howe Report On Municipal Budget Practices
PREPARED BY: Raymond Law – Manager, Business Operations (Ext. 3585)

RECOMMENDATION:

That the report dated February 20, 2014 entitled "C.D. Howe Report On Municipal Budget Practices" be received.

PURPOSE:

To inform Council of Staff's response to the C.D. Howe Institute's Commentary No. 397 titled "Baffling Budgets: Canada's Cities Need Better Financial Reporting". The commentary is attached as Attachment "A". This report outlines the key statements put forth in the commentary, addresses the major gaps in the opinions of the commentary authors, and will highlight Markham's continuing efforts to ensure fiscal transparency, responsibility and sustainability.

BACKGROUND:

In November 2011, the C.D. Howe Institute released a publication described as a backgrounder, titled "Holding Canada's Cities to Account: An Assessment of Municipal Fiscal Management". The backgrounder graded 23 municipalities and their budgets based on the following six criteria:

- Consistent accrual accounting in budgets and financial reports;
- Combined operating and capital budget;
- Multi-year budgets;
- Consistent aggregation;
- Combined rate- and tax-supported expenditures; and
- Gross revenues and expenses.

A municipality would receive a grade of "A" if it met at least four of the six criteria and and "F" if it met none. The City of Markham met five of the criteria, but did not meet the criteria of multi-year budgets. Only two other municipalities received a grade of "A".

On January 15, 2014 the C.D. Howe Institute released a follow-up commentary titled "Baffling Budgets: Canada's Cities Need Better Financial Reporting" expressing their opinions with regards to budget clarity and the financial performance of municipalities. The commentary is based on the comparability between the annual budget document and year-end financial statements, the difference in the accounting basis used in budgeting and reporting, and the lack of reconciliation between the budget and financial statements.

The commentary evaluated the clarity of approved budgets for the 24 Canadian municipalities that had a population of more than 275,000 and revenues in excess of $500 million, in 2011. The evaluation was based on the presence of the following four criteria:

- budget figures presented on the same accrual basis as is used in the financial report;

- combined capital and operating expenses presented early and prominently in budgets to present the total amount of annual municipal spending;
- budget presentations of combined rate and tax supported gross expenditures on the same basis as in financial reports; and
- reconciliation of gross spending figures to budget projections – as originally reported – in the financial report.

Of the selected municipalities, C.D. Howe reported that none met all four criteria. Markham was reported as meeting three of the named criteria, but not the final criteria as it did not provide a reconciliation of gross spending figures to budget projections in the annual financial statements.

Additionally, the authors of the commentary believe that budget inaccuracies have generated significant surpluses in recent years across the municipal sector.

DISCUSSION:

The goal of making budgets more understandable is fully supported by Markham. Markham continually strives to improve in the areas of fiscal transparency, responsibility and sustainability. A disconnect between the budget and financial statements does exist due to the different basis of accounting used, but it should be recognized that the two documents serve very different purposes. Criticisms put forth in the C.D. Howe commentary do not reflect the reality of municipal finances, nor would the recommendations necessarily make budgets more understandable.

The Ontario Municipal Act requires municipalities to produce a balanced operating budget. This means that a budget must be prepared, such that the expected revenues will be equal to the expected expenses. Like most municipalities, Markham's annual budget is prepared using a modified accrual basis of accounting, which closely resembles the cash basis of accounting. When using the cash basis of accounting, revenues and expenses are recognized based on the timing of cash inflows and outflows. The main objective of using the cash basis of accounting in the budget process is to determine the amount of financing, tax and user charge revenues required to meet current and anticipated financial obligations.

The annual budget, prepared using the modified accrual basis of accounting, does not include depreciation expenses. Depreciation expenses reflect the amortization of a tangible capital asset over its' estimated life-cycle. Depreciation expenses are considered non-cash expenses as no cash outlay is required at the time the expenses are incurred. As Provincial legislation mandates that budgets be balanced, corresponding revenues would be required if depreciation expenses were added. It could be argued that this is a prudent method of ensuring funds are available for the eventual replacement of aging assets. However, life-cycle reserve contributions made under this approach would be based on the historic asset value, which may not be aligned with its actual replacement value.

Markham distinguishes itself from other municipalities with its capital reserve program. Markham's ongoing annual investment and prudent capital spending ensures full replacement of the City's infrastructure for the next 25 years. The program is reviewed annually to ensure changes in interest, inflation and replacement cost estimates are reflected in reserve contributions to preserve the long-term sustainability of the City's infrastructure.

The budget is subsequently re-stated using the accrual basis of accounting for Council approval and published in the annual budget documents. The restatement of the budget conforms to requirements outlined by Provincial legislation. The restatement of the budget using the accrual basis of accounting shares the format with the annual financial statement but does not necessarily provide the reader with any additional useful information, or assist Council in decision making.

The annual financial statements are prepared and presented using the accrual basis of accounting, as governed by the Public Sector Accounting Board (PSAB). The accrual basis of accounting requires revenues to be recognized at the time the revenue is earned but not necessarily received, and records expenses when incurred, but not necessarily paid for. While it is agreed that the average reader may find the annual financial statements of municipalities to be confusing, the same could be said of any financial statement presented to a non-accounting person. In general, the cash basis of accounting is more easily understood by the non-accounting community.

The authors of the commentary make the suggestion that in recent years, municipalities are "running large surpluses" and that municipalities have collected more revenue than the value of the services provided. According to the commentary, Markham's annual surplus as a share of revenue is highlighted as one of the highest in Canada. It should be noted that the primary driver of the $163 million surplus reported in 2012 is not related to payments collected from taxpayers or user charges. In fact, the largest share of the reported surplus is classified as "Contributions from Developers". A total of $124 million classified as "Contributions from Developers" represents the infrastructure built and paid for by developers, and assumed by the City through the subdivision process. Under the accrual basis of accounting, the City must record the assumed assets as revenues received, even though there is no cash value to the City; That is, the City cannot at any time choose to sell paved roads, streetlights, underground water pipes, etc., all of which may be included in the infrastructure assumed from developers. This is a common driver of significant annual surpluses amongst growing municipalities.

Year-end operating surpluses of cash are intentionally not budgeted for but are handled responsibly when they occur. In fact, over the past six years, Markham's operations have resulted in an average annual cash surplus of $0.9M, which is less than 0.6% of the average annual revenues. Markham's policy regarding year-end operating surpluses of cash, is to first top-up the Corporate Rate Stabilization Reserve to a level equivalent to 15% of local tax revenues, secondly to replenish the Environmental Land Acquisition Reserve Fund, and finally to transfer the surplus to the Major Capital Repairs and Replacement Reserve.

OTHER FINANCIAL CONTROLS

The authors of the commentary developed conclusions of municipal finances based on only two documents, which are regulated by Provincial legislation. They failed to consider the various other means in which municipalities such as Markham provide financial information to members of the public and Council.

Some of the other financial processes and controls utilized by Markham include, but are not limited to, the:

- Capital and operating budget in-year variance reporting;
- Annual reporting for the Ontario Municipal Benchmarking Initiative (OMBI);
- Reserve and Reserve Fund reports such as the annual Development Charge Reserve Report;
- Annual Investment Policy report; and
- Annual Financial Information Return filing with the Ontario government.

A more detailed list outlining some of the measures Markham has taken over the past several years to promote transparent financial management and accountability is attached as Attachment "B".

CLOSING SUMMARY

Markham was approached by the C.D. Howe Institute's representatives in advance of the commentary being published. The authors' position did not come as a surprise as Markham had provided responses to an earlier draft of the commentary, both individually and as part of a group response through the Municipal Finance Officers Association (MFOA). City Staff share the authors' interest in advancing municipal transparency and accountability.

Markham continues to strive for greater financial transparency, accountability and sustainability, and is proud to have become the first Ontario municipality to achieve the top ranking in the Local Government Performance Index (LGPI) for financial transparency. Markham achieved this ranking for the 2011 fiscal year, and maintained the highest ranking for the most recent 2012 fiscal year. The LGPI is an evaluation of municipal financial transparency undertaken by the Frontier Centre for Public Policy, which takes factors such as the timeliness of information delivery, and the presence of additional comments or explanation into account. Although City Staff respect the opinions expressed in the C.D. Howe Institute's commentary, it should be recognized that there are factors to consider other than the accounting basis of the budget and financial statements alone.

FINANCIAL CONSIDERATIONS AND TEMPLATE: (EXTERNAL LINK)

Not applicable.

HUMAN RESOURCES CONSIDERATIONS

Not applicable.

ALIGNMENT WITH STRATEGIC PRIORITIES:

Not applicable.

BUSINESS UNITS CONSULTED AND AFFECTED:

Not applicable.

RECOMMENDED BY:

28/02/2014

X

Joel Lustig
Treasurer

28/02/2014

X

Trinela Cane
Commissioner, Corporate Services

ATTACHMENTS:

Attachment A – C.D. Howe Commentary No. 397 – Baffling Budgets Canada's Cities Need Better Financial Reporting

Attachment B – Measures the City of Markham has taken over the past several years to promote transparent financial management and accountability